

ACCOUNTING FOR LEASES

ASU 2016-02 LEASES



LEASE



“a contract, or part of a contract, that conveys the right to control the use of identified PP&E (an identified asset) for a period of time in exchange for consideration”

A contract is a lease if both of the following criteria are met

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graph TD; A[A contract is a lease if both of the following criteria are met] --> B[IDENTIFIED ASSET]; A --> C[CONTROL];
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IDENTIFIED ASSET

Fulfillment of the contract depends on the use of the identified asset which can be implicitly or explicitly identified, but must be physically distinct

CONTROL

Contract conveys right to use and receive the benefit from use of the identified asset

CURRENT FINANCE LEASE:

- Recognize asset and liability
- Interest on liability recognized separately from amortization of asset
- Cash flow –
 - Financing activities – Principal portion of lease liability
 - Operating activities – Interest payments on lease liability and variable lease payments

CURRENT OPERATING LEASE:

- Monthly lease/rent expense

FUTURE FINANCE LEASE:

- Recognize asset and liability
- Interest on liability recognized separately from amortization of asset
- Cash flow –
 - Financing activities – Principal portion of lease liability
 - Operating activities – Interest payments on lease liability and variable lease payments

FUTURE OPERATING LEASE:

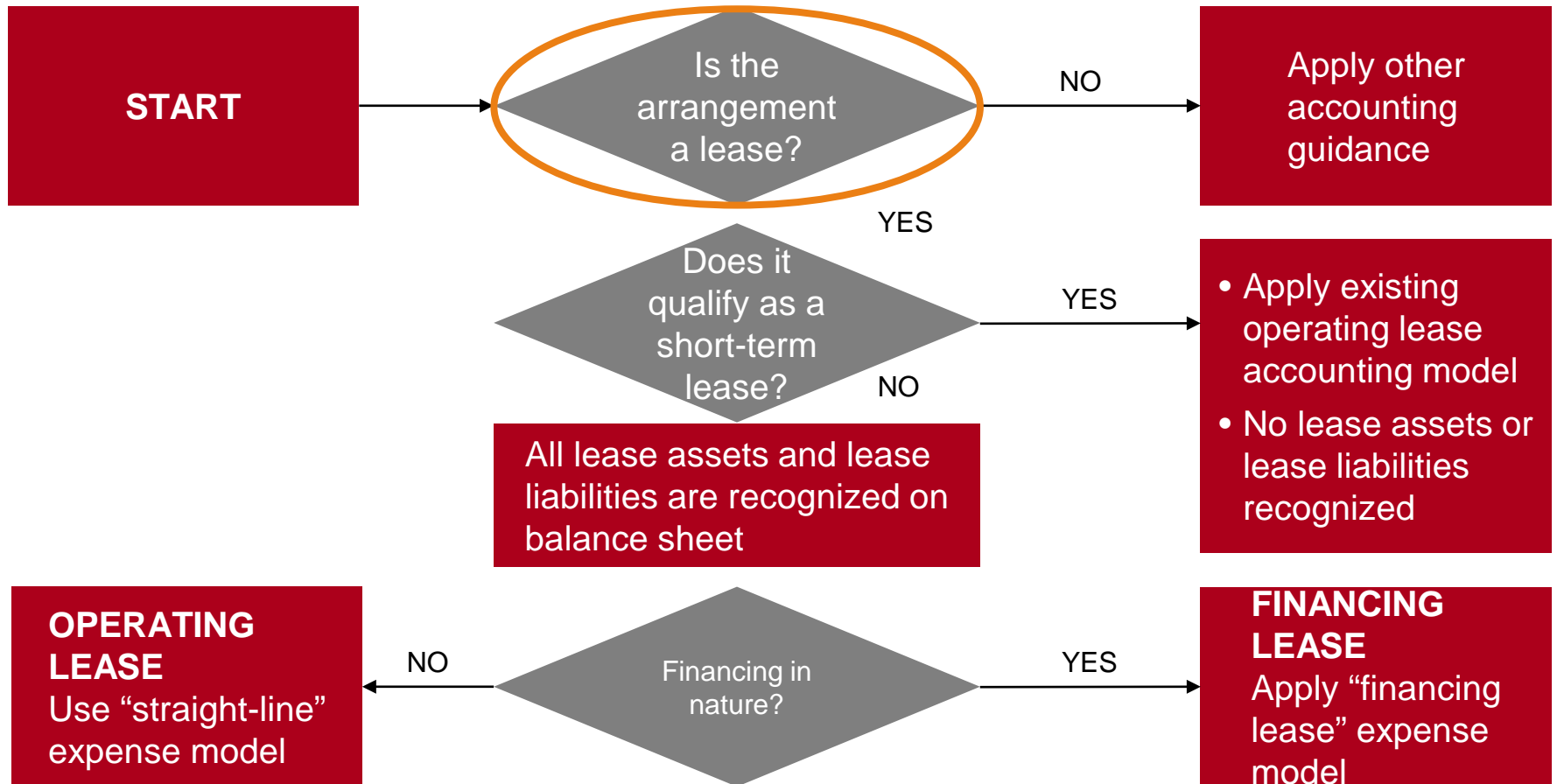
- Recognize asset and liability
- Single lease cost – cost of lease is allocated over lease term on a straight-line basis
- Cash flow – All cash payments within operating activities

IF A LEASE MEETS ANY OF THE FOLLOWING 5 CONDITIONS, IT IS A FINANCING LEASE:

- Transfer of ownership
- Option to purchase is reasonably certain
- Lease term is a “major part” of the economic life
- Present value of lease payments is “substantially all” of the fair value
- ***Specialized nature (NEW)***

KEY TAKE AWAY: FIRST FOUR ARE SIMILAR TO TODAY'S FAS 13 TESTS





LESSEE ACCOUNTING

Recognize asset and liability

- Liability –
 - Measured at present value of future minimum lease payments
 - Remeasured at the beginning of each year if any substantial lease modifications
 - Asset – equivalent to the liability, less incentives, plus any initial direct costs
- Measurement includes options to extend or purchase if lessee is reasonably expected to exercise those options
- Accounting policy election regarding leases with terms of less than 12 months



LESSOR ACCOUNTING

No substantive changes

ARE THE FOLLOWING SCENARIOS SHORT TERM LEASES?

SCENARIO A:

Lease term – 12 months

Renewal option/purchase option – None

Free rent period – None

SCENARIO B:

Lease term – 12 months

Renewal option/purchase option – Option to renew 12 months

Free rent period – None

SCENARIO C:

Lease term – 12 months (plus 1 month free)

Renewal option/purchase option – None

Free rent period – 1 month

CAPITALIZATION OF OPERATING LEASES

FINANCIAL STATEMENT IMPACT

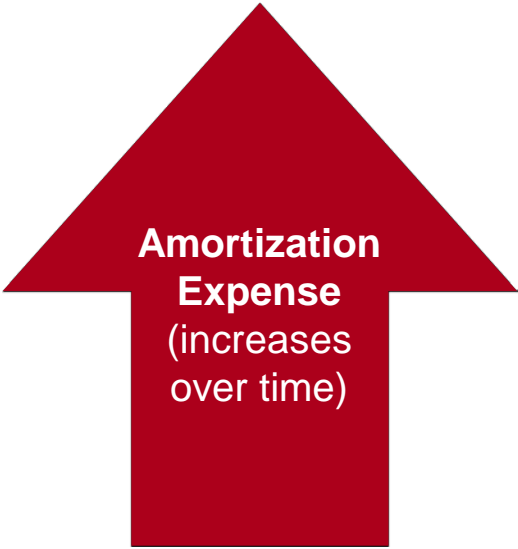
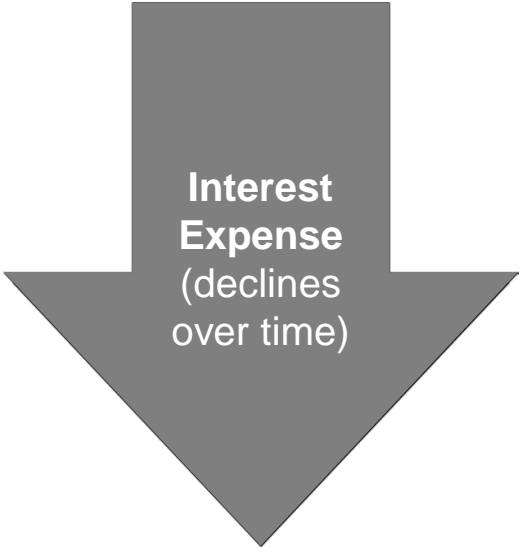
BALANCE SHEET	Establish ROU asset
	Capitalize operating lease payments
INCOME STATEMENT	Continue to recognize SL lease expense (like rent expense)
CASH FLOW STATEMENT	Continue to recognize operating outflows for operating lease payments

Intangible asset; initial amount corresponds to operating lease liability; unique amortization pattern

Calculation is similar to capital lease liability; HOWEVER, it is a long-term operating liability (not long-term debt)

EXPENSE RECOGNITION FOR OPERATING LEASES

**TOTAL
LEASE
EXPENSE**



(Straight Line Recognition Pattern)

ASSET & LIABILITY ACCOUNTING OPERATING LEASE

3 YEAR LEASE X \$10,000/YEAR = \$30,000 TOTAL PAYMENTS

ROU ASSET		LEASE LIABILITY	
Day 1 (inception)	\$27,233	Day 1 (inception)	\$27,233
<i>Year 1 activity</i>		<i>Year 1 activity</i>	
Amortization expense	8,638	Interest expense	1,362
Accum. amortization	8,638	Lease liability	8,638
		Cash	10,000
<i>Year 2 activity</i>		<i>Year 2 activity</i>	
Amortization expense	9,070	Interest expense	930
Accum. amortization	9,070	Lease liability	9,070
		Cash	10,000

KEY POINT: interest expense + amortization expense = lease payment amount

OPERATING LEASE

	INCEPTION	YEAR 1	YEAR 2	YEAR 3	TOTAL
Income statement					
Lease expense		\$10,000	\$10,000	\$10,000	\$30,000
<i>Lease expense is comprised of:</i>					
<i>Interest expense (declines over time)</i>		1,362	930	475	2,767
<i>Amortization expense (increases over time)</i>		8,638	9,070	9,525	27,233
		10,000	10,000	10,000	30,000
Balance sheet					
Right-of-use asset	\$27,233	\$18,595	\$9,525	–	
Liability to make lease payments	\$(27,233)	(\$18,595)	(\$9,525)	–	
Cash flow statement					
Operating outflows		\$10,000	\$10,000	\$10,000	\$30,000

FINANCE LEASE

	INCEPTION	YEAR 1	YEAR 2	YEAR 3	TOTAL
Income statement					
Interest expense		\$ 1,362	\$ 930	\$ 475	\$ 2,767
Amortization expense		9,078	9,078	9,077	27,233
Total expense		\$10,439	\$10,007	\$9,552	\$30,000
Balance sheet					
Right-of-use asset	\$27,233	\$18,155	\$9,525	–	
Liability to make lease payments	\$(27,233)	(\$18,595)	(\$9,525)	–	
Cash flow statement					
Operating outflows (interest expense)		\$ 1,362	\$ 930	\$ 475	\$ 2,767
Financing outflows (principal)		8,638	9,070	9,525	27,233
Total cash outlays		\$10,000	\$10,000	\$10,000	\$30,000

RATIO CHANGES

RATIOS THAT COULD BE IMPACTED

Current Ratio	Worsens (because ROU asset not current, but liability will have current portion)
Quick Ratio	Worsens (due to added liability)
Liabilities to Net Assets	Worsens (due to added liability)
Return on Assets	Worsens (due to addition of ROU asset)

RATIOS THAT WILL NOT BE IMPACTED

EBITDA
Gross margin
Operating ratio
Net worth
Debt/equity ratio
Return on equity

COMPONENTS

Required to separate lease components from non-lease components (e.g., maintenance)

- Only lease components are included in measurement of asset and liability
- Consideration is allocated to lease and non-lease components based on relative stand-alone price basis
- Activities that do not transfer a good or service or amounts paid to reimburse costs of lessor are not allocated as part of consideration
- Can make an accounting policy election not to separate components



ASSUMPTIONS TO CONSIDER IN INITIAL MEASUREMENT

**LEASE TERM &
RENEWAL OPTIONS**

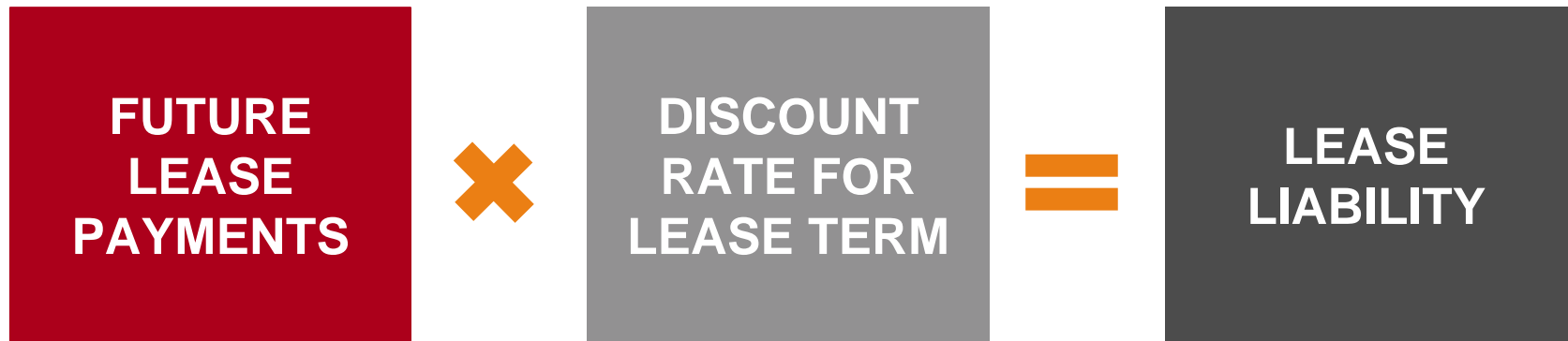
DISCOUNTING

**VARIABLE LEASE
PAYMENTS**

*Generally similar to
today's requirements,
with some tweaks*

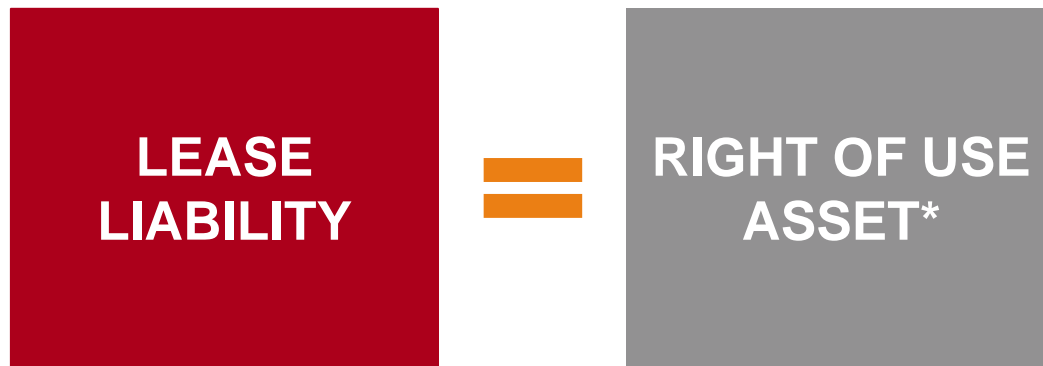
ASSUMPTIONS TO CONSIDER IN INITIAL MEASUREMENT

LIABILITY – INITIAL MEASUREMENT



ASSUMPTIONS TO CONSIDER IN INITIAL MEASUREMENT

RIGHT-OF-USE ASSET – INITIAL MEASUREMENT



**plus or minus any initial direct costs, incentives, or payments prior to lease commencement*

DISCLOSURES

Qualitative and non-qualitative

TRANSITION

Modified retrospective approach

- Remeasure leases as of beginning of earliest period presented
- Recognize asset and liability at PV of remaining future minimum lease payments
- Includes amounts probable of being owed under residual value guarantee



ADOPTION DATE

- Effective for years beginning after December 15, 2018 for NPOs with conduit bond obligations (fiscal 2020)
- All other NPOs have an additional year
- Early adoption permitted


TRANSITION METHOD

- Modified retrospective approach
- May apply hindsight to existing leases to determine lease term and asset impairment

LESSOR PERSPECTIVE

VERY LITTLE.....

The accounting applied by a lessor will largely be unchanged from that applied under today's GAAP for the most common NFP lessor scenarios

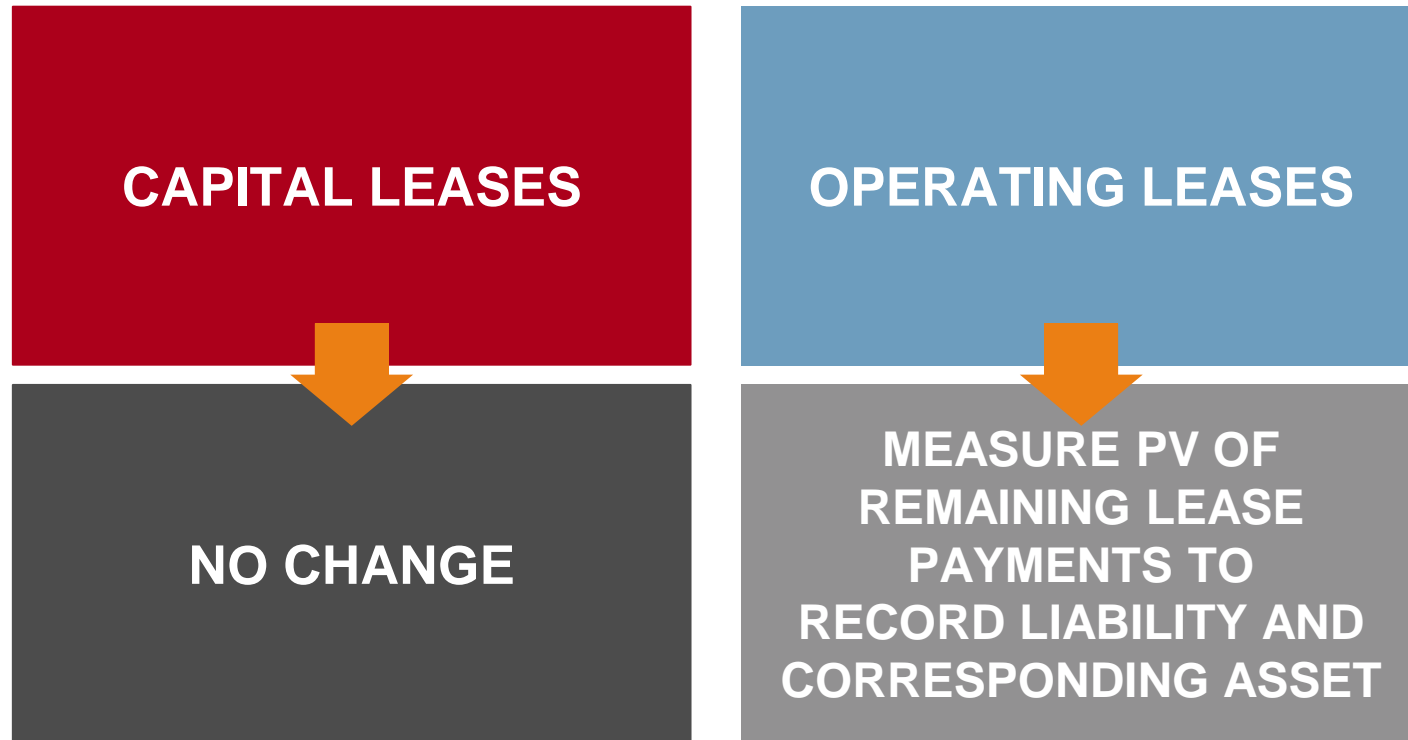


TODAY'S
LESSOR
GUIDANCE

TOMORROW'S
LESSOR
GUIDANCE

TRANSITION: AT A VERY HIGH LEVEL

LESSEE



WHAT TO THINK ABOUT

- What would be considered an appropriate capitalization threshold for leases?
- How granular do I need to get on identifying embedded leases?
- Will we need a new lease accounting system?
- Will our debt covenants be impacted?
- How do I start creating an inventory of leases?

QUESTIONS?

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