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CPAs & Advisors

**INSIGHT INTO THE IMPACT OF THE NEW
LEASE ACCOUNTING STANDARD.**

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Agenda

Lease Accounting

1. Overview of technical standard
2. Considerations to be made in valuing leases
 - Discount rate, measurement period
3. Impact on financial statements and disclosures
4. Impact on key financial and covenant ratios

Q&A

February 27, 2019

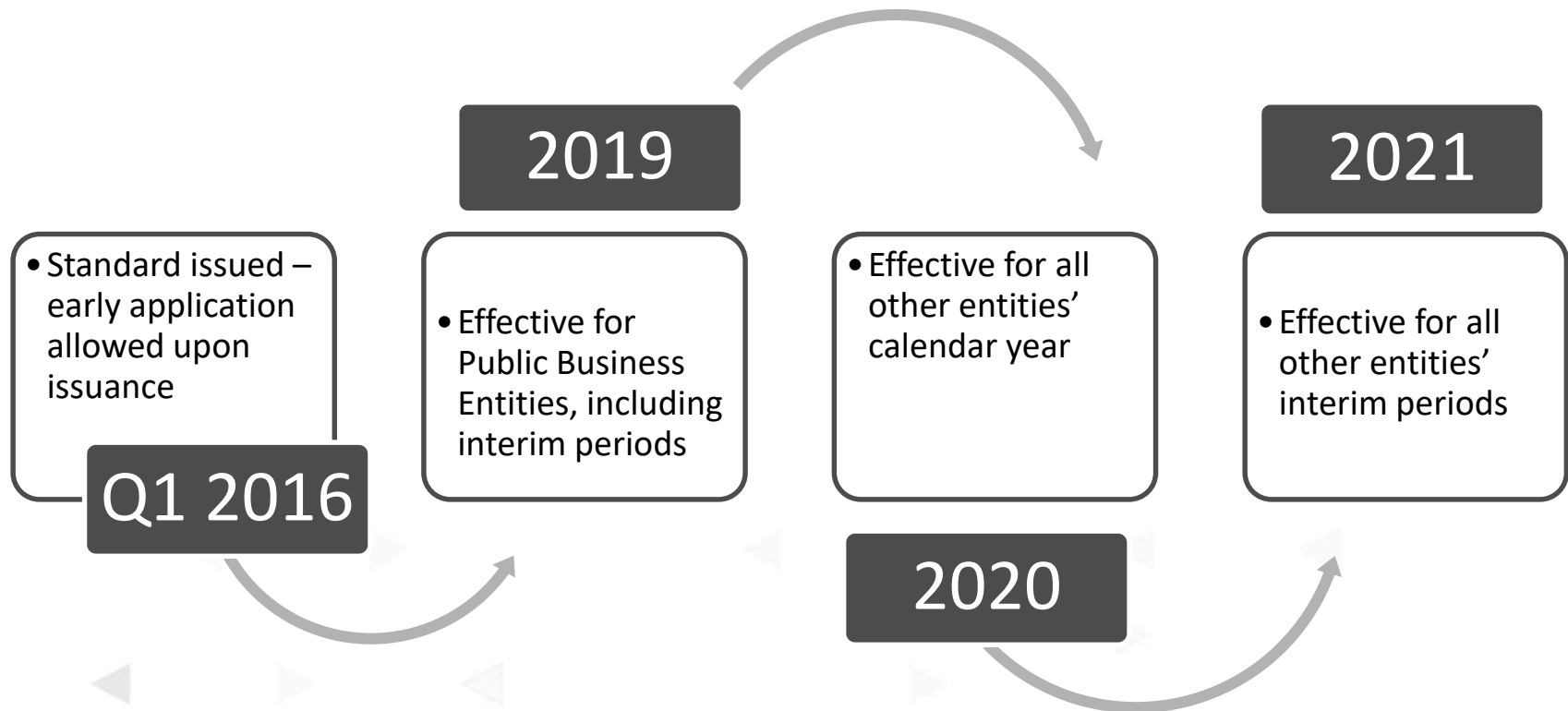
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ASU 2016 – 02 LEASES (TOPIC 842)

ASU 2016-02 LEASES (TOPIC 842)

ALL LEASES >1 YEAR ARE RECOGNIZED ON THE BALANCE SHEET



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SUBSEQUENT AMENDMENTS

ASU 2016-02

Leases (Topic 842)



ASU 2017-03

Leases (Topic 842): SEC Update



ASU 2018-01

Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842



ASU 2018-10

Codification Improvements to Topic 842, Leases



ASU 2018-11

Leases (Topic 842): Targeted Improvements



Exposure Draft

Practical Expedients for Sales Taxes & Certain Lessor Costs Paid by Lessees

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ASU 2016-02 LEASES (TOPIC 842)

Lessee:

All leases with a reasonably certain term of greater than one year result in a liability and an asset representing a lessee's right to use the underlying asset for the lease term



ASU 2016-02 LEASES (TOPIC 842)

- FASB's reasons for new standard
 - "...more faithful representation of an organization's leasing activities..."
 - SEC – largest form of off-balance sheet financing
 - 2005 SEC estimate - \$1.25 trillion off-balance sheet operating lease commitments for SEC registrants

ASU 2016-02 LEASES (TOPIC 842)

- Current U. S. GAAP
 - Operating leases (off-balance sheet)
 - Capital leases
- New Lessee Model – Dual Approach
 - Annual expense recognition in lessee's income statement depends on lease classification as either
 - Finance Lease - Financing approach (front-loaded expense pattern similar to today's capital leases with interest & amortization recognition) **or**
 - Operating Lease - Straight-line expense (similar to today's operating leases with lease expense recognition)

ASU 2016-02 LEASES (TOPIC 842)

Identified Asset

- Explicitly or implicitly specified
- Not able to substitute

Right to Control

- Decision-making authority
- Substantially all the economic benefits

Lease

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graph TD; A[Identified Asset] --> C((Lease)); B[Right to Control] --> C;
```



AN IDENTIFIED ASSET

A leased asset must be specifically identifiable either explicitly, *e.g.*, by a serial number, or implicitly, *e.g.*, the only asset that would satisfy the lease contract, at the time the asset is made available for use by the customer, & supplier does not have substantive substitution rights

- Supplier does not have practical ability to substitute alternative asset, *e.g.*, customer can prevent substitution
- Supplier would not benefit from substituting alternative asset

A physically distinct portion of a larger asset could represent a specified asset, *e.g.*, one floor of a building, or segment of a pipeline that connects a single customer to a larger pipeline. A capacity portion of a larger asset generally is not a specified asset.



RIGHT TO CONTROL THE USE OF THE ASSET

A lease contract conveys the right to control the use of the identified asset for a specified period of time. A customer controls an identified asset when the customer has both of the following:

- Customer has right to direct its use, *e.g.*, the right to direct how & for what purpose the asset is used, including the right to change how & for what purpose the asset is used
- Customer has right to obtain substantially all economic benefits from its use

ASU 2016-02 LEASES (TOPIC 842)

- Finance Lease Criteria
 - **Ownership of Asset Transfers** to lessee by end of lease term
 - Lease grants the **option to purchase asset** that the lessee is reasonably certain to exercise
 - **Lease term is for major part of the economic life** of asset
 - Criteria not used if the commencement date falls at the end of the life of the asset
 - **Present value of minimum lease payments** equals or exceeds substantially all of fair value of leased asset
 - Leased **asset is of such specialized nature** that it is expected to have no alternative use to the lessor at the end of the term
- If finance lease criteria are not met the lease is classified as operating

LESSEE CLASSIFICATION

Lessee is required to reassess lease classification throughout the lease term upon the occurrence of—

- A change in lease term
- A change in the lessee's assessment of whether it is reasonably certain to exercise a purchase option
- A contract modification that is not accounted for as a separate lease

Assumptions used, including discount rate, fair value & remaining economic life of the underlying asset are updated as of the modification effective date

LESSEE ACCOUNTING – INITIAL MEASUREMENT

- Initial Measurement of Lessee Right of Use Asset & Lease Liabilities
 - Lease Liability = present value of future lease payments (reasonably certain)
 - Option to purchase
 - Termination penalties
 - Implicit rate or incremental borrowing rate
 - Right of Use Asset = Lease Liability + Initial Direct Costs – Lessor-provided incentives
- No re-measurement unless the lease is modified

LEASE PAYMENTS

Lease Payments					
Fixed lease payments	Certain variable payments	Purchase options	Termination penalties	Lessee-paid SPE structuring fees	Residual Value Guarantee (RVG) (lessee only)

- Fixed lease payments consist of the lease payments per the lease agreement plus in-substance lease payments less lease incentives paid or payable to the lessee
- Variable lease payments should be calculated at lease commencement, using the index or rate at lease commencement & no future changes in the rate or index should be estimated
- Include only the present value of any payment under a lessee RVG that is probable of being owed



LEASE TERM

Lease term is the noncancelable period in which the lessee has the right to use an underlying asset, plus optional periods for which, after considering all relevant factors that may give lessee economic incentive to renew or terminate, it is **reasonably certain** the lessee will—

- exercise the renewal option, or
- not exercise the termination option, or
- the exercise of those options is controlled by the lessor

DISCOUNT RATE

The discount rate is the rate implicit in the lease at the lease commencement date. If the implicit rate is not determinable, the lessee will use its incremental borrowing rate at the lease commencement date. The incremental borrowing rate is the rate at which a lessee could borrow for a similar amount from its lending institution.

Incremental Borrowing Rate	
ASC 840	ASC 842
The rate the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset	The rate of interest 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 are permitted to make an accounting policy election to use the risk-free rate when measuring their lease obligations; once elected it must be used consistently for all leases.

INITIAL DIRECT COST

Initial Direct Costs	
Included	Excluded
Commissions	Fixed employee salaries
Legal fees resulting from the execution of the lease	Internal engineering costs
Lease document preparation costs incurred after the execution of the lease	Legal fees for services rendered before the execution of the lease
Certain payments to existing tenants to terminate a lease	Negotiating lease term & conditions
Consideration paid for a guarantee of a residual asset by an unrelated third party	Advertising
	Other origination efforts
	Depreciation
	Costs related to an idle asset

INCEPTION DATE VS. COMMENCEMENT DATE

- Lease commencement is the date a lessor makes an underlying asset available for use to a lessee & is the date for classification, recognition & measurement
 - The determination of whether a contract is a lease or contains a lease is done at the inception date
 - Lease classification, recognition & measurement are determined at the lease commencement date

LESSEE CLASSIFICATION & MEASUREMENT RELIEFS

- Lessees are permitted to apply requirements to a portfolio of similar leases, rather than to each individual lease
- For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets & lease liabilities
 - Lessees are permitted to recognize the payments on a short-term lease, generally on a straight-line basis over the lease term—in a manner similar to their recognition of an operating lease today

LESSEE CLASSIFICATION & MEASUREMENT RELIEFS

Lessee should remeasure the lease liability and adjust the ROU asset if any of the following occur—

1. The lease is modified & the modification is not accounted for as a new contract*
2. A contingency is resolved such that some or all variable payments become fixed
3. There is a reassessment of the lease term
4. A change in the assessment of whether the lessee is reasonably certain to exercise or not exercise an option to purchase the underlying asset
5. A change in amounts probable of being owed by the lessee under residual value guarantees

*Requires reallocation of the remaining consideration in the contract using an updated discount rate; other occurrences may or may not

LIABILITY REMEASUREMENT REQUIREMENTS

- When remeasurement occurs, lessee should measure variable lease payments based on the index or rate at the remeasurement date, & remeasure amounts probable of being owed under residual value guarantees
- A lessor only remeasures lease payments upon a lease modification

ASU 2016-02 LEASES (TOPIC 842)

- Lease Example - Building
 - 10 year lease term
 - \$50,000 annual payments – paid in advance
 - \$15,000 initial direct cost
 - 3.5% incremental borrowing rate

ASU 2016-02 LEASES (TOPIC 842)

- Lease Example – Building – Initial Measurement

- Lease Liability

- $\$50,000 + \$380,384$ (PV of 9 yrs of pmts) = **$\$430,384$**

- Right of Use Asset

- $\$50,000 + \$380,384$ (PV of 9 yrs of pmts) + $\$15,000$ = **$\$445,384$**

ASU 2016-02 LEASES (TOPIC 842)

- Lease Example – Building – Annual Recognition
- Operating Lease

Right of Use Asset				Lease Liability			
Year	Lease Expense	Interest	Carrying Value	Year	Payment	Interest	Carrying Value
0			445,384.00				430,384.00
1	(51,500.00)	13,313.44	407,197.44	1	(50,000.00)	13,313.44	393,697.44
2	(51,500.00)	12,029.41	367,726.85	2	(50,000.00)	12,029.41	355,726.85
3	(51,500.00)	10,700.44	326,927.29	3	(50,000.00)	10,700.44	316,427.29
4	(51,500.00)	9,324.96	284,752.25	4	(50,000.00)	9,324.96	275,752.25
5	(51,500.00)	7,901.33	241,153.57	5	(50,000.00)	7,901.33	233,653.57
6	(51,500.00)	6,427.88	196,081.45	6	(50,000.00)	6,427.88	190,081.45
7	(51,500.00)	4,902.85	149,484.30	7	(50,000.00)	4,902.85	144,984.30
8	(51,500.00)	3,324.45	101,308.75	8	(50,000.00)	3,324.45	98,308.75
9	(51,500.00)	1,691.25	51,500.00	9	(50,000.00)	1,691.25	50,000.00
10	(51,500.00)	(0.00)	(0.00)	10	(50,000.00)	(0.00)	(0.00)

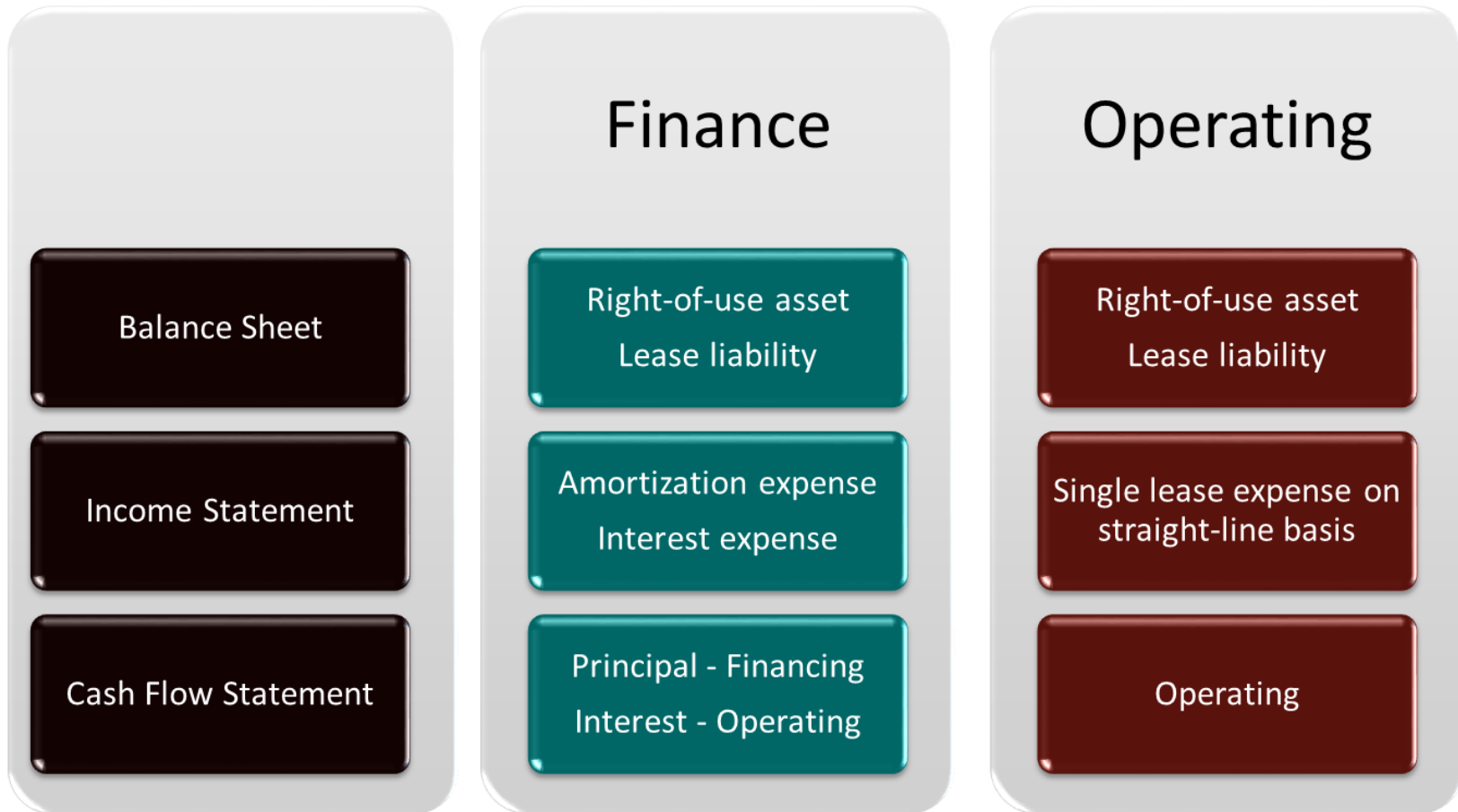
ASU 2016-02 LEASES (TOPIC 842)

- Lease Example – Building – Annual Recognition
- Finance Lease

Right of Use Asset		
Year	Amortization	Carrying Value
0		445,384.00
1	44,538.40	400,845.60
2	44,538.40	356,307.20
3	44,538.40	311,768.80
4	44,538.40	267,230.40
5	44,538.40	222,692.00
6	44,538.40	178,153.60
7	44,538.40	133,615.20
8	44,538.40	89,076.80
9	44,538.40	44,538.40
10	44,538.40	(0.00)

Lease Liability			
Year	Payment	Interest	Carrying Value
			430,384.00
1	(50,000.00)	13,313.44	393,697.44
2	(50,000.00)	12,029.41	355,726.85
3	(50,000.00)	10,700.44	316,427.29
4	(50,000.00)	9,324.96	275,752.25
5	(50,000.00)	7,901.33	233,653.57
6	(50,000.00)	6,427.88	190,081.45
7	(50,000.00)	4,902.85	144,984.30
8	(50,000.00)	3,324.45	98,308.75
9	(50,000.00)	1,691.25	50,000.00
10	(50,000.00)	(0.00)	(0.00)

ASU 2016-02 LEASES (TOPIC 842)



BALANCE SHEET – OPERATING LEASE EXAMPLE

	Current GAAP	ASU 2016-02
Total Current Assets	\$ 1,500,000	\$ 1,500,000
Other Assets	25,000	25,000
Finance Lease Assets	2,200	2,200
ROU Assets	-	445,384
Property, Plant & Equipment	67,000	67,000
Total Noncurrent Assets	94,200	539,584
Total Assets	\$ 1,594,200	\$ 2,039,584

BALANCE SHEET – OPERATING LEASE EXAMPLE (CONT)

	Current GAAP	ASU 2016-02
Current Maturities of Long-Term Debt & Finance Leases	\$ 1,700	\$ 1,700
Current Maturities of Operating Leases	-	36,687
Other Current Liabilities	55,000	55,000
Total Current Liabilities	56,700	93,387
Finance Lease Liabilities	1,200	1,200
Operating Lease Liabilities	-	393,697
Borrowings	250,000	250,000
Total Liabilities	307,900	738,284
Equity	1,286,300	1,301,300
Total Liabilities & Equity	<u>\$ 1,594,200</u>	<u>\$ 2,039,584</u>

INCOME STATEMENT – OPERATING LEASE EXAMPLE

	Current GAAP	ASU 2016-02
Revenue & Other Income	\$ 1,175,000	\$ 1,175,000
Cost of Sales	(850,000)	(850,000)
Gross Profit	325,000	325,000
Operating Costs	(126,700)	(111,700)
EBITDA	198,300	213,300
Depreciation & Amortization	(15,300)	(15,300)
Operating Profit	183,000	198,000
Net Finance Costs	(1,300)	(1,300)
Profit Before Tax	181,700	196,700
Income Tax	(38,000)	(38,000)
Profit for Year	<u>\$ 143,700</u>	<u>\$ 158,700</u>

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STATEMENT OF CASH FLOWS AND LEVERAGE RATIOS- OPERATING LEASE EXAMPLE

	Current GAAP	ASU 2016-02
Operating Activities	\$ 65,000	\$ 50,000
Investing Activities	\$ (50,000)	\$ (65,000)
Financing Activities	\$ (25,000)	\$ (25,000)
Total Cash Outflow	\$ (10,000)	\$ (10,000)
Leverage Ratios (Common Debt Covenant Ratios)		
Total Commitments (Borrowings plus Lease Liabilities) to EBITDA	1.275	3.031
Interest Cover (EBITDA to Net Finance Costs)	5.67	6.09
Debt to Equity	0.20	0.50
Performance Ratios		
ROCE: Return on Capital Employed (operating profit/(equity + borrowings + lease liab.))	11.89%	10.16%


LESSEE MODEL – SUBSEQUENT ACCOUNTING

- Annual expense recognition & subsequent amortization of ROU asset depends on lease classification
 - Finance lease
 - Front-loaded expense pattern similar to today's capital leases with interest & amortization recognized separately
 - Interest determined on the lease liability in each period during the lease term as the amount that produces a constant periodic discount rate
 - ROU asset generally amortized on a straight-line basis
 - Operating lease
 - Straight-line expense recognition similar to today's operating leases
 - ROU asset: Reduced by the difference between the lease expense & the interest cost on the lease liability

DISCLOSURE OBJECTIVE


Enable users of financial statements to assess amount, timing & uncertainty of cash flows arising from leases.





NEW DISCLOSURES: LESSEE

- Information about leases that have not yet commenced but create significant rights & obligations for the lessee
- Significant judgments, including
 - The determination of whether a contract contains a lease
 - The allocation of the consideration in a contract between lease & nonlease components
 - The determination of the discount rate for the lease
- Short-term lease accounting policy election
- Election of the practical expedient on not separating lease components from nonlease components

A dark, high-angle photograph of a construction site at dusk or night. The image shows a complex network of steel beams, scaffolding, and concrete structures. A crane is visible in the upper left corner. The overall tone is industrial and somewhat somber due to the low light.

NEW DISCLOSURES: LESSEE

- Amounts segregated between those for finance & operating leases for the following items
 - Cash paid for amounts included in the measurement of lease liabilities, segregated between operating & financing cash flows
 - Supplemental noncash information on lease liabilities arising from obtaining ROU assets
 - Weighted-average remaining lease term
 - Weighted-average discount rate

CASH PAID AMOUNTS BY LEASE CLASSIFICATION

Lease Presentation & Disclosure Requirements: Lessee

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2016	2017	2016
Operating lease cost	\$ 399	\$ 434	\$ 787	\$ 694
Finance lease cost:				
Amortization of right-of-use assets	\$ 57	\$ 23	\$ 105	\$ 38
Interest on lease liabilities	44	15	74	27
Total finance lease cost	\$ 101	\$ 38	\$ 179	\$ 65

SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental cash flow information related to leases was as follows:

(In millions)	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2016	2017	2016
Cash paid for amounts included in the measurement of lease liabilities:				
Operating cash flows from operating leases	\$ 375	\$ 314	\$ 744	\$ 581
Operating cash flows from finance leases	45	15	75	27
Financing cash flows from finance leases	31	9	56	15
Right-of-use assets obtained in exchange for lease obligations:				
Operating leases	308	119	699	174
Finance leases	650	498	1,378	765

WEIGHTED AVERAGE REMAINING LEASE TERM AND DISCOUNT RATES

Weighted Average Remaining Lease Term

Operating leases	7 years	7 years
Finance leases	14 years	13 years

Weighted Average Discount Rate

Operating leases	2.5%	2.5%
Finance leases	5.0%	4.7%

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ASU 2016-02 LEASES (TOPIC 842)

- Transition

- Standard Applies to All Outstanding Leases

- Modified Retrospective Approach

- Need not reassess whether existing contracts contain leases
 - Need not reassess lease classification for existing leases
 - Capital = Finance
 - Operating = Operating
 - Need not reassess initial direct costs for existing leases

IMPACT ON CLIENT – ACCOUNTING & REPORTING

POLICIES, PROCESSES & CONTROLS

- Inventory & assessment of all agreements/contracts
- Significantly amend accounting policies & procedures
 - Ongoing remeasurement requirements, *e.g.*, index or rate changes, modification to contract terms, lessee’s assessment of options to extend or terminate, or purchase underlying asset
 - Increased disclosure requirements
 - Definitions requiring management’s judgment, *e.g.*, definition of lease, lease term, terminology, *e.g.*, “insignificant,” “reasonably certain,” “substantially all,” & book versus tax differences
- Internal control changes with policy & process changes

IMPACT ON CLIENT – INFORMATION SYSTEMS

SYSTEM REQUIREMENTS

- Separate recordkeeping for lease & nonlease components
- “Triggering” of reassessment criteria
- Maintain financial reporting risk at acceptable level
- Data retention & security; audit trails for lease classification & changes
- Support management’s financial statement forecasting & budgeting requirements, *e.g.*, anticipated changes in ROA & EBITDA calculations

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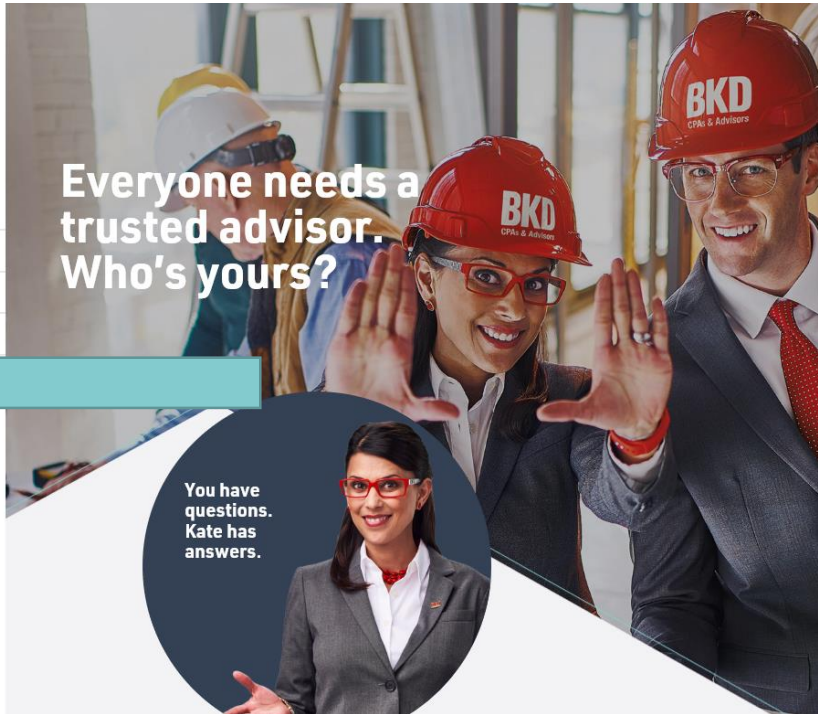
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