New leases standard ASC 842
Lessee - operating leases

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July 2017

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Overview

- Under Accounting Standards Codification (ASC) 842, *Leases*, lessees recognize assets and liabilities for most leases but recognize expenses in a manner similar to today's accounting (ASC 840, *Leases*).
- All entities classify leases to determine how to recognize lease-related expenses.
- The new guidance could have broad implications for entities' finances and operations.
- Implementing the standard could require an entity to develop new processes and controls or adjust existing ones to identify and account for leases.
- Effective date
  - For public companies - annual periods beginning after 15 December 2018 (i.e., 1 January 2019 for a calendar-year entity), and interim periods within those years.

Overview (cont.)

- Securities and Exchange Commission (SEC) Staff Accounting Bulletin Topic 11.M (SAB 74) requires registrants to disclose the effect the standard is expected to have on their financial statements.
  - If a registrant does not know or cannot reasonably estimate the effect, it should make a statement to that effect and consider providing qualitative disclosures to help users assess the significance of the effect on the financial statements (ASC 250-10-S99-6).
- The International Accounting Standards Board issued a similar standard, but there are significant differences (e.g., under IFRS, lessees don’t classify leases).

Scope and scope exceptions
General

The guidance applies to:

- Leases of property, plant and equipment

The guidance does <u>not</u> apply to:

- Leases of
  - inventory
  - intangible assets
  - assets under construction and
  - biological assets, including timber
- Arrangements in the scope of ASC 853, *Service Concession Arrangements*

A lease is a **contract**, or part of a contract, that conveys the right to **control the use** of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration.

Scope and scope exceptions

Determining whether an arrangement contains a lease (cont.)

- An identified asset can be:
  - Implicitly or explicitly specified in a contract
  - A physically distinct portion of a larger asset (e.g., a floor of a building)
  - A capacity portion of a larger asset that represents substantially all the capacity of that asset
- There is no identified asset if the supplier has a substantive substitution right.
- A substitution right is substantive when **both** of the following conditions are met:
  - The supplier has the practical ability to substitute alternative assets throughout the period of use.
  - The supplier would benefit economically from the exercise of its right to substitute the asset.
- An entity evaluates whether a supplier's substitution right is substantive based on the facts and circumstances at inception of the contract.
  - An entity should not consider future events that are not likely to occur.

Scope and scope exceptions (cont.)

- Some agreements to be considered related to Technology industry:
  - Data center agreements
  - Outsourcing agreements
  - Supply contracts

Scope and scope exceptions
Identifying and separating lease and non-lease components (cont.)

- Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components).
  - Non-lease components (e.g., maintenance activities, including common area maintenance) are identified and accounted for separately from the lease component in accordance with other US GAAP.
- Some contracts contain items that do not relate to the transfer of goods or services by the lessor to the lessee (e.g., fees or other administrative costs that a lessor charges a lessee, payments for insurance that protects the lessor’s asset, taxes related to the lessor’s asset).
  - These items should not be considered separate components.
  - Lessees and lessors do not allocate consideration in the contract to these items.
- Lessees can make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component.

Key concepts
Lease term and purchase options

Lease term

Any noncancelable periods

Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option

Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option

Periods covered by an option to extend (or not terminate) the lease in which the exercise of the option is controlled by the lessor

- The FASB said that “reasonably certain” has the same meaning as “reasonably assured” in ASC 840.
  - Reasonably certain is generally interpreted as a high threshold.
- Purchase options should be assessed in the same way as options to extend the lease term or terminate the lease.

Key concepts
Lease payments

- Lease payments should be consistent with the lease term.

Lease payments				
Fixed (including in-substance fixed) payments, less any lease incentives paid or payable to the lessee	Variable payments based on an index or rate	Exercise price of a purchase option*	Payments for penalties for terminating the lease**	Amounts it is probable that the lessee will owe under residual value guarantees (lessees only)

* Include only if reasonably certain of exercise

** Include only if the lease term reflects the lessee exercising an option to terminate the lease

Key concepts
Initial direct costs (“IDCs“)

- Lessees and lessors apply the same definition of IDCs
- IDCs are costs that would not have been incurred if the lease had not been obtained. Examples include**:**
  - Commissions
  - Payments made to an existing tenant as an incentive to terminate the lease
- The following are examples of costs that do not qualify as IDCs (i.e., costs that are not incremental):
  - Allocation of general overhead (e.g., salaries, depreciation)
  - Costs related to activities that occur before the lease is obtained (e.g., negotiating costs, legal advice)

Lease classification

Criteria for lease classification – lessees

At the commencement date, a lease is a finance lease if it meets any one of the criteria below; otherwise the lease is an operating lease.

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for the **major part** of the remaining economic life of the underlying asset*.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds **substantially all** of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of lease term.

* Not applicable for leases that commence at or near the end of the underlying asset's economic life

Reassessment and remeasurement

- Lease modifications and triggering event for reassessment:
  - Triggering event for reassessment of lease classification
  - Lease modification

Lease modification
A change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a **lease** (for example, a change to the terms and conditions of the contracts that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term)

- If a lease is modified, lessees and lessors evaluate the modified contract to determine whether it is or contains a lease.
- A lease modification can result in either:
  - A separate contract (i.e., the unmodified original contract and a separate contract)
  - A change in the accounting for the existing lease (i.e., not a separate contract)

Lessee accounting
Recognition and measurement

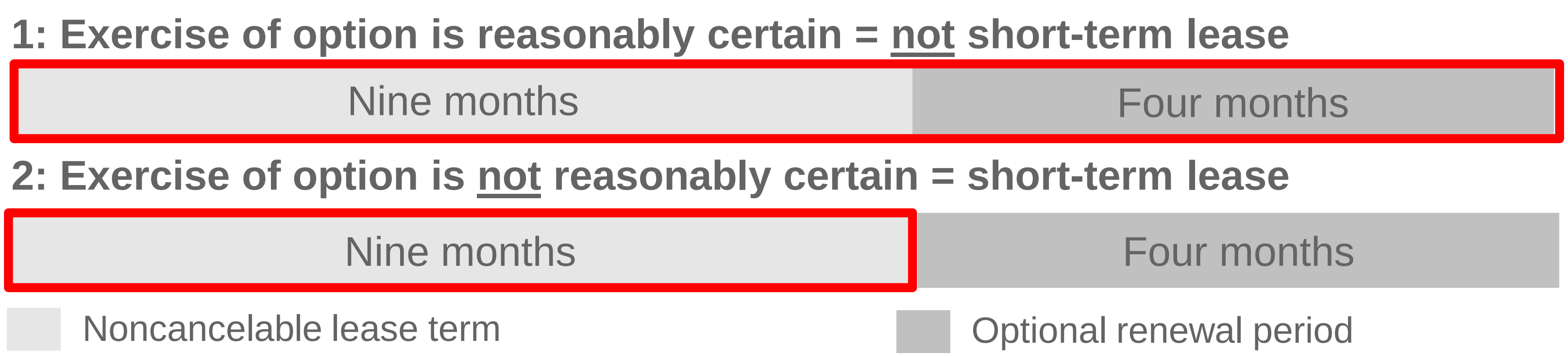
	Operating leases	Finance leases
Initial recognition and measurement	Initially measure the ROU asset[1] and lease liability at the present value of the lease payments to be made over the lease term	
Subsequent measurement – lease liability	Measure the lease liability at the present value of remaining lease payments using discount rate determined at lease commencement[2]	Accrete the lease liability based on the interest method using the discount rate determined at lease commencement[2] and reduce the lease liability by the payments made
Subsequent measurement – ROU asset	Measure the ROU asset at the amount of remeasured lease liability, adjusted for the remaining balance of any lease incentives received, any cumulative prepaid or accrued rents (i.e., uneven rent payments), any unamortized IDCs and any impairment of the ROU asset	Amortize the ROU asset, generally on a straight-line basis, over the shorter of the lease term or the useful life of the ROU asset, and record any impairment of the ROU asset
Income statement effect	Generally straight-line expense	Generally “front-loaded” expense

(1) Initial measurement of the ROU asset also includes the lessee’s IDCs and prepayments made to the lessor at or before the commencement date, less lease incentives received from the lessor

(2) As long as the discount rate has not been updated as a result of a remeasurement event

Lessee accounting
Short-term leases

- Lessees can make an accounting policy election, by class of underlying asset to which the right of use relates, to use the short-term lease exception.
  - Applies to leases with a lease term of 12 months or less that do not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise
  - Election can only be made at the commencement date
  - Lessees do not recognize an ROU asset or lease liability for qualifying leases and recognize lease payments as an expense on a straight-line basis
  - Exception is not available for lessors
- Example: noncancelable lease term of nine months with a four-month renewal option (assume no purchase option)



Lessee accounting
Presentation – balance sheet

Balance sheet	
ROU asset	**Lease liability**
► Present either separately or together with other assets (e.g., owned assets) ► If presented together with other assets, disclose line items that include ROU assets and their amounts ► Finance lease ROU assets must be presented separately from operating lease ROU assets ► Subject to same classification as other nonfinancial assets	► Present either separately or together with other liabilities ► If presented together with other liabilities, disclose the line items that include lease liabilities and their amounts ► Finance lease liabilities must be presented separately from operating lease liabilities ► Subject to current and noncurrent classification, similar to other financial liabilities

Other considerations
Subleases

Sublease

A transaction in which an **underlying asset** is re-leased by the **lessee** (or intermediate **lessor**) to a third party (the sublessee), and the original (or head) **lease** between the lessor and the lessee remains in effect

Lessor

The accounting for the original lease doesn't change.

Head lease

Original lessee/sublessor

- Sublease term may affect head lease classification
- Sublease classification is assessed independently of head lease
  - Consider the underlying asset for classification purposes (rather than the ROU asset arising from the head lease)
  - Use the discount rate of the head lease if the rate implicit in the lease cannot be readily determined
- Additional sublease disclosures are required

Sublease

Lessee/sublessee

- Lease classification is assessed in the same manner as any new lease
  - Consider the underlying asset for classification purposes (rather than the ROU asset arising from the head lease)

ASC 842 *Leases*

Impact on lessee's key performance indicators for operating leases

KPIs	Effect of ASC 842 (operating leases)	
Gearing (Debt to Equity Ratio) Liabilities/Equity	*Increase* (because most leases previously accounted for as operating leases will now be on balance sheet)	↑
EBIT Earnings before interest and tax	*Remains unchanged* (because lease expense continued to be reported in operating income on straight-line basis)	↔
EBITDA Earnings before interest, tax and amortization	*Remains unchanged* (because lease expense continued to be reported in operating income on straight-line basis)	↔
Operating cash flow	*Remains unchanged*	↔
Leverage Net Debt/EBITDA	*Increase* (EBITDA remains unchanged while net debt will increase)	↑

ASC 842 *Leases*
Impact on lessee's economic decisions

- ASC 842 may effect the following:
  - covenants
  - Hedging transaction related to foreign exchange rates
  - Purchase vs long-term operating lease
    - Option to purchase underlying asset
  - Leasehold improvement

ASC 842 *Leases*

Impact on lessee's key performance indicators for operating leases vs finance lease

KPIs	Effect of ASC 842 (operating leases)		Effect of ASC 842 (finance lease/acquisition with a loan)	
Gearing (Debt to Equity Ratio) Liabilities/Equity	*Increase* (because most leases previously accounted for as operating leases will now be on balance sheet)	↑	*Increase* (because most leases previously accounted for as operating leases will now be on balance sheet)	↑
EBIT Earnings before interest and tax	*Remains unchanged* (because lease expense continued to be reported in operating income on straight-line basis)	↔	*Increase* (because part of the expense classify as interest expense)	↑
EBITDA Earnings before interest, tax and amortization	*Remains unchanged* (because lease expense continued to be reported in operating income on straight-line basis)	↔	*Increase* (because the expense classify as depreciation and interest)	↑
Operating cash flow	*Remains unchanged*	↔	*Increase* (because part of the payment classify as a repayment of principal)	↑
Leverage Net Debt/EBITDA	*Increase* (EBITDA remains unchanged while net debt will increase)	↑	*Depend* (both net debt and EBITDA increase)	?

ASC 842 *Leases*

Impact on lessee's key performance indicators for operating leases vs finance lease (cont.)

KPIs	Effect of ASC 842 (operating leases)		Effect of ASC 842 (finance lease)	
Revenues	*Remains unchanged*	↔	*Remains unchanged*	↔
Depreciation & amortization	*Remains unchanged* (because lease expense continued to be reported as lease expense)	↔	*Increase* (because part of the expense classify as depreciation)	↑
Operating income	*Remains unchanged* (because lease expense continued to be reported in operating income on straight-line basis)	↔	*Increase* (because part of the expense classify as interest)	↑
Interest expense	*Remains unchanged* (because lease expense continued to be reported as lease expense)	↔	*Increase* (because part of the expense classify as interest)	↑
Income before taxes	*Remains unchanged*	↔	*Remains unchanged**	↔

ASC 842 *Leases*
Discount rates

- Lessees - the discount rate for the lease is the “rate implicit in the lease”.
  - When the rate implicit in the lease cannot be readily determined, lessees use their incremental borrowing rate (i.e., the rate of interest that the lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment).
    - In some cases, this rate may be the parent’s incremental borrowing rate.

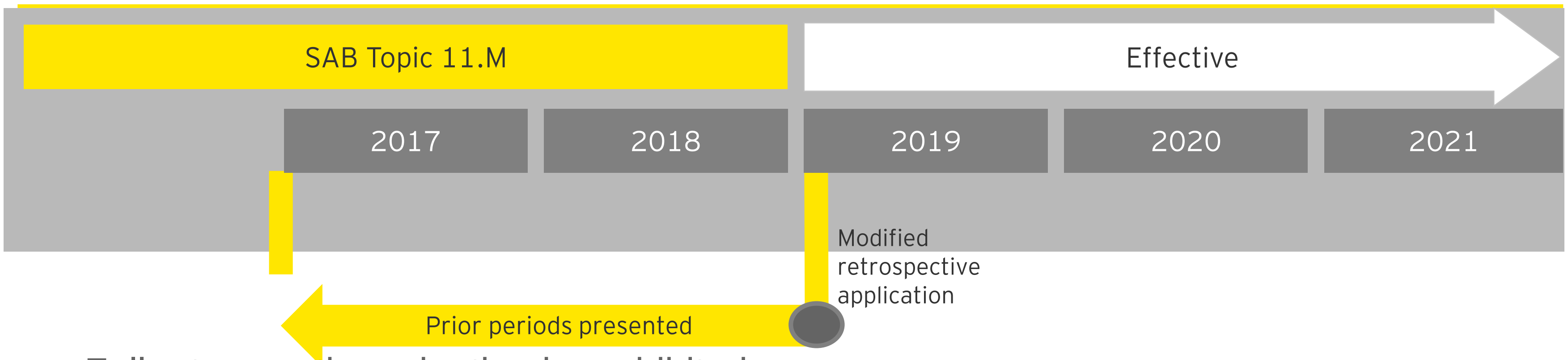
- Factors which influence the incremental borrowing rate:
  - Specific rate that reflects the credit-worthiness of the company
  - The term of the arrangement
  - The amount of the funds
  - The “security” – the nature and quality of the underlying asset
  - Economic environment such as:
    - The jurisdiction
    - The currency
    - The date at which the lease is entered into

ASC 842 *Leases*

Discount rates – lessee incremental borrowing rate (cont.)

Influence as result of increase in the incremental borrowing rate		
Section	***ASC 842 operating lease***	***ASC 842 finance lease***
Lease liabilities	↓	↓
ROU asset	↓	↓
Depreciation expense	*N/A*	↓
Interest expense	*N/A*	↑
Gearing (Debt to Equity Ratio)	↓	↓
Operating income	*N/A*	↑
EBITDA	*N/A*	↔

Effective date and transition



- Full retrospective adoption is prohibited.

Modified retrospective application:

- ASC 842 transition provisions are applied as of the beginning of the earliest comparative period presented in the financial statements. A calendar-year entity that adopts ASC 842 on 1 January 2019 and presents three-year comparative financial statements applies the transition provisions on 1 January 2017.
- On March 14, 2018 the FASB affirm the proposed additional transition method which allow companies to adopt ASC 842 without revising comparative period reporting.
  - The FASB clarify that if an entity elects this new transition method, the comparative periods should include the disclosures required under Topic 840, Leases, including the operating lease obligations disclosure in paragraph 840-20-50-2.
- Transition guidance does not specify whether the discount rate selected should be based on the original lease term or the remaining lease term.

ASC 842 *Leases*
Next steps

- Scoping agreements under ASC 842
  - Identify a complete population of leases.
- Determine which of the practical expedients company elects to apply.
- Implementation of Leases system
- EY enablers and tools.
- Developing and implementing new policies.
- Design and implement internal controls over adoption and subsequent measurement
- Analyze lease contracts for accounting consequences
- Estimate the Company incremental borrowing rate when the interest rate implicit in the lease cannot be readily determined (may require use of 3rd party valuation specialist).

Appendix A– Illustrative

Appendix A
Lessee accounting example

Operating lease vs Finance lease	
Lessee enters into a three-year lease of office space. The arrangement provides the following:	
Lease term	Three years
Annual payments	Year 1 – $10,000 Year 2 – $12,000 Year 3 – $14,000
Discount rate	4.235%
Present value of lease payments	$33,000

* Refer to section 4.2.4 in the FRD for more details on the fact pattern and calculations

Appendix A
Lessee accounting examples (cont.)

Operating lease	Debit	Credit
Initial measurement		
ROU asset	$ 33,000	
Lease liability		$ 33,000
To initially recognize the ROU asset and lease liability		
Subsequent measurement		
Lease expense	$ 12,000	
ROU asset		$ 2,000
Cash		10,000
Lease liability	$ 8,602[1]	
ROU asset		$ 8,602
To record lease expense and adjust the ROU asset for the difference between cash paid and straight-line lease expense (i.e., accrued rent) and adjust the lease liability to the present value of the remaining lease payments with an offset to the ROU asset		

(1) The adjustment of $8,602 is calculated as the initially recognized lease liability ($33,000) less the present value of remaining lease payments ($24,398) at the end of Year 1.

Appendix A
Lessee accounting examples (cont.)

Operating lease	Initial	Year 1	Year 2	Year 3
Cash lease payments		$ 10,000	$ 12,000	$ 14,000
Income statement				
Periodic lease expense (straight-line)		12,000	12,000	12,000
Prepaid/(accrued) rent		$ (2,000)	$ –	$ 2,000
Balance sheet				
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –
ROU asset:				
Lease liability	$ 33,000	$ 24,398	$ 13,431	$ –
Adjust: prepaid/(accrued) rent (cumulative)	–	(2,000)	(2,000)	–
	$ 33,000	$ 22,398	$ 11,431	$ –

Appendix A
Lessee accounting examples (cont.)

Finance lease	Debit	Credit
Initial measurement		
ROU asset	$ 33,000	
Lease liability		$ 33,000
To initially recognize the ROU asset and lease liability		
Subsequent measurement		
Interest expense	$ 1,398	
Lease liability		$ 1,398
To record interest expense and accrete the lease liability using the interest method ($33,000 x 4.235%)		
Amortization expense	$ 11,000	
ROU asset		$ 11,000
To record amortization expense on the ROU asset ($33,000 ÷ 3 years)		
Lease liability	$ 10,000	
Cash		$ 10,000
To record the lease payment		

Appendix A
Lessee accounting examples (cont.)

Finance lease	Initial	Year 1	Year 2	Year 3
Cash lease payments		$ 10,000	$ 12,000	$ 14,000
Lease expense recognized:				
Interest expense		$ 1,398	$ 1,033	$ 569
Amortization expense		11,000	11,000	11,000
Total periodic expense		$ 12,398	$ 12,033	$ 11,569
Balance sheet:				
ROU asset	$ 33,000	$ 22,000	$ 11,000	$ –
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –

Appendix A
Lessee accounting examples (cont.)

	Finance lease			Operating lease	
	Interest expense	Amortization expense	Total expense	Total expense	Periodic difference
Year 1	$ 1,398	$ 11,000	$ 12,398	$ 12,000	$ 398
Year 2	1,033	11,000	12,033	12,000	33
Year 3	569	11,000	11,569	12,000	(431)
	$ 3,000	$ 33,000	$ 36,000	$ 36,000	$ –

	Lease liability	ROU asset	
	Both lease types	Finance lease	Operating lease
Initial	$ 33,000	$ 33,000	$ 33,000
Year 1	24,398	22,000	22,398
Year 2	13,431	11,000	11,431
Year 3	–	–	–

Appendix A
Lessee accounting examples (cont.)

ASC 842 Operating lease

	Cash flow from operating activities	Cash flow from financing activities
Year 1	$ (10,000)	-
Year 2	$ (12,000)	-
Year 3	$ (14,000)	-

ASC 842 Finance lease

	Cash flow from operating activities	Cash flow from financing activities
Year 1	$ (1,398)	$ (8,602)
Year 2	$ (1,033)	$ (10,966)
Year 3	$ (569)	$ (13,431)

Thanks !

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