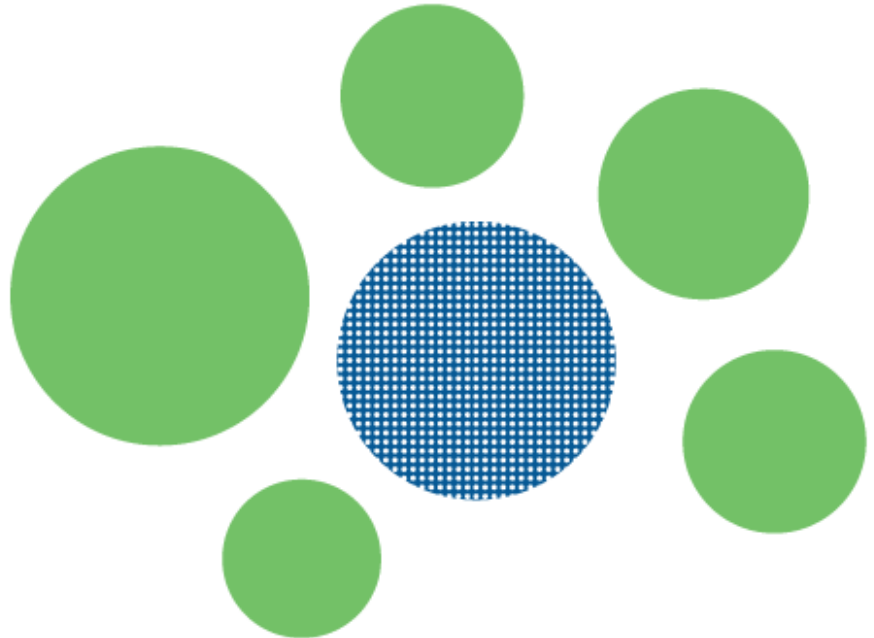


IMPLEMENTING ASC 842 – LEASES

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AGENDA

- Overview
 - *Refresher of the key concepts of new standard*
- Implementation Considerations
 - *Items to consider when adopting the new standard*
- Other Considerations
 - *How can UHY help*

OVERVIEW

- ASC 842 replaces ASC 840
- Effective date

If you are....	Fiscal years beginning after....
<ul style="list-style-type: none"> • Public business entities • Certain not-for-profit entities • Employee benefit plans 	<ul style="list-style-type: none"> • December 15, 2018
<ul style="list-style-type: none"> • Other entities 	<ul style="list-style-type: none"> • December 15, 2021

- How prepared are you?

OVERVIEW

Primary Objectives

- To increase transparency and comparability of financial statements.
- To align U.S. GAAP with IFRS and minimize off-balance sheet items.

Scope

- Generally similar to current U.S. GAAP
- ASC 842 only applies to the lease of property, plant and equipment.
- Excludes: lease of intangible assets, biological assets, inventory, asset under construction and lease to explore for/use nonregenerative resources
- No scope exceptions for small-ticket leases (e.g., leases of low value assets such as personal computers or copiers)

OVERVIEW

	Legacy Accounting (ASC 840)	New Lease Model (ASC 842)
Lessee accounting	<p>Leases are either:</p> <ul style="list-style-type: none"> • Operating leases (off-balance sheet) • Capital leases 	<ul style="list-style-type: none"> • All leases recorded on balance sheet (except short-term) • Two income statement presentations <ul style="list-style-type: none"> • Operating lease • Finance lease
Lessor accounting	<ul style="list-style-type: none"> • Operating leases • Sales-type or direct finance leases • Leveraged leases 	<ul style="list-style-type: none"> • Operating leases • Sales-type / direct-finance leases • No more leveraged leases

OVERVIEW

On the balance sheet —

Lessee	Lessor
<p>Non-current assets:</p> <ul style="list-style-type: none"> ➤ Finance lease right of use assets ➤ Operating lease right of use assets <p>Classified as current or non-current:</p> <ul style="list-style-type: none"> ➤ Finance lease liabilities ➤ Operating lease liabilities <p>➤ If not presented separately, disclose which line items and amounts in the balance sheet include those ROU assets and lease liabilities.</p>	<p>Sales-type and direct financing leases:</p> <ul style="list-style-type: none"> ➤ Derecognizes the leased asset and recognizes a lease net investment. The aggregate net investment in the lease is presented separately. ➤ Classified as current or noncurrent assets. <p>Operating leases:</p> <ul style="list-style-type: none"> ➤ As PPE or as a separate line item (e.g., assets subject to operating leases).

OVERVIEW

In the income statement —

	Finance Lease	Operating Lease
Lessee	Interest and amortization expense are presented separately, consistently with how the entity records similar expenses	Lease expense, which includes both an interest and amortization component, is presented on the income statement as rent expense
Lessor	If lease income not presented separately, the lessor shall disclose which line items include lease income	

In the statement of cash flows —

	Finance Lease	Operating Lease
Lessee	Operating activities (interest) Financing activities (principal)	Operating activities
Lessor	Cash lease payments received are presented within operating activities	

OVERVIEW

Illustration:

A lessee enters into a three-year lease and agrees to make the following annual payments at the end of each year: Year 1 - \$10,000, Year 2 - \$15,000, Year 3 - \$20,000. The discount rate utilized is 8%.

Both Leases			Finance Lease			Operating Lease			
Year	Payment	Lease Liability	Interest Expense	Amort of ROU Asset	Total Lease Expense	ROU Asset	Lease Expense	Amort of ROU Asset	ROU Asset
0	\$ -	\$38,000				\$38,000			\$38,000
1	10,000	31,038	\$ 3,038	\$12,666	\$15,704	25,334	\$15,000	\$11,962	26,038
2	15,000	18,520	2,481	\$12,667	15,148	12,667	15,000	12,519	13,519
3	20,000	-	1,481	\$12,667	14,148	-	15,000	13,519	-
Total	\$45,000	-	\$ 7,000	\$38,000	\$45,000	-	\$45,000	\$38,000	-

OVERVIEW

Balance sheet

Finance Lease		Operating Lease	
Journal Entry:		Journal Entry:	
Dr. Right of Use Asset	\$38,000	Dr. Right of Use Asset	\$38,000
Cr. Lease Liability	(\$38,000)	Cr. Lease Liability	(\$38,000)

OVERVIEW

Income statement

Finance Lease		Operating Lease	
Year 1 Journal Entry:		Year 1 Journal Entry:	
Dr. <u>Interest</u> Expense	\$3,038	Dr. <u>Lease</u> Expense	\$3,038
Dr. Lease Liability	\$6,962	Dr. Lease Liability	\$6,962
Cr. Cash	\$(10,000)	Cr. Cash	\$(10,000)
Dr. <u>Amortization</u> Expense	\$12,666	Dr. <u>Lease</u> Expense	\$11,962
Cr. Right of Use Asset	\$(12,666)	Cr. Right of Use Asset	\$(11,962)

ADJUSTMENTS TO ROU ASSET

- At adoption, the ROU asset and lease liability will agree, unless you have the following items:
 - Lease incentives
 - Initial direct costs
 - Beginning deferred rent
- Any difference between the cash expenditure for leases and the expense recorded on a straight-line basis will flow through the ROU asset
- Example initial journal entry to record ROU asset and lease liability:

Account	Debit	Credit
ROU asset	\$10,000	
Deferred rent	\$2,000	
Lease liability		\$12,000

OVERVIEW – KEY CHANGES

- Significant changes include:
 - New definition of a lease
 - Operating leases are now on the balance sheet (lessee accounting)
 - Lease reassessment requirements
 - Lease modification accounting
 - More judgment is required – e.g., reasonably certain is a high degree of confidence that a future event will occur based on all economic factors relevant to that assessment. See ASC 842-10-55-26 for guidance.
 - Disclosure requirements for lessees

POLLING QUESTION #1

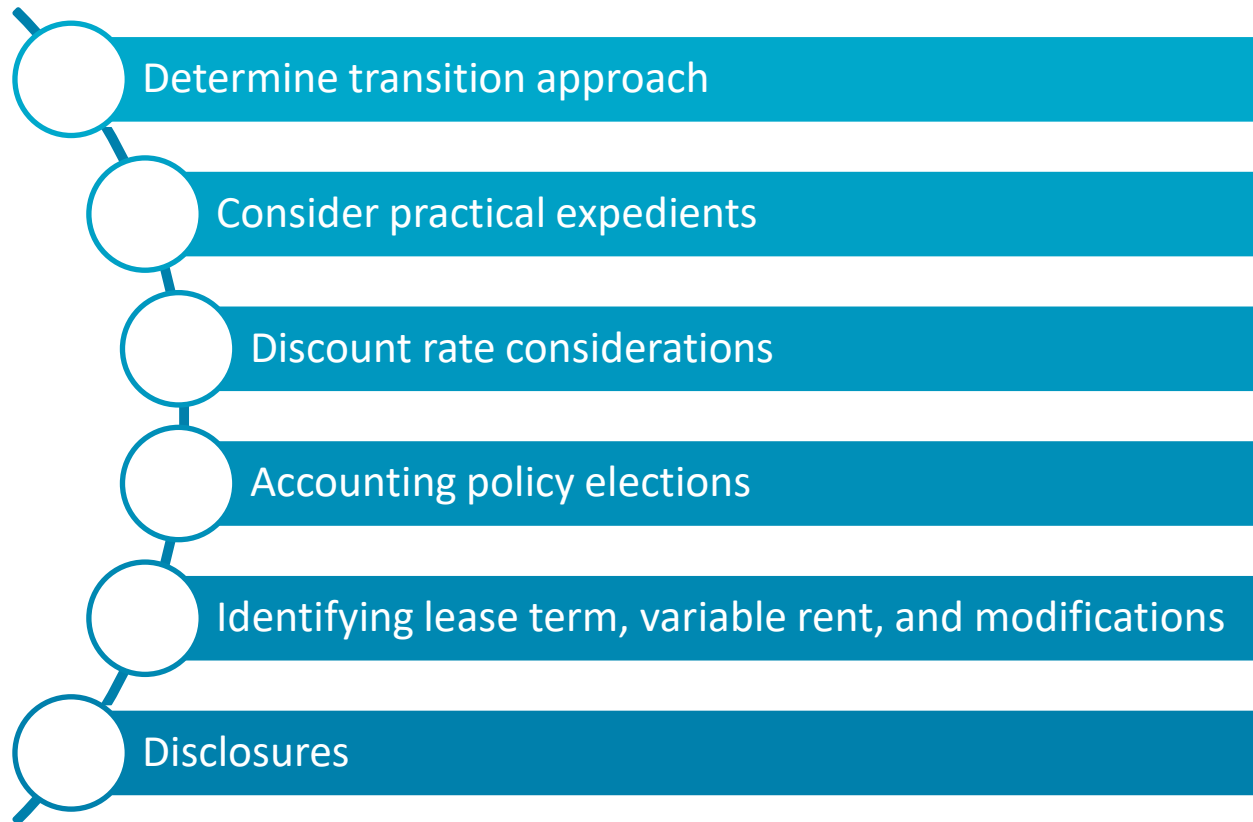
True or False?

- Under ASC 842 interest and amortization expense will now be recorded as separate line items on the income statement for all operating leases that meet the criteria to be capitalized as a right-of-use asset and corresponding lease liability.

POLLING QUESTION #1 - ANSWER

- **False** – While there is a separate interest and amortization expense component for all operating leases that meet the criteria to be recorded on the books as a right of use asset and lease liability, these amounts are combined into a single line item on the P&L as “lease (or rent) expense.”

IMPLEMENTATION CONSIDERATIONS



TRANSITION OPTIONS

- **Method 1:** modified retrospectively to each prior reporting period presented
 - The date of initial application is the beginning of the earliest comparative period presented

- **Method 2:** cumulative effect recognized at beginning of the period of adoption
 - Apply ASC 840 in pre-ASC 842 comparative periods
 - Recognize the effects of applying ASC 842 as a cumulative-effect adjustment to retained earnings as of January 1 in the year of adoption

PRACTICAL EXPEDIENTS

Several optional practical expedients are available:

<p>Must be elected as a package at the adoption date</p>	<p>An entity may elect not to reassess:</p> <ul style="list-style-type: none"> • If a contract meets the new <u>definition</u> of a lease • Lease <u>classification</u> for expired or existing leases • If capitalized <u>initial direct costs</u> qualify for capitalization under ASC 842
<p>May be elected individually or with the other practical expedients</p>	<ul style="list-style-type: none"> • An entity may use <u>hindsight</u> in determining the lease term (e.g., evaluating renewal options, termination options and purchase options)
<p>Private company practical expedient</p>	<p>A non-public entity may elect to:</p> <ul style="list-style-type: none"> • Utilize a <u>risk-free rate</u> for a period comparable to the lease term instead the incremental borrowing rate

DISCOUNT RATE

Rate Implicit in Lease

- Pro: Will be most accurate / applicable for the lease
- Con: May not be easily determinable

Incremental Borrowing Rate

- Pro: Easier to determine than implicit rate*
- Con: May be difficult to determine if the Company does not have any debt

Risk-Free Rate

- Pro: Easiest to determine
- Con: Will result in significantly higher ROU asset and lease liability balance

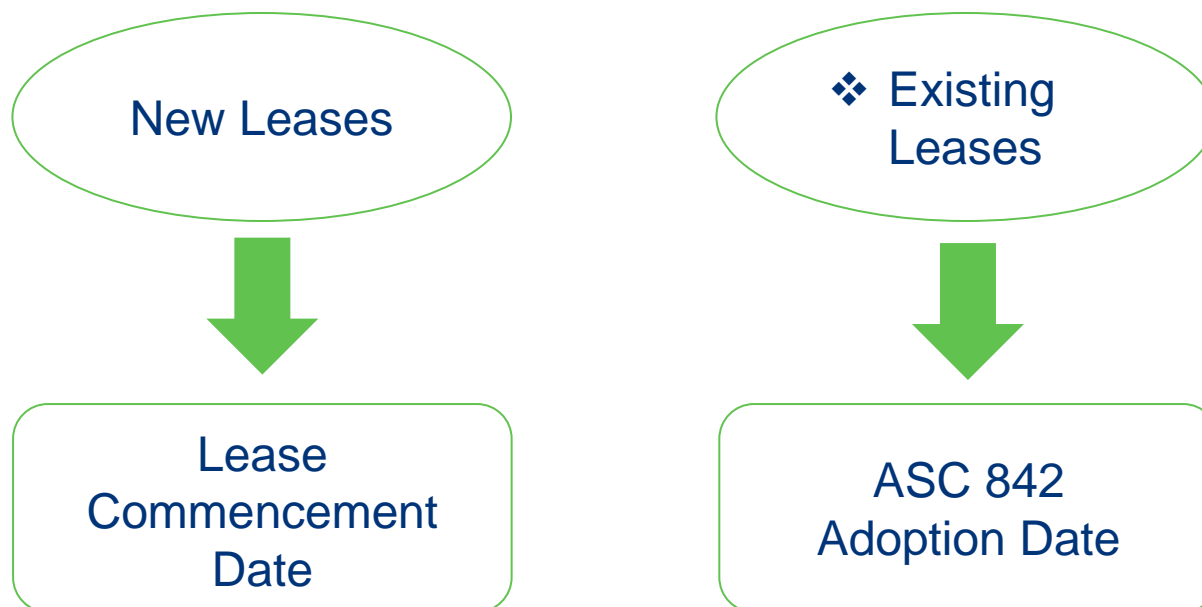
* Must be over a similar term and an amount equal to the lease payments in a similar economic environment

DISCOUNT RATE – ASU 2021-09

- **Changes:** Discount rate for lessees that are not public business entities
 - Allow a qualified lessee to make the risk-free discount rate accounting policy election by class of underlying asset
 - Lessees would be required to disclose its election
 - Require a qualified lessee to use the rate implicit in the lease when it is readily determinable instead of the risk-free rate, regardless of whether the lessee applies the risk-free rate election.

DISCOUNT RATE

- At what date should the discount rate be calculated?

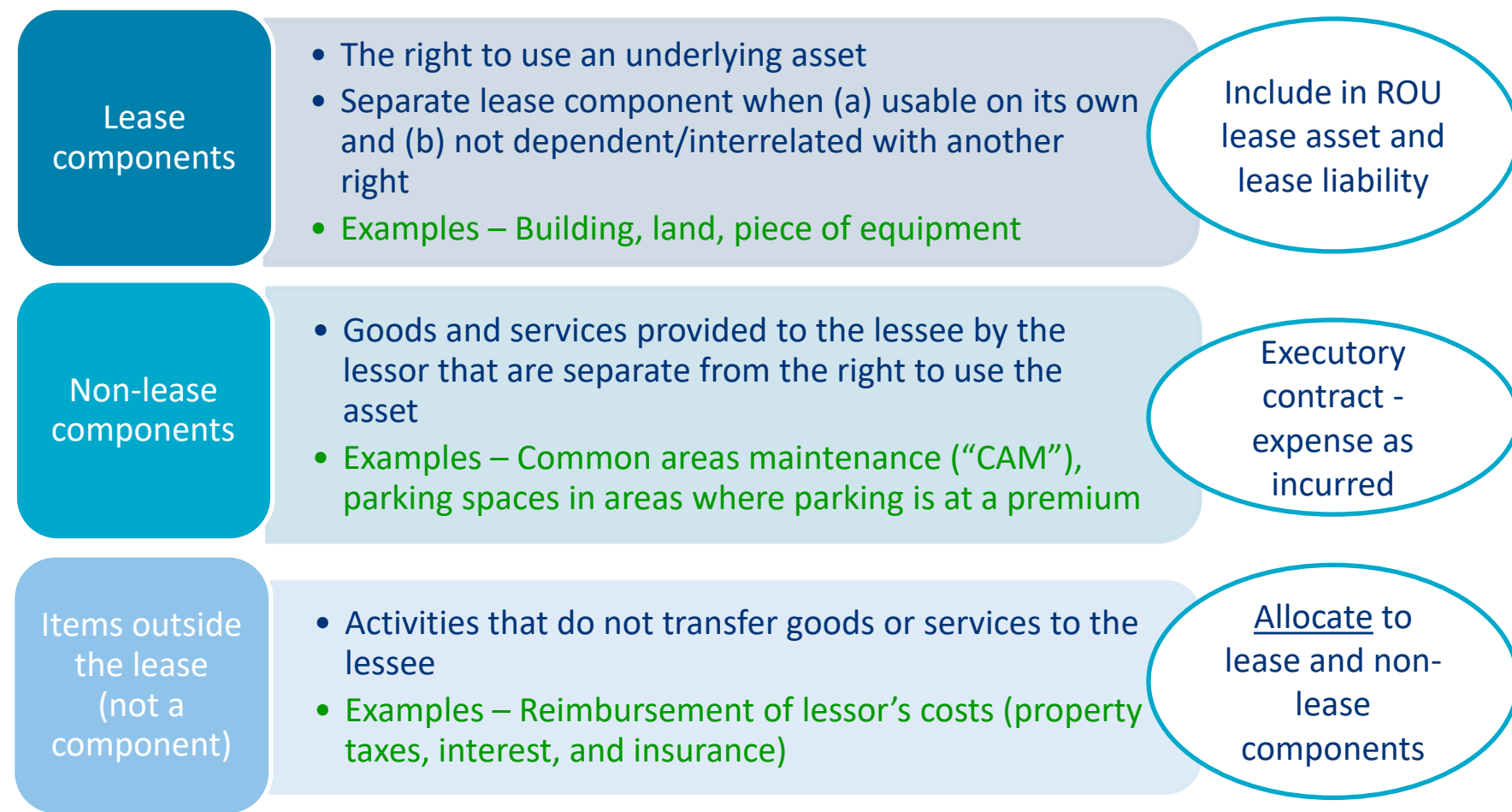


- ❖ Unless the hindsight practical expedient is elected
- ❖ If the IBR or risk-free rate is utilized you can either use the original term or remaining lease term, but must be consistent

ACCOUNTING POLICY ELECTIONS

- Depending on your situation, the election of certain accounting policies could assist in making the transition and future accounting under ASC 842 less complicated.
 - ***Separation of lease and non-lease components*** – electing not to separate these items can reduce the administrative burden of identifying and separately accounting for any non-lease components
 - ***Portfolio approach*** – if the company has many leases with similar characteristics, this may simplify the process of identifying the lease classification, applying one discount rate, etc.
 - ***Short-term lease exemption*** – likely the most popular election and will enable a company to exclude short-term leases from the ROU asset and lease liability calculations (BEWARE of renewal options)
 - ***Materiality thresholds*** – if the present value of the ROU asset is below your threshold for capitalization of assets, it can be excluded

LEASE AND NON-LEASE COMPONENTS



POLLING QUESTION #2

Which of the following is a non-lease component?

- A. Property taxes
- B. Insurance
- C. Snow Removal
- D. All of the above

POLLING QUESTION #2 - ANSWER

Which of the following is a non-lease component?

- C – Snow Removal

LEASE AND NON-LEASE COMPONENTS

- Allocating consideration to lease and non-lease components

Lessee	Based on a relative standalone selling price
Lessor	Follow the guidance in ASC 606

- Lessees and Lessors can make an accounting policy election to not separate a lease component from its associated non-lease components.



LEASE AND NON-LEASE COMPONENTS – FIXED VS. VARIABLE

	Fixed	Variable that Depends on Index or Rate	Variable and Not Based on Index or Rate
Common area maintenance (CAM)	<ul style="list-style-type: none"> • Included as non-lease component • Practical expedient can be elected not to separate 	<ul style="list-style-type: none"> • Included as non-lease component measured using rate at commencement • Practical expedient can be elected not to separate 	<ul style="list-style-type: none"> • Not included with contract consideration for initial evaluation.
Taxes and Insurance	<ul style="list-style-type: none"> • Included as part of the total bundled lease consideration and do not need to be separated 	<ul style="list-style-type: none"> • Included as part of the total bundled lease consideration and not a separate component 	<ul style="list-style-type: none"> • Not included with contract consideration

LEASE AND NON-LEASE COMPONENTS – EXAMPLE #1

Lessor and lessee entered into a 5-year building lease whereby the lessee is required to pay for the following:

- Use of the building
- Real estate taxes
- Insurance (lessor is named as the insured on the building)
- Payments are fixed at \$10,000 per year; however, annual taxes and insurance will vary and are billed separately to the lessee

Analysis:

- Real estate taxes and insurance are outside of the lease
- Real estate taxes and insurance are variable lease payments that do not depend on an index or rate and are excluded from the measurement of the lease liability
- Expensed as variable lease payments in accordance with ASC 842-20-25-6

LEASE AND NON-LEASE COMPONENTS – EXAMPLE #2

Assume the same facts as noted in the previous slide, with the following changes:

- Payments are fixed at \$13,000 per year and are itemized as follows:
 - \$10,000 – Rent
 - \$ 2,000 – Real Estate Taxes
 - \$ 1,000 – Insurance

Analysis:

- Real estate taxes and insurance are outside of the lease
- The \$65,000 in payment ($\$13,000 * 5$ years) are all lease payments for the single component of the contract and are included in the measurement of the lease liability.

LEASE AND NON-LEASE COMPONENTS – EXAMPLE #3

Assume the same facts as noted in the previous slide, except the lease is for a space within the building, rather than for the entire building, and the fixed annual payment of \$13,000 also covers the following charges:

- Cleaning of common areas
- Parking lot maintenance
- Utilities to the building

Analysis:

- Common area maintenance (CAM) is a non-lease component since the lessor's activities transfer services to the lessee
- The \$65,000 in payments ($\$13,000 * 5 \text{ years}$) is allocated between the two components (lease and non-lease) unless the practical expedient is elected

LEASE TERM

Noncancelable period for which the lessee has the right to use the underlying asset, adjusted for:

- **Lessee-controlled options:** Extension/renewal periods or termination options, if lessee is reasonably certain to exercise (or not exercise).
- If lessee subsequently changes its assessment of lease term, it will trigger remeasurement of lease payments and lease liability
- **Lessor-controlled options:** Assume that lessor will trigger the extension/renewal option and not terminate the lease.

REASONABLY CERTAIN THRESHOLD

- Reasonably certain should be considered a high threshold; however, there are no bright lines for this criteria.
- An entity should assess whether it is reasonably certain that the lessee will exercise an option by considering all factors relevant to that assessment, including the following:
 - If a significant economic incentive exists
 - If the pricing of the lease renewal option is below or above market rates
 - If there are significant leasehold improvements that would be impaired if renewal option is not taken
 - If significant lease termination or relocation costs would be incurred if renewal option is not taken
 - The importance of the lease to the lease's operations in avoiding any business interruptions.

POLLING QUESTION #3

What economic factors must be considered for options to extend or renew the lease term?

- A. Contract factors (e.g., Hefty termination penalty)
- B. Asset-specific factors (e.g., Highly-specialized asset)
- C. Entity-specific factors (e.g., Asset is critical to entity's operations)
- D. Market factors (e.g., Renewal is priced far below market)
- E. All of the above

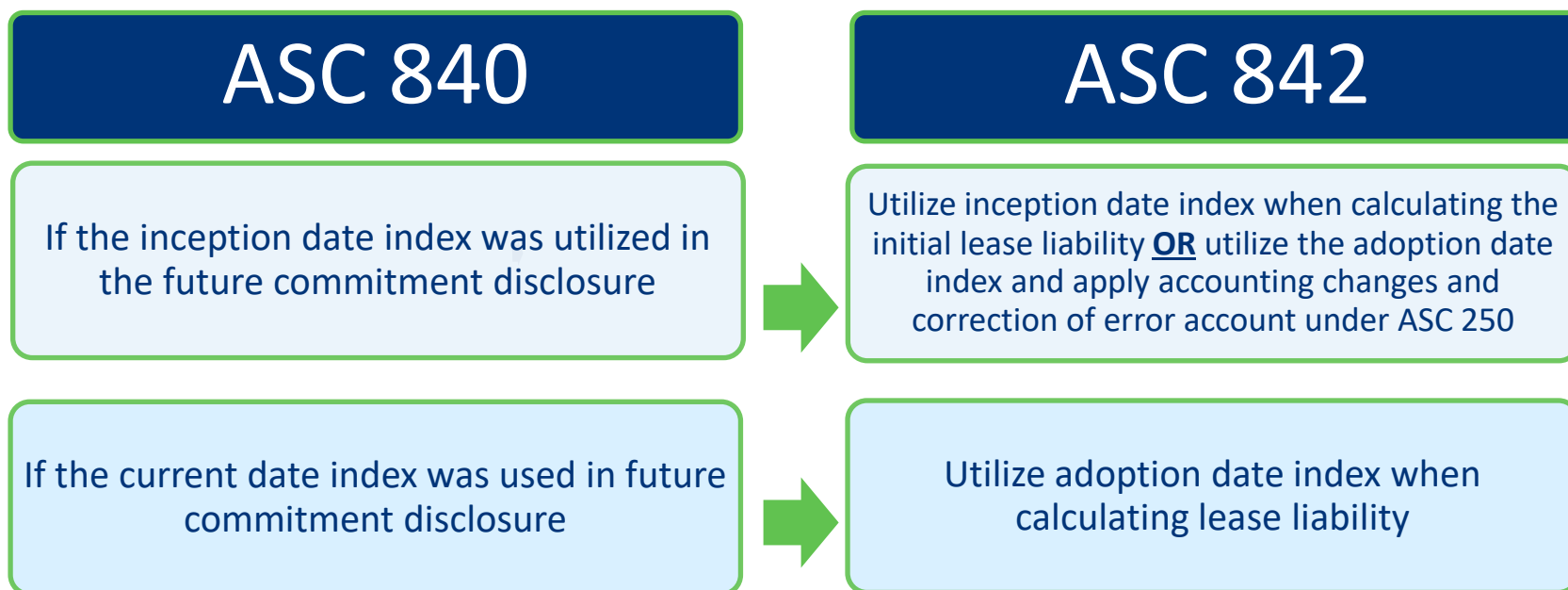
POLLING QUESTION #3 – ANSWER

What economic factors must be considered for options to extend or renew the lease term?

E. All of the above

VARIABLE LEASE PAYMENTS – INDEX

- Variable lease payments that depend on an index or rate should be included in the calculation of lease payments when classifying a lease and in the measurement of the lease liability.



- Changes to the CPI each year do **NOT** require remeasurement, but instead will be **expensed** as incurred and included in **variable** rent expense.

VARIABLE LEASE PAYMENTS – INDEX EXAMPLE

Facts:

- Company X entered into a lease agreement beginning January 1, 2017 for a term of 5 years.
- The Company adopted ASC 842 effective January 1, 2019
- The Company's incremental borrowing rate at the date of adoption was 6.5%
- Lease payments for year 1 are \$120,000
- Each year lease payments are increased by an amount equivalent to the percentage increase in the prior year Consumer Price Index (CPI)
- Under ASC 840, the Company disclosed future commitments utilizing the inception date index and plans to calculate the lease liability utilizing the inception date index.

VARIABLE LEASE PAYMENTS – INDEX EXAMPLE

Analysis:

Lease Year Post Adoption	Inception Date Index	Payment Utilized for Lease Liability	Actual Index	Actual Payments	Rent Expense	Variable Lease Expense
2019	3.00%	\$127,308	3.25%	\$127,617	\$127,419	\$309
2020	3.00%	\$131,127	3.50%	\$132,084	\$127,419	\$957
2021	3.00%	\$135,061	3.75%	\$137,037	\$127,419	\$1,976
Total		\$393,496		\$396,738	\$393,496	\$3,241

LEASE MODIFICATIONS

- Any change to the contractual terms and conditions of a lease.
- For Lessee:
 - a) Account for a lease modification as a separate contract when:
 - grants the lessee an additional ROU asset

AND

 - the price of the additional ROU asset has its stand-alone price
 - b) If not a separate contract use the discount rate as of the modification effective date to adjust lease liability and ROU asset for the change in the lease payment
 - c) could result in a gain or loss if the modification results in a full or partial termination of an existing lease
- For Lessor: account for a lease modification based on ASC 606

LEASE MODIFICATION – EXAMPLE #1

Facts:

- Company X leases two trucks under a 5 year lease classified as an operating lease. At the end of year 2, the Company and the lessor agree to modify the lease to eliminate one of the trucks, the remaining truck continues to be leased subject to the original lease terms.

Analysis:

- Under ASC 842 the Company would remeasure the lease liability using the discount rate as of the modification date and adjust the right of use asset proportionally. For example, if the ROU asset and lease liability are \$48,000 and \$56,000, respectively, as of the modification date and the remeasured lease liability is now \$24,000

Journal Entry Posted:

Account	Debit	Credit
Lease liability	\$32,000	
ROU asset		\$27,428
Gain on modification		\$4,572

LEASE MODIFICATION – EXAMPLE #2

Facts:

- On January 1, 2018, Company enters into a 5-year lease for 2,000 sqft of warehouse space for \$10,000 per month
- On December 31, 2018, the Company amends the lease contract to include an additional 1,000 sqft of warehouse space in the same building for remaining 4 years
- The Company will pay \$6,000 per month for the additional space, which is inline with market rates for 1,000 sqft of space
- Going forward the Company will make one payment of \$16,000 per month

Analysis:

- Company will account for additional 1,000 sqft of space as a separate lease
- At the adoption date of ASC 842 on January 1, 2019, the Company has two leases:
 1. Original lease for 2,000 square feet for remaining 4 years
 2. A new lease for 1,000 square feet for 4 years

DISCLOSURES

Additional disclosure requirements apply to lessees and lessors:

- Qualitative information
 - Description of leases
 - Basic terms and conditions of leases
 - Existence of options to extend or terminate a lease and which options are recognized as part of its ROU assets and lease liabilities
- Quantitative information
 - Details of lease cost
 - Weighted average remaining lease term
 - Weighted average discount rate *
- Transition disclosures
 - Required by ASC 250, Accounting Changes and Error Corrections
 - Use of practical expedients

** Weighted-average discount rate does not need to be separated between leases using a risk-free rate and leases using an incremental borrowing rate, per Sept 2021 tentative board decision*

POLLING QUESTION #4

Which of the following items must be disclosed separately in the lease footnote for lessees?

- A. Finance lease cost
- B. Operating lease cost
- C. Variable lease cost
- D. Sublease income
- E. All of the above

POLLING QUESTION #4 - ANSWER

Which of the following items must be disclosed separately in the lease footnote for lessees?

- E – All of the above. A lessee should disclose all components of the expense separately and in total.

HOW CAN WE HELP?

UHY Lease Implementation Team

Summarize lease terms and
verify lease completeness

Calculate the ROU asset
and lease liability

Assist management in
documenting practical
expedient and accounting
policy elections

Determine lease classification
for new and/or existing leases
under new standard

Discuss and determine
likelihood of lease renewal
and purchase options

Calculate monthly or annual
journal entries

Development of appropriate
discount rate

Prepare reports and
disclosure data

LEASE SOFTWARE

UHY is a Software Reseller

Features

- Discounted pricing
- User-friendly interface
- Cloud-based solution
- Access controls for clients and third parties (consultants, auditors, etc.)
- Leases can be entered individually or in bulk
- Automated quantitative footnote disclosures
- US GAAP or IFRS calculations

Reports

- Disclosure summary reports
- Amortization schedules
- Journal entries

QUESTIONS

Who has the first question?



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