CACUBO

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ACCOUNTING TECHNOLOGY ADVISORY

CACUBO Webinar Series on:

Accounting for Leases Under ASC 842

March 17, 2022

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Thank you for joining, the webinar will start shortly.

CACUBO

- This is the 19th monthly webinar CACUBO has hosted since the pandemic began. The webinars have been an effort to stay engaged with our members during the pandemic.
- Today, we will hear from panelists who will provide us an update on the accounting for leases under ASC 842, which is more pertinent to FASB institutions.
- This webinar is eligible for CPE. If you are interested in receiving CPE credit for this webinar, please e-mail me (Marty Mickey) at mmickey@nl.edu now. During the webinar, there will be three check in questions for you to answer. **In order to receive CPE, you must answer all three of these questions.**
- We will send out a survey afterwards to solicit thoughts and topics for future webinars.
- If you would be willing to present in a future webinar, please e-mail me at mmickey@nl.edu.

TODAY'S **PRESENTERS**

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AGENDA

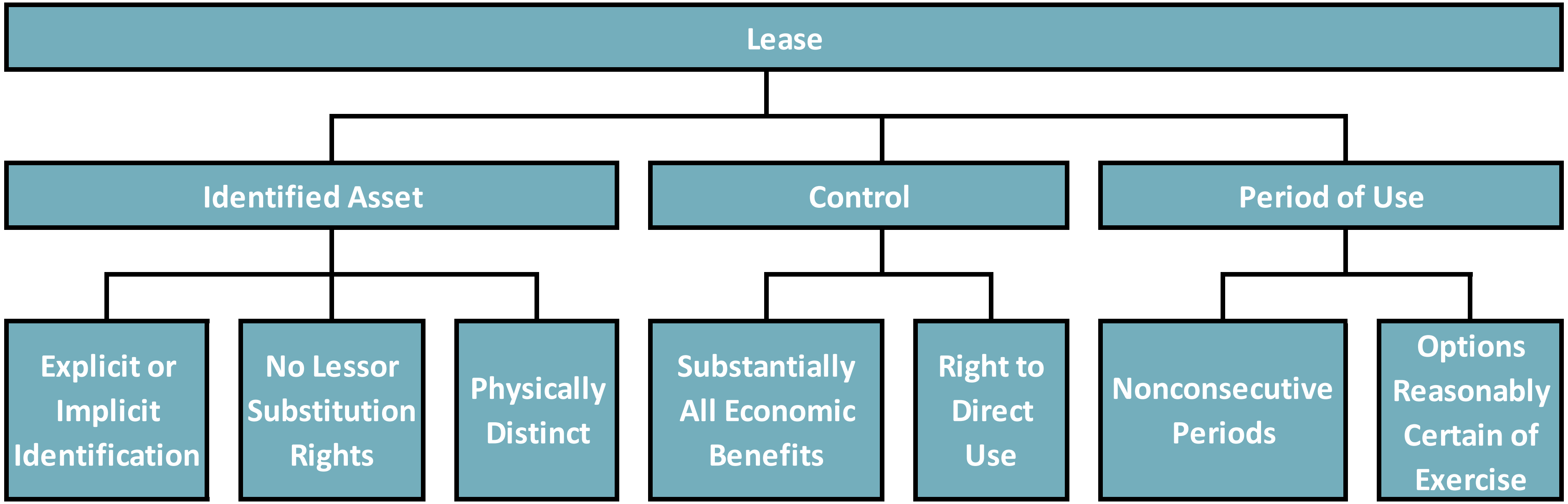
- Overview and concepts
- Practical expedients and policy elections
- Related party lease considerations
- Financial statement presentation and disclosure
- Issues seen in implementations
- Frequently asked questions
- Helpful resources

OVERVIEW

- Increase transparency and comparability related to leasing activity
- Effective dates:
  - Public businesses, certain non-profits and EBPs – years beginning after 12/15/18 (or 12/15/19)
  - All other entities – years beginning after 12/15/21 (calendar year ending 12/31/22 or fiscal years ending in 2023)
- Lessor accounting is fundamentally unchanged
- Lessees:
  - Recognize lease liabilities and right-of-use assets on the balance sheet for nearly all leases
  - Expanded disclosure requirements

LEASE **IDENTIFICATION**

- A contract is or contains a lease if the contract 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.



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EMBEDDED **LEASES**

- "A contract is **<u>or contains</u>** a lease if…"
- Possible examples:
  - Student transportation/shuttle service – contract for transportation services but do not own shuttles/busses
  - IT and telecom services – dedicated servers, fiber optic lines
  - Advertising – billboards, arena/stadium rights
  - Cafeteria and vending – vendor supplied kitchen equipment, vending machines
  - Waste management – dumpsters, compactors, other collection/management equipment
  - Campus security – vehicles, emergency call buttons/stations

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SHUTTLE SERVICE **ILLUSTRATION**

- University contracts with Speedy Shuttle for transportation of students, employees, and visitors around campus for 3 years.
- Speedy Shuttle owns and maintains the busses and employs drivers.
- Busses are branded with University logo and reside on campus full time.
- University dictates routes and schedule.
- University pays monthly fee for transportation services.

IT SERVICES **ILLUSTRATION**

- University enters into contract with Outsourced IT for managed IT services for 3 years.
- Outsourced IT provides servers and networking equipment according to contract specifications.
- Outsource IT provides all maintenance and support. Outsourced IT can substitute the equipment for repair/maintenance only.
- University determines where equipment is installed, what data is stored, and how the network is used.

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CHECK IN **QUESTION #1**

- How many leases does your organization have?
  - A) Less than 5
  - B) 6 to 20
  - C) 21 to 50
  - D) More than 50
  - E) Let me go look for embedded leases and get back to you…

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LEASE **CLASSIFICATION**

Lessee	Lease Criteria	Lessor
Finance lease	Any one of the following five criteria are met: 1. Lease **transfers ownership** by end of term 2. Lessee has **option to purchase** asset, and is **reasonably certain to exercise** it 3. Lease term is for a **major part of the remaining life** of the asset (if the commencement date falls at or near the end of the economic life of the underlying asset, this criteria shall not be used) 4. Present value of lease payments plus residual value guarantee by lessee is equal to or greater than **substantially all of the fair value** of the asset, or 5. The asset is **specialized** and is expected to have **no alternative future use to the lessor**.	Sales type lease
n/a	None of the above criteria are met; **however,** both of these criteria are met: ▪ Present value of lease payments plus residual value guarantee (including third party guarantee) is equal to or greater than substantially all of the fair value of the asset, and ▪ It is probable that the lessor will collect lease payments and residual value guarantee.	Direct financing lease
Operating lease	None of the above criteria are met.	Operating lease

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PAYMENTS USED FOR LEASE **CLASSIFICATION** **VS.** LEASE **LIABILITY MEASUREMENT**

LEASE CLASSIFICATION	LEASE LIABILITY MEASUREMENT
Lease payments include **all lease payments made <u>before commencement</u>**, and those not yet made, including:	Lease payments include **only those not yet made**, including:
▪ Fixed payments less lease incentives,	▪ Fixed payments less lease incentives,
▪ Variable lease payments that depend on an index or rate,	▪ Variable lease payments that depend on an index or rate,
▪ Exercise price of purchase option if lessee reasonably certain to exercise,	▪ Exercise price of purchase option if lessee reasonably certain to exercise,
▪ Payments for penalties to terminate lease if lease term reflects lessee exercising option to terminate,	▪ Payments for penalties to terminate lease if lease term reflects lessee exercising option to terminate,
▪ Fees paid by lessee to special-purpose entity for structuring the transaction,	▪ Fees paid by lessee to special-purpose entity for structuring the transaction,
▪ **<u>Entire potential amounts</u>** owed under residual value guarantees.	▪ **Amounts that are <u>probable</u>** of being owed under residual value guarantees.

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VARIABLE LEASE PAYMENTS

- **Q:My lease payments increase each year based on the change in CPI. How do I determine the payment amount to use for future periods in the initial recognition and measurement of the lease?**

- **A:** In the initial recognition and measurement of the lease you do not adjust for the potential change in CPI. While the variability is based on a change in rate or index such as CPI, the amount of that rate or index at commencement is 0 because there is no change in the CPI at that date. Therefore, you would not include any amount for the change in CPI in the future payments for recognition and measurement; you would use the initial period stated amount for the future periods as well. In future periods, the change in lease payments due to the change in CPI would be reported as variable lease expense in that period.

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VARIABLE LEASE PAYMENTS

- **Q: My lease contract contains renewal options with payment amounts established at future market rents. These amounts are variable, so do I include them in lease payments for measurement?**

- **A:** Yes, future payments dependent on future fair market rents are tied to economic factors. While the amount cannot be known until the renewal date, the payment is not avoidable (assuming the renewal option is exercised). While the payment amount could increase or decrease from the last scheduled payment, there will still be a required payment and it is reasonable to expect it will be consistent with scheduled payments. <u>The amount for the last scheduled payment should be used for renewal periods reasonably certain to be exercised</u>.

DETERMINING THE **DISCOUNT RATE**

- **Rate implicit in the lease**
  - Required to be used by lessors
  - Used by lessees when readily determinable
  - The rate of interest at which:

PV of lease payments + PV of the residual value of the asset = Fair value of the asset − Related investment tax credits + Deferred initial direct costs

- **Incremental Borrowing Rate** (IBR)
  - The rate of interest that a 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
- **Risk-Free Rate** (RFR)
  - The theoretical rate of return of an investment with zero risk *(U.S. Treasury bond rates)*
  - Nonpublic business entity accounting policy election, by class of underlying asset

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ROU **ASSETS**

- ROU asset is computed as:

Initial measurement of lease liability + Lease payments made at or before commencement − Lease incentives received at or before commencement + Initial direct costs

- Initial direct costs
  - Incremental costs that would not have been incurred had the lease not been executed
  - Examples include
    - legal fees resulting from the execution of a lease
    - commissions to employees acting as selling agents
    - certain payments to existing tenants to move out

PRACTICAL EXPEDIENTS AND **POLICY ELECTIONS**

- Short-term lease exception
- Reasonable capitalization threshold
- Not separating lease and nonlease components
- Major part of the economic life
- Substantially all of the fair value
- Risk-free rate
- Financial statement presentation
- Transition method
- Transition “package of three”
- Hindsight in transition
- Easements at transition

SHORT-TERM LEASES

- A short-term lease is a lease that, at commencement, has a lease term of 12 months or less, *including renewal periods the lessee is reasonably certain to exercise*, and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

- **Q: Do leases that have a remaining term of 12 months or less at the ASC 842 application date, but at commencement had a term of more than 12 months, qualify for the short-term lease exception?**
- **A:** No, these would not qualify since the measurement is as of the commencement date.

REASONABLE **CAPITALIZATION THRESHOLD**

- "…entities will likely be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized…"

- **Q: How is the "reasonable" capitalization threshold determined? Can you just use the same threshold that is used for PP&E?**
- **A:** Possibly, but further consideration is needed. The threshold for PP&E only considers the impact of assets. ASC 842 accounting will affect both assets and liabilities. There will also be some accumulation over time due to overlapping lease terms. One reasonable approach is to determine what is material for assets and liabilities separately and then using the lesser of those two amounts.

CONTRACT **COMPONENTS**

- **Lease components** – provide right to the use of an underlying asset
  - Examples: Rent/lease payments
  - Part of ROU assets and lease liabilities under ASC 842
- **Nonlease components** – transfer a good/service related to use of the underlying asset
  - Examples: CAM charges, security services, provide an operator (e.g., a pilot), etc.
  - Accounted for under other guidance
- **Non components** (other payments not considered "components") – activities that do not transfer any goods or services to the lessee
  - Examples: Property taxes and insurance

  Payments for non components are allocated to lease and nonlease components, and accounted for with those payments

- As a policy election, an entity may elect to combine lease and nonlease components and account for them as a single component

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TRANSITION **METHODS**

- Option 1 - **Comparative** reporting
  - Apply ASC 842 retrospectively to each prior period presented with the cumulative effect at the **beginning of the earliest comparative period** presented
  - For a calendar year-end entity presenting two years of financial statements (2021 and 2022):
    - Present cumulative effect as of January 1, 2021
    - Present financial statement impacts for all of 2021 and 2022, restating 2021
    - Financial statements are comparable
- Option 2 - **Non-comparative** reporting
  - Apply ASC 842 **retrospectively at the beginning of the period of adoption** through a cumulative-effect adjustment
  - For a calendar year-end entity presenting two years of financial statements (2021 and 2022):
    - Present cumulative effect as of January 1, 2022
    - Present financial statement impacts for 2022
    - Financial statements are **not** comparable

CHECK IN **QUESTION #2**

- Has your organization determined its policy elections?
  - A) Yes, and documented!
  - B) Some, but we have a few to review yet.
  - C) Not yet.
  - D) Can we get a policy election template please?

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RELATED PARTY LEASES

- Accounted for based on legally enforceable terms and conditions, which would be the same as if the lease was between unrelated parties.
- Is a "short-term" lease truly short term? What is the term for an "evergreen" lease? Possible indicators of legally enforceable terms and conditions:
  - Existence of significant leasehold improvements
  - Underlying asset financed through debt provided, or guaranteed, by lessee
  - Cash flow from lessee critical to lessor's ability to meet debt obligations
  - Economically disruptive or commercially unrealistic for lessee to move operations in short-term
  - Other agreements (operating agreements, management agreements, etc.) that directly or indirectly impose enforceable terms and conditions
- Discount rate – rate implicit in the lease may be very high
- Lease classification – impact of discount rate on "substantially all the fair value"

STATEMENT OF **FINANCIAL POSITION**

<table>
<tr><th>FINANCE LEASE</th><th>OPERATING LEASE</th></tr>
<tr><td colspan="2">Statement of Financial Position</td></tr>
<tr><td colspan="2">Record ROU asset and lease liability at commencement
▪ ROU asset will be presented as long term
▪ Lease liability will be presented in current and non-current portions</td></tr>
<tr><td>Amortize ROU asset, typically on a straight-line basis over:
▪ Lease term, or
▪ Remaining economic life of underlying asset when transfer or title or purchase option reasonably certain to be exercised</td><td>Amortize ROU asset by an amount representing straight-line lease expense less accretion of interest on the lease liability (amortization increases over lease term)</td></tr>
<tr><td colspan="2">Test ROU asset for impairment (ASC 360)</td></tr>
<tr><td colspan="2">Increase liability for accretion of interest and reduce liability for amounts paid</td></tr>
<tr><td colspan="2">Adjust ROU asset and lease liability for effects of modifications and remeasurements, as applicable</td></tr>
</table>

STATEMENT OF **ACTIVITIES**

FINANCE LEASE	OPERATING LEASE
Statement of Activities	
Expense will decrease over lease term ▪ Amortization is recognized on a straight-line basis ▪ Interest accretion is reduced as the liability declines	Expense will remain the same (straight-line) over the lease term ▪ ROU amortization increases to result in combined straight-line expense ▪ Interest accretion is reduced as the liability declines
Present two expense line items: ▪ Amortization expense ▪ Interest expense *Do not have to be separately presented; should be consistent with how entity presents other interest and amortization*	Present a single expense line item: ▪ Operating lease expense ▪ Referred to as "single lease cost"
Recognize variable lease expense	
Recognize impacts of impairments, remeasurements, and modifications, as applicable	

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FINANCE vs OPERATING **LEASE ILLUSTRATION**

	Finance and Operating Lease		Finance Lease				Operating Lease				Difference Finance vs. Operating	
	Payments	Lease Liability	Straightline Amortization Expense	Interest Expense	Total Expense	ROU Asset	ROU Reduction "Plug"	Interest Accretion	Single Lease Cost (Straightline)	ROU Asset	Total Expense	ROU
0		**392,017**				**392,017**				392,017		-
1	50,000	362,094	39,202	20,076	59,278	352,815	29,924	20,076	50,000	362,094	9,278	(9,278)
2	50,000	330,413	39,202	18,320	57,522	313,614	31,680	18,320	50,000	330,413	7,522	(16,800)
3	50,000	296,874	39,202	16,460	55,662	274,412	33,540	16,460	50,000	296,874	5,662	(22,462)
4	50,000	261,365	39,202	14,491	53,693	235,210	35,509	14,491	50,000	261,365	3,693	(26,155)
5	50,000	223,772	39,202	12,407	51,609	196,009	37,593	12,407	50,000	223,772	1,609	(27,764)
6	50,000	183,973	39,202	10,200	49,402	156,807	39,800	10,200	50,000	183,973	(598)	(27,166)
7	50,000	141,837	39,202	7,864	47,066	117,605	42,136	7,864	50,000	141,837	(2,934)	(24,232)
8	50,000	97,228	39,202	5,391	44,593	78,403	44,609	5,391	50,000	97,228	(5,407)	(18,824)
9	50,000	50,000	39,202	2,772	41,974	39,202	47,228	2,772	50,000	50,000	(8,026)	(10,798)
10	50,000	0	39,202	-	39,202	-	50,000	-	50,000	0	(10,798)	0
	500,000		392,017	107,983					500,000		0	

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STATEMENT OF **CASH FLOWS**

<table>
<tr><th>FINANCE LEASE</th><th>OPERATING LEASE</th></tr>
<tr><td colspan="2">Statement of Cash Flows</td></tr>
<tr><td>Payments of principal = Financing Activities</td><td rowspan="2">Lease payments* = Operating Activities</td></tr>
<tr><td>Payments of interest = Operating Activities</td></tr>
<tr><td colspan="2">Variable payments = Operating Activities</td></tr>
<tr><td colspan="2">Short-term lease payments = Operating Activities</td></tr>
<tr><td colspan="2">Impairment = Non-cash Activities</td></tr>
<tr><td colspan="2">Effects of remeasurement or modification = Non-cash Activities</td></tr>
<tr><td></td><td>*Payments associated with the cost of bringing another asset to the condition/location for intended use that are capitalized as part of the asset = Investing Activities</td></tr>
</table>

QUANTITATIVE DISCLOSURES - **ILLUSTRATION**

	Year Ending December 31, 20X2	Year Ending December 31, 20X1
Lease cost		
Finance lease cost:	$XXX	$XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	$XXX	$XXX

	Year Ending December 31, 20X2	Year Ending December 31, 20X1
Other information		
(Gains) and losses on sale and leaseback transactions, net	$(XXX)	$XXX
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term—finance leases	XX years	XX years
Weighted-average remaining lease term—operating leases	XX years	XX years
Weighted-average discount rate—finance leases	XX%	XX%
Weighted-average discount rate—operating	XX%	XX%

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QUANTITATIVE DISCLOSURES – **FUTURE MATURITIES**

- Lessee should also disclose a maturity analysis of its finance and operating lease liabilities, separately showing:
  - Undiscounted cash flows on an annual basis for a minimum of each of the next 5 years
  - Sum of undiscounted cash flows for all years thereafter
  - Reconciliation of undiscounted cash flows to the discounted finance lease liabilities and operating lease liabilities

	Operating leases		Finance leases	
	Year Ending December 31,		Year Ending December 31,	
	20X2	20X1	20X2	20X1
20X2		$XXX		$XXX
20X3	$XXX	XXX	$XXX	XXX
20X4	XXX	XXX	XXX	XXX
20X5	XXX	XXX	XXX	XXX
20X6	XXX	XXX	XXX	XXX
20X7	XXX		XXX	
Thereafter	XXX	XXX	XXX	XXX
Total	XXX	XXX	XXX	XXX
Less interest	(XXX)	(XXX)	(XXX)	(XXX)
Present value of future minimum lease payments	$XXX	$XXX	$XXX	$XXX

LEASES BELOW **CAPITALIZATION THRESHOLD**

- **Q: What are the presentation and disclosure requirements for leases that fall below the recognition threshold?**

- **A:** As the leases have been deemed to be immaterial, there are no presentation and disclosure requirements. The expenses would be recognized as period expenses in the financial statements and no related lease disclosures are necessary. We recommend that the expenses related to these immaterial leases be included in other expense line items, separate from “lease” or “rent” expense type captions.

IMPACTS ON **COVENANTS AND RATIOS**

- Increased assets and liabilities may impact debt covenants
  - Liabilities will have current and long-term portions while assets will all be long-term
- Policy elections will impact recorded balances:
  - Short-term leases
  - Capitalization threshold
  - Not separating lease and non lease components
  - Risk-free rate
- Common ratios that may be impacted
  - Debt-to-net assets *(total debt/net assets)*
  - Debt service coverage ratio *(net income/current debt obligations)*
  - Current ratio *(current assets/current liabilities)*
  - Operating cash flow ratio *(operating cash flow/current liabilities)*

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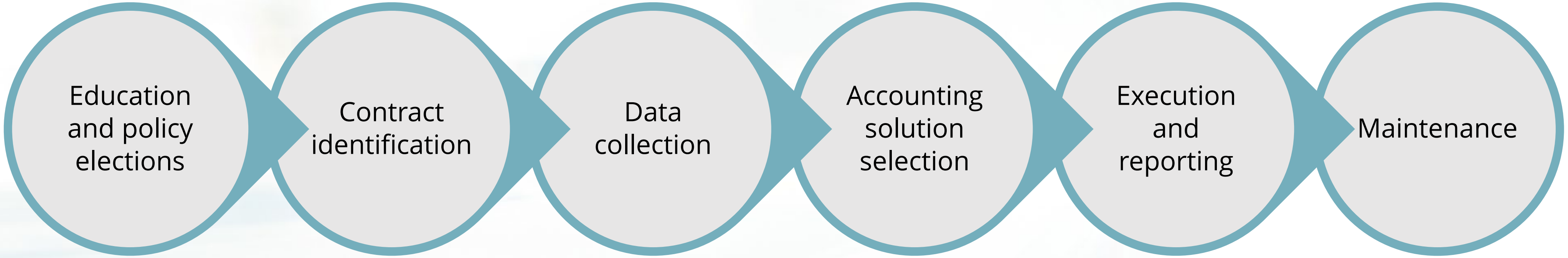
ASC 842 **IMPLEMENTATION STEPS**



ITEMS TO **CONSIDER**

- Where are your organization's leases?
  - Review disbursements for recurring payments
  - Service arrangements requiring use/provision of equipment
  - Dedicated IT equipment to protect sensitive information (student health services, student financial aid, etc)
  - Educational programs requiring specialized equipment (Arts, Broadcasting, Production)
  - Satellite locations/facilities (period of use; substantially all the economic benefits)
- Policy elections and practical expedients
- Impacts on covenants/ratios
- How will you prepare and maintain lease calculations?

ISSUES SEEN IN EARLY **IMPLEMENTATIONS**

- Insufficient time and resources allocated to implementation
- Calculations being performed as of lease commencement date, not standard application date
- Inaccurate NPV calculations
- Using the NPV calculations to determine adjustment to liabilities and ROU assets over the lease term rather than using proper amortization schedules
- Improper use of discount rates and/or lack of documentation
- Corrections of errors being presented as cumulative effect adjustments
- Presentation and disclosure errors

CHECK IN **QUESTION #3**

- How prepared is your organization for implementation?
  - A) Already completed! Just here for CPE.
  - B) We have all the information in place but need to decide on a way to perform the calculations.
  - C) We feel comfortable with the new requirements but have some work to do.
  - D) Not feeling very ready at all…

HELPFUL **RESOURCES**

- ASC 842 Lessee Handbook and policy election template
- ASC 842 Lessee Ledger
- Data collection tool
- Implicit rate calculator
- ASC 842 FAQ
- Lessor considerations
- Other related Sikich Insights and recorded webinars

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QUESTIONS?

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