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Webinar Series

The New Lease Accounting Standard

May 12, 31, or June 2, 2016

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WITH YOU TODAY

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LEARNING OBJECTIVES

Upon completion of this program, participants will be able to:

- Identify the main provisions of the new lease standard as contrasted with prior accounting requirements
- Identify financial statement presentation and disclosures required by the new lease standard
- Recognize operational impact of the new standard

AGENDA

- Introduction
- Scope and Identifying a Lease
- Lease Classification and Payments
- Lessee Accounting and Presentation
- Lessor Accounting and Presentation
- Disclosures
- Transition
- Implementation Considerations

Introduction

- ASU 2016-02, *Leases (Topic 842)* issued February 2016
- Dual approach for lessees and lessors
- Effective dates (early adoption permitted):

Public Business Entities	All Other Entities
FYs beginning after 12/15/18 (and interim periods within)	FYs beginning after 12/15/19 (interim periods within FYs beginning after 12/15/20)

Introduction

Lessees

- Right of use model – recognize ROU asset and lease liability at inception for all leases
  - Optional exemption for leases with terms < 12 months
- Classify all leases as finance or operating (5 criteria)
  - Finance lease – lessee effectively obtains control of underlying asset
  - Operating lease – lessee does not effectively obtain control of underlying asset
- Similar balance sheet impact; different income statement and cash flow results

Introduction

Lessors

- Classify all leases as sales-type, direct finance, or operating (similar to existing U.S. GAAP) based on same criteria as lessees, plus a few others
  - Sales-type lease - transfers all risks and rewards, plus control of underlying asset, to lessee
  - Direct financing – transfers risks and rewards but not control
  - Operating – does not transfer risks and rewards or control
- Subsequent accounting is consistent with existing U.S. GAAP*
- Control principle aligned with new revenue standard

* Leveraged lease treatment no longer available for new leases

Scope

- Applies to all leases and subleases, except:
  - Leases of intangible assets (Topic 350)
  - Leases for exploration or use of certain natural resources (Topics 930 & 932)
  - Leases of biological assets (Topic 905)
  - Leases of inventory (Topic 330)
  - Leases of assets under construction (Topic 360)
- Scope exception for short-term leases (term less than 12 months)
- Separation of non-lease components

Identifying a Lease

Lease

A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration

Determine at inception based upon:

- Whether contract fulfillment depends on use of an *identified asset**
- Whether contract conveys right to control use of identified asset for consideration for a time period

* Consider whether supplier has *substantive right of substitution*

Identifying a Lease

- Right to control use of the identified asset depends upon:
  - Right to obtain economic benefits from the use of the identified asset (e.g., through using, holding, or subleasing the asset).
    - "Economic benefits" is fairly broad
    - Consider within defined scope of customer's contractual right to use the asset
  - Right to direct the use of an identified asset. This exists when customer has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the period of use.

Identifying a Lease: Fiber Optic Cables

- Customer enters into a 15-year contract with a utilities company (Supplier) for the right to use three specified, physically distinct dark fibers within a larger cable connecting New York to London.

- Customer makes all of the decisions about the use of the fibers by connecting each end of the fibers to its electronics equipment (i.e. Customer 'lights' the fibers).

The arrangement contains a lease.

Identifying a Lease: Fiber Optic Cables

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- Customer enters into a 15-year contract with Supplier for the right to use a specified amount of capacity within a cable connecting New York to London.
- The specified amount is equivalent to Customer having the use of the full capacity of three fiber strands within the cable (the cable contains 15 fibers with similar capacities).

The arrangement does NOT contain a lease.

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Multiple Arrangements

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- Contract combinations: multiple contracts should be combined when entered into with the same counterparty if:
  - The contracts are negotiated as a package
  - The price in one depends on the other
  - Underlying assets conveyed by the contracts are a single lease component
- Non-lease components: if an arrangement contains both lease and non-lease components, they must be accounted for separately
  - Lessees can elect a practical expedient to combine and account for as one lease

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Lease Classification

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Five criteria for finance lease (lessee) / sales-type lease (lessor):

1. Transfer of ownership of underlying asset to lessee by end of lease term
2. Option to purchase underlying asset that lessee is reasonably certain to exercise
3. Lease term = major part of remaining economic life of underlying asset
4. Sum of PV lease payments and PV any residual value guaranteed by lessee ≥ substantially all of the FV of underlying asset
5. Underlying asset is of such a specialized nature that it is expected to have no alternative use to lessor at end of lease term

If one or more of the above are met, classify as finance/sales-type lease.

Lease Classification

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When none of the first five criteria are met, two other criteria for direct financing classification should be evaluated (lessor):

1. PV of lease payments + residual value guarantee by third party equals or exceeds substantially all of underlying asset FV.
2. It is ***probable*** that lessor will collect lease payments plus residual value guarantee.

Both of the above criteria must be met for a lessor to classify as direct financing. Otherwise, classify as an operating lease.

Short-Term Leases

Two criteria for short-term leases:

- Lease term of 12 months or less
- No option to purchase underlying asset that lessee is reasonably certain to exercise

If short-term lease, lessee can elect not to apply recognition requirements (no balance sheet gross-up for ROU asset and related lease liability)

- Recognize lease payments in P&L on straight-line basis
- Recognize variable lease payments as they are incurred

Accounting policy must be made by class of underlying asset and be disclosed

Lease Term and Payments

Two elements form basis for PV of lease payments:

Lease Term

- Estimated as the non-cancellable period of the lease
- Include periods under option to extend IF lessee is *reasonably certain* to exercise option
- Include periods under option to terminate IF lessee has *is reasonably certain NOT to exercise* option
- Same analysis for purchase options

Lease Payments (Rentals)

- Fixed lease payments (less incentives to be paid by lessor)
- Variable payments tied to an index
- Variable payments which are in-substance fixed payments
- Residual value guarantees (probable amount)
- Exercise price of purchase option IF lessee is reasonably certain *to exercise* option
- Termination penalties IF lease term reflects lessee exercising option
- Fees paid to structure an SPE

Lease Term

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- *Reasonably certain* is a high threshold substantially the same as *reasonably assured* in existing U.S. GAAP.
  - Includes assessment of economic incentives.
- Reassess the lease term only upon the occurrence of a significant event or change in circumstances that are within the control of the lessee.

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Lease Payments

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- Variable payments:
  - Day 1 - include index-based payments (e.g., CPI escalator) measurement based on the rate at commencement.
  - Day 2 - only reassess when the lease liability is reassessed for other reasons (e.g., contract modification). Otherwise, changes in the index are period expenses.
- In-substance fixed payments are included in Day 1 lease liability, consistent with current practice.
- Discount rate - use the rate implicit in the lease if determinable, otherwise use incremental borrowing rate.
  - Nonpublic entities – policy election to use risk-free rate

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Lease Term and Payments: Retail Store

- Retailer enters into a 5-year lease agreement with a mall operator that includes three 5-year renewal options. Rent payments are $5,000/month plus 1% of sales during the initial term, with base rent growing 10% in each renewal period.

- Retailer incurs costs of $100,000 installing leasehold improvements to customize space to its brand requirements. LHI has a useful life of 8 years.

Lease Term and Payments: Retail Store

- The existence of significant leasehold improvements with a useful live longer than the base lease term indicates that Retailer would incur an economic loss from not exercising the first renewal option.

Lease term is 10 years, base term plus one renewal period.

- Percentage rent is variable, and thus is not included in lease payments. Instead expensed as incurred.

Lease payments total $126,000 ($60k for base + $66k for renewal).

Initial Direct Costs

Include:

- Commissions
- Payments made to an existing tenant as an incentive to terminate its lease

Do not include costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained, such as:

- General overhead costs
  - Examples: depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time
- Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities
- Costs related to activities that occur before the lease is obtained
  - Examples: costs of obtaining tax or legal advice, negotiating lease terms and conditions, or evaluating a prospective lessee's financial condition

Lessee Accounting

Initial measurement	**Right-of-use asset** • Present value (PV) of lease payments + lessee's initial direct costs • Initial direct costs: Incremental costs directly attributable to negotiating and arranging a lease • Recognize lease incentives as a reduction in the right-of-use asset **Lease liability (LL)** • PV of lease payments • Private company practical expedient - use risk-free rate to measure LL
Subsequent measurement	**Right-of-use asset** • Amortized cost: Method of amortization depends on lease classification (finance or operating) • Impairment: Refer to existing standards (ASC 360) **Lease liability** • Amortized cost: Use the effective interest method • Private company practical expedient - use risk-free rate to measure LL

Lessee Accounting

Presentation for LESSEES:

Balance Sheet

All leases:

Present separately* or within similar classes of assets and liabilities with proper disclosure

*No co-mingling of finance and operating leases

Income Statement

- *Finance:* Display interest on lease liability and amortization of ROU asset consistently with other interest and amortization expenses (combine or separate)
- *Operating:* Display interest on lease liability ***together with*** amortization of ROU asset, within income from continuing operations

Lessee Accounting

Presentation for LESSEES:

Statement of Cash Flows

- Operating activities
  - Interest on lease liability arising from finance leases*
  - Payments arising from operating leases
  - Variable lease payments and S/T lease payments not included in lease liability
- Financing activities
  - Principal repayments on finance leases

**the requirement is to present consistent with Topic 230, which generally will result in operating classification*

Lessee Accounting Example

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Facts:

- 10-year lease, option to extend 5 years
- LP = $50K/year (initial term); $55K/year (optional period)
- Not reasonably certain to exercise option to extend, therefore, lease term = 10 years
- Payments due at beginning of each year
- Initial direct costs (IDC) = $15K
- Lessee's incremental borrowing rate = 5.87%
- PV of remaining LP after payment of 1st year rental & IDC = $342,017

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Lessee Accounting Example (Continued)

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Journal entry to record lease assets & liabilities at commencement:

Right-of-use asset	407,017	
Lease liability		342,017
Cash (lease payment for year 1)		50,000
Cash (initial direct costs)		15,000

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Lessee Accounting Example (Continued)

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Journal entry to recognize lease expense during 1st year, if finance:

Interest expense	20,076 [1]	
Lease liability		20,076
Amortization expense	40,702 [2]	
Right-of-use asset		40,702

1. Calculated as (5.87% × 342,017)
2. Calculated as (407,017 ÷ 10)

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Lessee Accounting Example (Continued)

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Journal entry to recognize lease expense during 1st year, if operating:

Lease expense	51,500 [1]	
Lease liability		20,076 [2]
Right-of-use asset		31,424 [3]

1. Calculated as [(500,000+15,000) ÷ 10]
2. Calculated as (5.87% × 342,017)
3. Calculated as (51,500-20,076)

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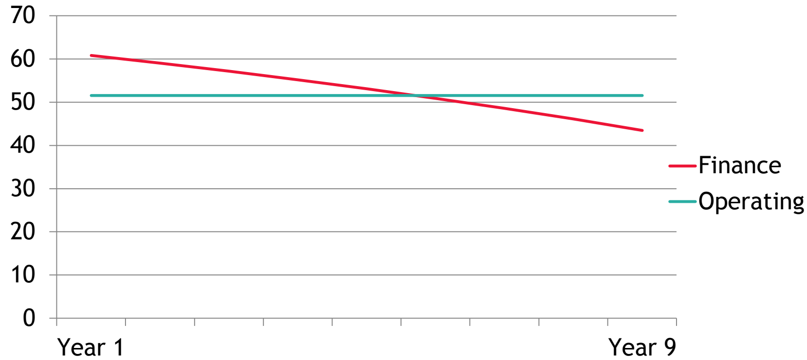
Lessee Accounting Example (Continued)

Total lease expense recognized over life of lease – Finance vs. Operating (in $000s, approximate)



Lease Modification

- Any change to contractual terms and conditions of a lease that was not part of the original terms and conditions of a lease
  - New lease: additional right of use priced on a standalone basis
    - Generally require adjustment to lease asset and liability without affecting P&L
    - Exception is a reduction of the lease's scope which would reduce lease asset and liability proportionately, with any difference recognized in P&L
  - Modified lease: change in terms with no additional right of use or additional right of use not consistent with standalone value
    - Reassess classification as of date of modification

Lease Modification: Office Space

- A company leases one floor of an office building, which it uses to house its headquarters. The lease commences on 1/1/2016, has a term of 10 years, and a price of $70/ft^2$.
- The company experiences tremendous growth, so that on 1/1/2018, it modifies the lease to include an additional 6,000 ft^2 on a second floor of the building. The price for the new space is $80/ft^2$, the then current market price. The term remains unchanged.

The modification results in a new lease. Recognize new ROU asset and lease liability.

Lease Modification: Office Space

- Same facts as last example, except that the lease was modified to reprice the entire space (existing floor plus new 6,000 ft^2) at $75/ ft^2, and the term of the combined lease was extended for an additional five years.

The modification results in a modified lease. Remeasure lease liability on 1/1/2018 based on the new terms. Recognize difference between remeasured lease liability and carrying value of existing lease liability as adjustment to ROU asset. Operating or finance classification should also be reassessed.

Lessor Accounting

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Sales-Type Lease

Initial measurement	**Net investment in the lease** • Lease receivable + unguaranteed residual asset **Selling Profit (Loss)** • Difference between fair value of the underlying asset and its book value **Initial Direct Costs** • Expense immediately if underlying asset's FV does not equal book value • Defer if underlying asset's FV equals book value **The underlying asset is derecognized**
Subsequent measurement	**Net Investment** • Reduced by payments received, net of interest and accretion. • Assessed for impairment under ASC 310. **Other, as applicable** • Variable lease payments • Impairment of net investment

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Lessor Accounting

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Direct Financing Lease

Initial measurement	**Net investment in the lease** • Lease receivable + unguaranteed residual asset - deferred selling profit **Selling Loss (if applicable)** • Difference between fair value of the underlying asset and its book value • Note: selling profit and IDCs are deferred **The underlying asset is derecognized**
Subsequent measurement	**Net Investment** • Reduced by payments received, net of interest and accretion. • Assessed for impairment under ASC 310. **Other, as applicable** • Variable lease payments • Impairment of net investment

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Lessor Accounting

Operating Lease

Initial measurement	**Underlying asset** • Continue to recognize underlying asset **Initial direct costs** • Expensed over the lease term on the same basis as lease income
Subsequent measurement	**Underlying asset** • Impairment: refer to ASC 360 guidance **Lease Income** • Recognized on a straight line basis unless another systematic basis is more representative

Lease Receivable

Lease Receivable

A lessor's right to receive lease payments arising from a sales-type lease or a direct financing lease plus any amount that a lessor expects to derive from the underlying asset following the end of the lease term to the extent that it is guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis.

Measure at present value, discounted using *rate implicit in lease*:

1. Future lease payments, and
2. Amount lessor expects to derive from residual asset guarantee

Collectibility Not Assured at Commencement

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- Sales-type lease
  - Do not derecognize underlying asset
  - Defer selling profit
- Direct financing lease
  - Treat as operating lease
- Operating Lease
  - Lesser of straight line or lease payments collected

Variable Lease Payments

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- Lessee and lessor accounting model is consistent
  - Day 1 - include index-based payments (e.g., CPI escalator) measurement based on the rate at commencement.
  - Day 2 - only reassess when the lease liability is reassessed for other reasons (e.g., contract modification). Otherwise, changes in the index are period expenses.

Other Considerations

- Impairment of net investment
- Modifications – change in lease type
- Components
- Sale/leasebacks
- Leveraged leases
- Alignment of principles with Topic 606

Lessee Disclosures

- Contractual details (lease term, contingent rentals, options, etc.) and related accounting judgments*
- Information about significant leases that have not yet commenced
- Information about lease liabilities separately for operating and finance leases:
  - Maturity analyses of undiscounted lease payments
  - Weighted-average remaining lease term
  - Weighted-average discount rate
  - Cash flows and supplemental noncash information
- Amounts related to lease cost (including any amounts capitalized) and related cash flows, separately for operating and finance leases
- If practical expedients related to short-term leases and separation of lease and non-lease components elected, disclose that fact and related details
- No specific format required; ASU provides tabular example
- Judgment required to determine level of aggregation or disaggregation

** Also disclose this information about subleases if applicable*

Lessor Disclosures

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- Contractual details (lease term, contingent rentals, options, etc.) and related accounting judgments
- Narrative disclosures about leases (including information about variable lease payments and options)
- Tabular presentation of:
  - Profit or loss at commencement (sales-type and direct financing)
  - Interest income on receivables and residual assets (sales-type and direct financing)
  - Lease income (operating)
- Maturity analysis of lease receivables (sales-type and direct financing) or lease payments (operating)
- Narrative disclosure about risk management for residual assets

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Transition

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Lessee & lessor transition

- Modified retrospective approach with hindsight allowed for evaluating renewal and purchase options on existing leases. No option for full retrospective.
- Significant relief provisions allowed as a policy election – No reassessment of:
  - Whether any expired or existing contracts are or contain leases
  - Classification for any expired or existing leases
  - Initial direct costs for expired or existing leases
- Leveraged lease treatment grandfathered

Sale-leaseback transition

- No reassessment of initial sale/leaseback conclusions
- Specific transition for deferred gains (or losses) related to capital or operating leases

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Transition Considerations

Developing a plan to transition, including impacts on:

- ICFR
- Planning and budgeting
- Taxes
- Compensation arrangements
- Debt covenants and other contracts
- Internal and external communication
- IT systems/data management
- Lease structure strategy

RESOURCES

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- Quarterly Technical Update (Q2 2016) – July 11, 12 & 14, 2016

Recent Archived Webinars:

- The New Lease Accounting Standard – May 2016
- How is Your Board Positioned to Respond to Illegal Acts? – May 2016
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BDO BOARD GOVERNANCE – PUBLICATIONS

https://www.bdo.com/services/assurance/board-governance/overview

- FASB Exposure Draft on Income Tax Disclosures (ASC 740)
- FASB Clarifies Identifying Performance Obligations and Licenses Guidance in New Revenue Standard
- SEC Publishes Concept Release on Regulation S-K
- Significant Accounting & Reporting Matters – Q1 2016
- FASB Simplifies Aspects of Accounting for Stock Compensation
- SEC Staff Updates the Financial Reporting Manual
- FASB Clarifies Principal Versus Agent Considerations Under Topic 606
- FASB Simplifies Transitioning to the Equity Method of Accounting
- FASB Issues ASU on Contingent Put and Call Options in Debt Instruments
- FASB Issues ASU on the Effect of Derivative Contract Novations on Existing Hedges
- FASB Issues ASU on Recognizing Breakage for Prepaid Stored-Value Products
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- U.S. IPO Activity Comes to Virtual Halt in Q1 of 2016
- The BDO 600: 2015 Survey of Board Compensation Practices of 600 Mid-Market Public Companies
- Elevating Cybersecurity to the Board – Questions Board Should Be Asking
- 9 Questions Boards Should Ask About Risk Management
- BDO Shareholder Meeting Alert – March 2016
- The BDO 600: 2015 Survey of CEO and CFO Compensation Practices of 600 Mid-Market Public Companies
- PCAOB Adopts rules Requiring Disclosure of the Engagement Partner and Other Accounting Firms Participating in the Audit
- Zero Growth Forecast for U.S. IPOs in 2016
- Proxy Voting Policies Focus on Overboarding
- CAQ Issues 2015 Audit Committee Transparency Barometer

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Evaluation

We continually try and improve our programming and appreciate constructive feedback.

Following the program, we will be sending out a thank you e-mail that contains a link to a brief evaluation.

Thank you in advance for your participation!

CONCLUSION

Thank you for your participation!

Certificate Availability - If you participated the entire time and responded to at least 75% of the polling questions, click the Participation tab **to access the print certificate button.**

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