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842 Standards Update: Changes to Your Balance Sheet

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Agenda

- ✔ Changes from ASC 840 to 842
- ✔ Embedded Leases
- ✔ How to Prepare to Comply



ASC 842



Goal	Previously	Now
<ul style="list-style-type: none">✓ Increased visibility into company leasing obligations.	<ul style="list-style-type: none">✓ Capital leases – Recorded as assets and liabilities on balance sheet.✓ Operating leases – Off balance sheet.	<ul style="list-style-type: none">✓ All leases – Create an asset and liability that must be recorded.✓ Disclosure reports – Enhanced and require more quantitative & qualitative disclosures.

840 to 842: Capital/Finance Leases

840 Finance	842 Finance
Capitalized on balance sheet	Capitalized on balance sheet
Capital Lease Asset / Capital Lease Liability	ROU Asset / Lease Liability
Residual Value Guarantee included in minimum lease payments	Residual Value Guarantee only used in lease type test
Probable amount owed not considered	Probably amount owed used in minimum lease payments

Example: A \$5,000 residual value guarantee, however, the actual residual value of the asset at the end of the lease is estimated to be \$3,000. Under ASC 842, include \$2,000 in minimum lease payments in final period to get to your starting lease liability.



<u>ASC 840</u>		<u>ASC 842</u>	
ABC Test Company, Inc.		ABC Test Company, Inc.	
Balance Sheet		Balance Sheet	
As of December 31, 2018		As of December 31, 2018	
Assets		Assets	
Current Assets		Current Assets	
Cash and Equivalents	6,500,000	Cash and Equivalents	6,500,000
Accounts Receivable	1,250,000	Accounts Receivable - net	1,250,000
Prepaid Expenses	150,000	Prepaid Expenses	150,000
Other Current Assets	25,000	Other Current Assets	25,000
Total Current Assets	7,925,000	Total Current Assets	7,925,000
Long Term Assets		Long Term Assets	
Fixed Assets - Net	1,750,000	Fixed Assets - Net	1,750,000
Capital Lease Asset - Net	1,110,000	Finance ROU Asset - Net	1,110,000
Total Assets	10,785,000	Total Assets	10,785,000
Liabilities & Equity		Liabilities & Equity	
Current Liabilities		Current Liabilities	
Accounts Payable	860,000	Accounts Payable	860,000
Accrued Expenses	450,000	Accrued Expenses	450,000
Short-Term Deferred Revenue	2,650,000	Short-Term Deferred Revenue	2,650,000
Short-Term Capital Lease Liability	250,000	Short-Term Finance Lease Liability	250,000
Other Current Liabilities	300,000	Other Current Liabilities	300,000
Total Current Liabilities	4,510,000	Total Current Liabilities	4,510,000
Long Term Liabilities		Long Term Liabilities	
Long-Term Deferred Revenue	1,250,000	Long-Term Deferred Revenue	1,250,000
Long-Term Capital Lease Liability	775,000	Long-Term Finance Lease Liability	775,000
Total Long Term Liabilities	2,025,000	Total Long Term Liabilities	2,025,000
Equity		Equity	
Members Capital	3,000,000	Members Capital	3,000,000
Retained Earnings	1,100,000	Retained Earnings	1,100,000
Net Income	150,000	Net Income	150,000
Total Equity	4,250,000	Total Equity	4,250,000
Total - Liabilities & Equity	10,785,000	Total - Liabilities & Equity	10,785,000

840 to 842 Operating Leases

- ✓ **ASC 840:** Operating leases were unrecorded obligations.
- ✓ **ASC 842:** Operating leases being brought onto balance sheet as ROU asset and lease liability.
 - All operating leases, except short term leases.
 - Operating lease expense is still straight-lined over lease term.
 - Operating lease liability accounted for the same as a finance lease using an amortized cost basis.

Short term lease: At commencement date, the lease term is 12 months or less, and does not include a purchase option that the lessee is reasonably certain to exercise.





Discount Rate	5%
Lease Term	1/1/2018 - 12/31/2025
NPV of Payments	2,285,792.09

Category ▲	Frequency	Type	Schedule	Amount
BASE RENT (BR)	Monthly	Payable	01/01/2018 - 12/31/2018	27,000.00
			01/01/2019 - 12/31/2019	27,540.00
			01/01/2020 - 12/31/2020	28,090.80
			01/01/2021 - 12/31/2021	28,652.62
			01/01/2022 - 12/31/2022	29,225.67
			01/01/2023 - 12/31/2023	29,810.18
			01/01/2024 - 12/31/2024	30,406.39
01/01/2025 - 12/31/2025	31,014.51			

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ASC 840		ASC 842	
ABC Test Company, Inc.		ABC Test Company, Inc.	
Balance Sheet		Balance Sheet	
As of December 31, 2018		As of December 31, 2018	
Assets		Assets	
Current Assets		Current Assets	
Cash and Equivalents	6,500,000	Cash and Equivalents	6,500,000
Accounts Receivable	1,358,610	Accounts Receivable	1,358,610
Prepaid Expenses	150,000	Prepaid Expenses	150,000
Other Current Assets	25,000	Other Current Assets	25,000
Total Current Assets	8,033,610	Total Current Assets	8,033,610
Long Term Assets		Long Term Assets	
Fixed Assets - Net	1,750,000	Fixed Assets - Net	1,750,000
Total Assets	9,783,610	Operating ROU Asset	2,046,217
		Total Assets	11,829,827
Liabilities & Equity		Liabilities & Equity	
Current Liabilities		Current Liabilities	
Accounts Payable	860,000	Accounts Payable	860,000
Accrued Expenses	450,000	Accrued Expenses	450,000
Short-Term Deferred Revenue	2,650,000	Accrued Expenses	450,000
Other Current Liabilities	300,000	Short-Term Deferred Revenue	2,650,000
Total Current Liabilities	4,260,000	Short-Term Lease Liability	233,672
Long Term Liabilities		Long Term Liabilities	
Long-Term Deferred Revenue	1,250,000	Other Current Liabilities	300,000
Deferred Rent	23,610	Total Current Liabilities	4,493,672
Total Long Term Liabilities	1,273,610	Long Term Liabilities	
Equity		Long Term Liabilities	
Members Capital	3,000,000	Long-Term Deferred Revenue	1,250,000
Retained Earnings	1,100,000	Long-Term Lease Liability	1,836,155
Net Income	150,000	Deferred Rent	-
Total Equity	4,250,000	Total Long Term Liabilities	3,086,155
Total - Liabilities & Equity	9,783,610	Equity	
		Members Capital	3,000,000
		Retained Earnings	1,100,000
		Net Income	150,000
		Total Equity	4,250,000
		Total - Liabilities & Equity	11,829,827

Changes on the balance sheet

- 1 Title transfer
- 2 Bargain purchase options / Likely to exercise purchase options
- 3 Lease term (major part of remaining economic life of the asset)
- 4 $PV \text{ of Lease Payments} + RVG \geq$ Substantially all of the fair market value of the asset
- 5 Asset so specialized that it's only useful to the lessee

How to: Calculate the Lease Liability and ROU Asset under ASC 842

- ✓ **Lease liability** is calculated as the Present Value of minimum future lease payments.
- ✓ **ROU asset** is calculated as the lease liability, +/- certain adjustments.

+ Initial Direct Costs

+ Prepaid Lease Payments

- Lessor Incentives

- Accrued Rent

- ASC 420 Liability at Transition Date

Embedded Leases

Certain contracts not labeled as leases may contain a lease portion inside

- ✓ i.e. IT service contracts, supply contracts, dedicated manufacturing capacity, advertising

Rules for identifying embedded lease

- ✓ **840:** Immaterial impact to income statement; Operating leases were off balance sheet
- ✓ **842:** Much larger financial statement impact; All leases now capitalized on balance sheet

Polling Question 1

Have you started reviewing service contracts for embedded leases?

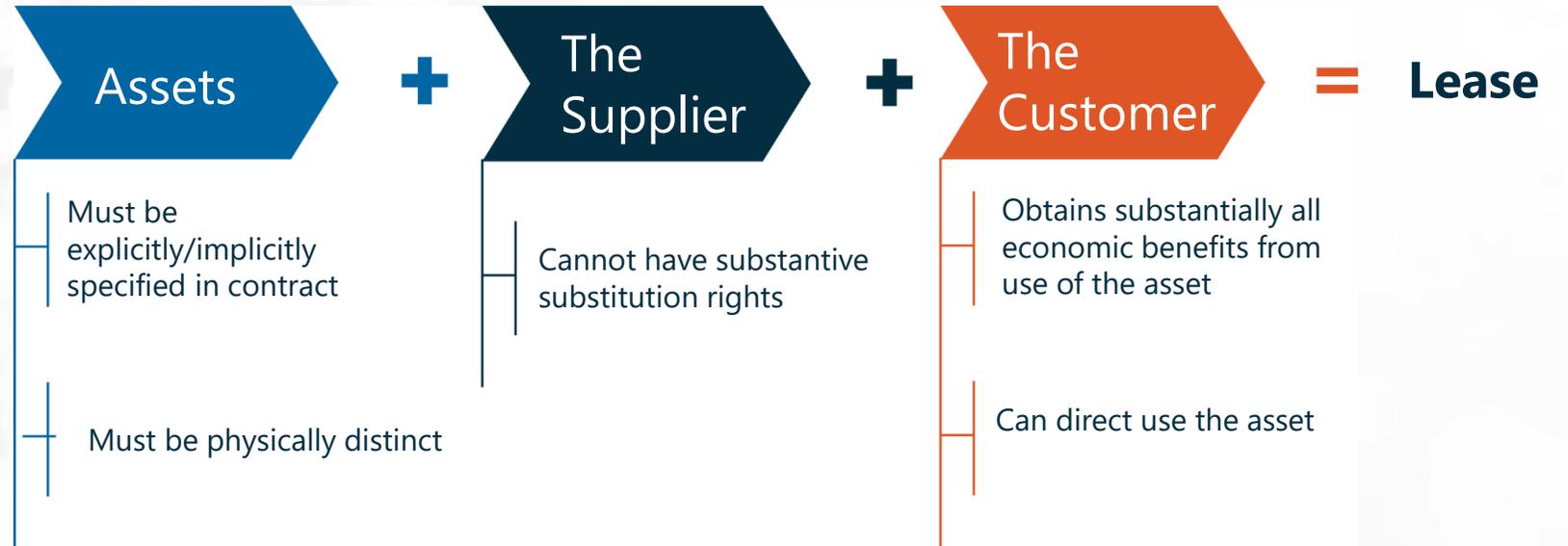


Yes



No

Rules for Embedded Leases:



Embedded Leases:

- ✔ Often include substantial non-lease elements
- ✔ For classification purposes, allocate lease components vs. non-lease components



Poll Question 2

In the following example, is there a lease?

A company outsources its tech support to a third-party in another country.

The third-party supplies the equipment to the tech support employees, and the location where the tech support employees work.

The customer is using all of the capacity of the staff in the office, but the third-party can move the support staff throughout the building or switch supplies as they see fit.

There is a variable and fixed component to the contract, where the rent and supplies provided are a fixed cost and the hours worked by the employees are variable.



Yes



No

Poll Question 3

In the following example, is there a lease?

A company outsources production to an outside supplier for a specialized piece of equipment that manufactures widgets.

There is no other equipment in the facility that can create these widgets.

The contract states that there is a minimum monthly payment, regardless of how many widgets are made, and a variable portion for the widgets created.

The company has exclusive rights to the manufacturing equipment and gets to decide when and how the equipment is used.

In general, the company uses the equipment at 95% of its capacity in any particular month.



Yes



No

How to Prepare to Comply

Involve different teams from your company



Real estate, Operations, Corporate IT, G&A



Get contracts from every team



Do you have a dedicated team or resources for 842?

Yes

No

Poll Question 4



Prepare to Comply Checklist

- ✓ Get started ASAP
- ✓ Pinpoint resources and personnel accountable for reviewing contracts, making data decisions, and capturing data
- ✓ Identify critical details within your leases
- ✓ Develop a plan for your **policies** and **procedures**
- ✓ Get software

Q&A