ASC 842: NEW LEASE ACCOUNTING STANDARDS

ACCOUNTING GUIDANCE FOR LESSEES

February 17, 2022

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AGENDA

TOPIC	SPEAKER
INTRO	Satpal Nagpal, Partner and Audit and Assurance Practice Leader
PURPOSE OF ASC 842	Satpal Nagpal, Partner and Audit and Assurance Practice Leader Elad Menna, Senior Manager
EFFECTIVE DATES	Elad Menna, Senior Manager
LEASE CLASSIFICATION	Elad Menna, Senior Manager
IMPLEMENTATION	Elad Menna, Senior Manager Melissa McCann, Manager
ACCOUNTING CONSIDERATIONS	Elad Menna, Senior Manager Melissa McCann, Manager
PRACTICAL CONSIDERATIONS	Elad Menna, Senior Manager
WALKTHROUGH EXAMPLE	Melissa McCann, Manager
WRAP UP AND QUESTIONS	Satpal Nagpal, Partner and Audit and Assurance Practice Leader

SPEAKERS

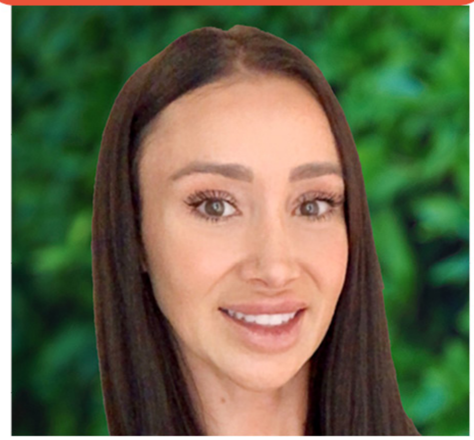
Moderator

Satpal Nagpal
Partner and Audit and Assurance Practice Leader
GHJ

Panelist

Elad Menna
Senior Manager
GHJ

Panelist



Melissa McCann
Manager
GHJ

POLLING QUESTION 1

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PURPOSE OF ASC 842

- Increase in transparency and comparability among industry players
- To provide financial statement users with increased visibility into the leasing obligations of companies and organizations
- To bring most operating leases, previously off-balance sheet under ASC 840, onto the balance sheet.

EFFECTIVE DATES

- Public Companies Fiscal years beginning after 12/15/2018

- Private Companies
  - Was originally to be implemented in fiscal years beginning after Dec. 15, 2019. Delayed twice due to COVID-19. Per FASB update on June 2020:
  - Now finally effective for fiscal years beginning after **12/15/2021**
    - December FYE: **12/31/2022**
    - June FYE: **6/30/2023**

- Early adoption is permitted

FINANCING LEASE CHARACTERISTICS

- Lease transfers ownership of the asset to the lessee at the end of the lease term
- Lessee has a bargain purchase option
- Lease term is for the ***major part*** of the remaining economic life of the asset (no longer 75% threshold)
- Present Value of lease payments amounts to ***substantially all*** of the fair value of the leased asset (no longer 90% threshold)
- The underlying asset is of such a specific nature such that it would have not alternative use to the lessor

POLLING QUESTION 2

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LEASE ACCOUNTING MODEL COMPARISON

FINANCE LEASE

- **Balance Sheet:**
  - Right of Use Asset
  - Lease Liability
- **Income Statement:**
  - Interest Expense
  - Amortization Expense
- **Statement of Cash Flows**
  - Financing Activity: Cash paid for principal portion of lease
  - Operating Activity: Cash Paid for interest, Amortization

OPERATING LEASE

- **Balance Sheet:**
  - Right of Use Asset
  - Lease Liability
- **Income Statement:**
  - Rent Expense
- **Statement of Cash Flows**
  - Operating Activity: Cash Paid for rent

ORIGINAL MEASUREMENT

- Original Lease Liability = Present Value of Future Lease Payments
- Original Right of Use Asset = Lease Liability, subject to any adjustments such as initial direct costs or lease incentives

LEASING LIABILITY INITIAL AND SUBSEQUENT MEASUREMENT

lease liability = present value of unpaid lease payment

ROU ASSET INITIAL MEASUREMENT

lease liability + initial direct costs + prepaid lease payments − lease incentives received

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DISCOUNT RATE

- Lessees to use the rate implicit in lease, however, to obtain this rate the lessee must know several assumptions used by the lessor in pricing the lease, fair value and residual value of underlying asset at end of the lease. This information may not be readily available.

- Absent the implicit rate, lessees are to use an incremental borrowing rate (IBR), defined by ASC 842 as "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."

- Nonpublic entities may elect to use the risk-free rate when measuring lease obligations. Application must be consistently applied to all leases:
  - 5 year T-Bill rate for a 5 year lease.

LEASE TERM

- Per ASC 842, the lease term includes the non-cancellable period of the lease, plus any periods covered by an option to:

  a) Extend the lease if the lessee is reasonably certain to exercise that option.
     - See next slide

  b) Terminate the lease if the lessee is reasonably certain not to exercise that option

  c) Either of the aforementioned, if the lessor controls the ability to exercise that option.

LEASE TERM (OPTION TO EXTEND)

- Judgment is necessary in evaluating whether reasonable certainty exists. Consider the following:
  - Contract-based factors: Substantial penalty for failure to renew.
  - Asset-based factors: If the asset it difficult to acquire and is crucial to operations.
  - Entity-based factors: Significant money and time invested in underlying asset. Heavy cost of replacement.
  - Market-based factors: below market rates.

- Options to terminate will also impact the evaluation of the lease term

SHORT-TERM LEASE EXEMPTION

- Under Topic 842, a short-term lease is a lease that, at the commencement date, has a term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- Although short-term leases are in the scope of Topic 842, an exemption is permitted. A lessee can elect, by class of underlying asset, not to apply the recognition requirements of Topic 842, and instead to recognize the lease payments as lease cost on a straight-line basis over the lease term.
- Specific disclosure required.

POLLING QUESTION 3

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ADOPTION AND TRANSITION

- Modified retrospective method is required, with two available options:
  - Effective Method: apply ASC 842 as of the effective date, present comparative periods under ASC 840.
  - Comparative Method: Apply the new standard as of the earliest period presented.

- Use of effective Method (2018-11 amendment)
  - Apply ASC 840 in comparative periods
  - Provide ASC 840 disclosures for all periods presented in accordance with ASC 840.
  - Recognize the effects of applying ASC 842 as a cumulative-effect adjustment to retained earnings as of the beginning of the current period.

- At transition, determine the total payments over the *remaining lease term* (at transition) and calculate PV as a basis for the ROU Asset and Lease Liability.

- Available practical expedient package at adoption
  - Adopters are NOT required to reassess the following:
    - (i) Whether any expired or existing contracts are leases or contain leases (ii) the lease classification for any expired or existing leases (iii) initial direct costs for any existing leases
  - If elected, must elect all three.

ADOPTION AND TRANSITION (CONTINUED)

- Treatment of deferred rent asset/liability from prior years under ASC 840.
  - There is no deferred rent under ASC 842. Thus any deferred rent balance sheet components must be eliminated upon transition.
  - Net deferred balance sheet components against Right of Use Asset (ROU), zero out deferred rent liability/asset.
  - For example –An operating lease with a PV of $100,000 at implementation, with PY deferred rent liability of $20,000, will result in a ROU of $80,000.
  - The deferred rent component included in the initial valuation of ROU Asset is amortized over the course of the lease term by a debit to ROU Asset and a credit to rent expense.

PRACTICAL CONSIDERATIONS

- It is crucial that every lease is backed by an executed agreement with agreed-upon terms. Related party month-to-month leases are not immune from LT evaluation. Lack of an agreement will result in complications.

- Companies may elect to update their lease accounting at the end of each reporting period.

- Bank Covenants: ASC 842 will affect certain covenants, such as debt to equity ratios. Clients should be advised.

- Companies with a high volume of lease may wish to consider lease accounting software.

WALKTHROUGH EXAMPLE

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INITIAL RECOGNITION

- Initial Right of Use Asset
  - Terms:
    - Discount rate 4.971%
    - Lease liability $200,000
    - Broker commission paid by lessee $8,000
    - Lessor buy out of lessee from original lease $25,000
    - Last month's rent paid at inception $6,125
    - Refundable security deposit $10,000
  - Calculation based on the above information:
    - ROU Asset = Lease Liability + Prepaid Rent + Broker Commission – Lease Incentives
      - $200,000 + 6,125 + 8,000 – 25,000 = $189,125
  - Journal Entry To Record:

ROU Asset	189,125		
Cash	25,000		
		Lease Liability	200,000
		Prepaid Rent	6,125
		Cash	8,000

BALANCE SHEET ASC 840 VS. 842

ASC 840 BALANCE SHEET	
Assets	
Current Assets	
Cash	$xx,xxx
Accounts Receivable	xx,xxx
Prepaid Rent	6,125
Capitalized Broker Commission	8,000
Long-term Assets	
PP&E, Net	xx,xxx
TOTAL ASSETS	$xxx,xxx
Liabilities and Equity	
Current Liabilities	
Accounts Payable	$xx,xxx
Accrued Expenses	xx,xxx
Long-term Liabilities	
LT Notes Payable	xx,xxx
Lease Incentive	25,000
Deferred Rent	xx,xxx
TOTAL LIABILITIES	$xxx,xxx

ASC 842 BALANCE SHEET	
Assets	
Current Assets	
Cash	$xx,xxx
Accounts Receivable	xx,xxx
Long-term Assets	
ROU Asset	189,125
PP&E, Net	xx,xxx
TOTAL ASSETS	$xxx,xxx
Liabilities and Equity	
Current Liabilities	
Accounts Payable	$xx,xxx
Accrued Expenses	xx,xxx
ST Lease Liabilities	65,337
Long-term Liabilities	
LT Notes Payable	xx,xxx
LT Lease Liabilities	134,663
TOTAL LIABILITIES	$xxx,xxx

INCOME STATEMENT JOURNAL ENTRIES

- **ASC 840 – Month 1**

DR. Lease Incentive Liability	$ 694	
CR. Rent Expense		$ 694
DR. Rent Expense	$ 222	
CR. Capitalized Broker Commission		$ 222
DR. Rent Expense	$ 6, 125	
CR. Cash		$ 6, 125

- **ASC 842 – Month 1**

DR. Lease Expense	$ 5,653	
DR. Lease Liability	$ 5,322	
CR. ROU Asset		$ 4,850
CR. Cash		$ 6,125

IMPACT ON KEY PERFORMANCE INDICATORS

- Changes to operating lease accounting will significantly impact certain leverage ratios, and rate of return (return on assets, return on liabilities) ratios.
- Entities with Finance Leases, which previously did not qualify as capital leases under ASC 840, will exhibit changes in operating income and EBITDA.

KPIs	EFFECTS OF ASC 842 (OPERATING LEASES)		EFFECT OF ASC 842 (NEW FINANCE LEASE CLASSIFICATION)	
Debt to Equity Ratio	Increase	↑	Increase	↑
EBIT *Earnings before interest and tax*	Remains unchanged	=	Increase	↑
EBITDA *Earnings before interest, tax and amortization*	Remains unchanged	=	Increase	↑
Operating cash flow	Remains unchanged	=	Increase	↑

POLLING QUESTION 4

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ENHANCED DISCLOSURE REQUIREMENTS

- Information about nature of leases
- Maturity analysis of lease liabilities
- Lease expense, separated between operating and financing
- Short-term lease expense
- Weighted average remaining lease term
- Weighted average discount rate
- Cash flows from Financing and Operating Activities

WRAP UP AND QUESTIONS

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