Crowe Horwath.

Smart decisions. Lasting value.™

New Lease Accounting Standard

15th Annual IMA Michigan Fall Conference
October 31, 2016

Jim Hannan
Scott Sachs

Meet the Presenters…

Jim Hannan
- Managing Director
- Chicago, Illinois

Scott Sachs
- Assurance Practice Senior Manager
- Sacramento, California

Agenda

- Background
- Scope
- Effective dates & transition requirements
- Lessee accounting model
- Implementation framework
- Other practical considerations

Background and Scope

Background

Project added to agenda - July 2006

Discussion Paper - March 19, 2009

Exposure Draft – August 17, 2010
Comment period ended December 15, 2010

Outreach / Fieldwork / Re-deliberations

Revised Expose Proposal – May 16, 2013
Comment period ends Sept. 13, 2013

Outreach / Fieldwork / Re-deliberations

Issue final ASU – Feb. 25, 2016

Scope

Identifying a lease includes determining that the following are present:

Identified Asset	Right to Control Use During Term
Explicitly or implicitly specified	Ability to obtain substantially all of the economic benefits from the use
No ability to substitute (or no benefit from substituting)	Right to direct the use of the identified asset

Most leases today will be leases under the new standard!

Effective dates and transition requirements

Effective date

- Public business entities (PBEs) and certain not-for-profit entities and employee benefit plans - fiscal years (including interims within) beginning after Dec. 15, 2018, including interim periods within those fiscal years
- All other entities - fiscal years beginning after Dec. 15, 2019, interim periods beginning after Dec. 15, 2020.
- Early application permitted for all entities.

Transition

- Lessee – require modified retrospective for capital and operating leases existing at or entered into after the beginning of the earliest comparative period presented (no required transition for leases that expired before application).
- Lessor – require modified retrospective transition approach for sales-type, direct financing, and operating leases existing at, or entered into after, the date of initial application (no required transition for leases that expired before application).

Lessee Accounting Model – How to determine classification

Criteria

- Five classification criteria (ASC 842-10-25-2) similar to existing GAAP
- No bright line thresholds
- Largely based on whether lessee obtains control of the underlying asset rather than control over merely **<u>the use of</u>** the underlying lease asset
- “Reasonably certain to exercise”
  - Lease term includes periods subject to extension options if the lessee is ***Reasonably Certain*** to exercise that option
  - Application of reasonably certain in the lease term assessment and consideration of options to purchase is intended to be applied similar to the existing “reasonably assured” threshold

Related party leases

- Accounted for on the basis of legally enforceable terms and conditions stated in the lease, rather than on the basis of the lease’s economic substance.

Lessee Accounting Model – Five classification criteria

At lease commencement, a lessee classifies a lease as a finance lease if the lease meets **any one** of the following criteria:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for a major part of the remaining economic life of the underlying asset.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments equals or exceeds substantially all of the fair value.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

Lessee Accounting Model – Measurement and presentation

	Finance Lease	Operating Lease
Has control of the lease asset passed to the lessee?	Yes	No
Balance sheet	Right-of-use asset Lease liability	Right-of-use asset Lease liability
Income statement (characterization)	Interest expense Amortization expense	Lease expense (including initial direct costs)
Pattern of expense	Front-loaded	Straight-line
Cash flow statement	Operating - cash paid for interest Financing - cash paid for principal	Operating - cash paid for lease payments

Lessee Accounting Model – Measurement and presentation (cont.)

Other considerations related to measurement and presentation

- Most short term leases will not require recognition on balance sheet
- Discount rate
  - Practical expedient – non-PBEs may use a risk free rate in measuring the lease liability
  - Portfolio approach – entities with large number of similar leases
  - Implementation planning is critical in selecting a discount rate
- Variable lease payments
  - Only included in lease liability if they depend on an index or rate
  - Use the applicable index or rate at the commencement date; no need to adjust the rate at each period unless another event causes the lease to be adjusted
  - Recognize variable lease payments that were not included in the lease liability when the amounts become probable
  - Variable payments could be considered fixed if the variable payments are virtually assured of being incurred (eg. below-market rent).

Let's walk through a hypothetical lease…

Entity ABC, a lessee, entered into a four year lease of a commercial office building. At lease commencement, management of Entity ABC determined that the lease should be classified as an operating lease because the lease did not meet any of the five criteria to be classified as a finance lease.

- The lease includes the following annual escalating lease payments due at the end of each year:
  - Year 1 - $12,000
  - Year 2 - $14,000
  - Year 3 - $16,000
  - Year 4 - $18,000
- The lessor agreed to provide Entity ABC with six months of free rent in the first year of the lease. There are no extension periods, no options to purchase, and no other lease incentives from the lessor. Additionally, there were no initial direct costs.
- As the rate implicit in the lease could not be determined, Entity ABC used a discount rate of 6.682% which is its incremental borrowing rate.

Let’s walk through a hypothetical lease…

At the commencement of the lease, Entity ABC would initially measure and record the right-of-use asset, lease liability, and the free-rent incentive as follows:

	Payments
Year 1	$ 6,000
Year 2	14,000
Year 3	16,000
Year 4	18,000
Total	$ 54,000

	Debit	Credit
Right-of-use asset	$ 45,000	
Lease liability		$ 45,000

PV of lease payments at the discount rate of 6.682% = $45,000

- The initial measurement of the lease liability and right-of-use asset was determined based on the present value of the lease payments using the 6.682% discount rate. Note that the free-rent incentive is factored into the Year 1 cash flows.

Let’s walk through hypothetical lease…

Entity ABC would then record the following entries in Year 1 of the lease:

	Debit	Credit
Lease expense	$ 13,500	
Right-of-use asset		$ 7,500
Cash		$ 6,000

- To record lease expense and adjust the right-of-use asset for the difference between cash paid of $6,000 and the straight-line lease expense of $13,500 (i.e., accrued rent).

	Payments
Year 2	14,000
Year 3	16,000
Year 4	18,000
Total	$ 48,000

	Debit	Credit
Lease liability	$ 2,993	
Right-to-use asset		$ 2,993

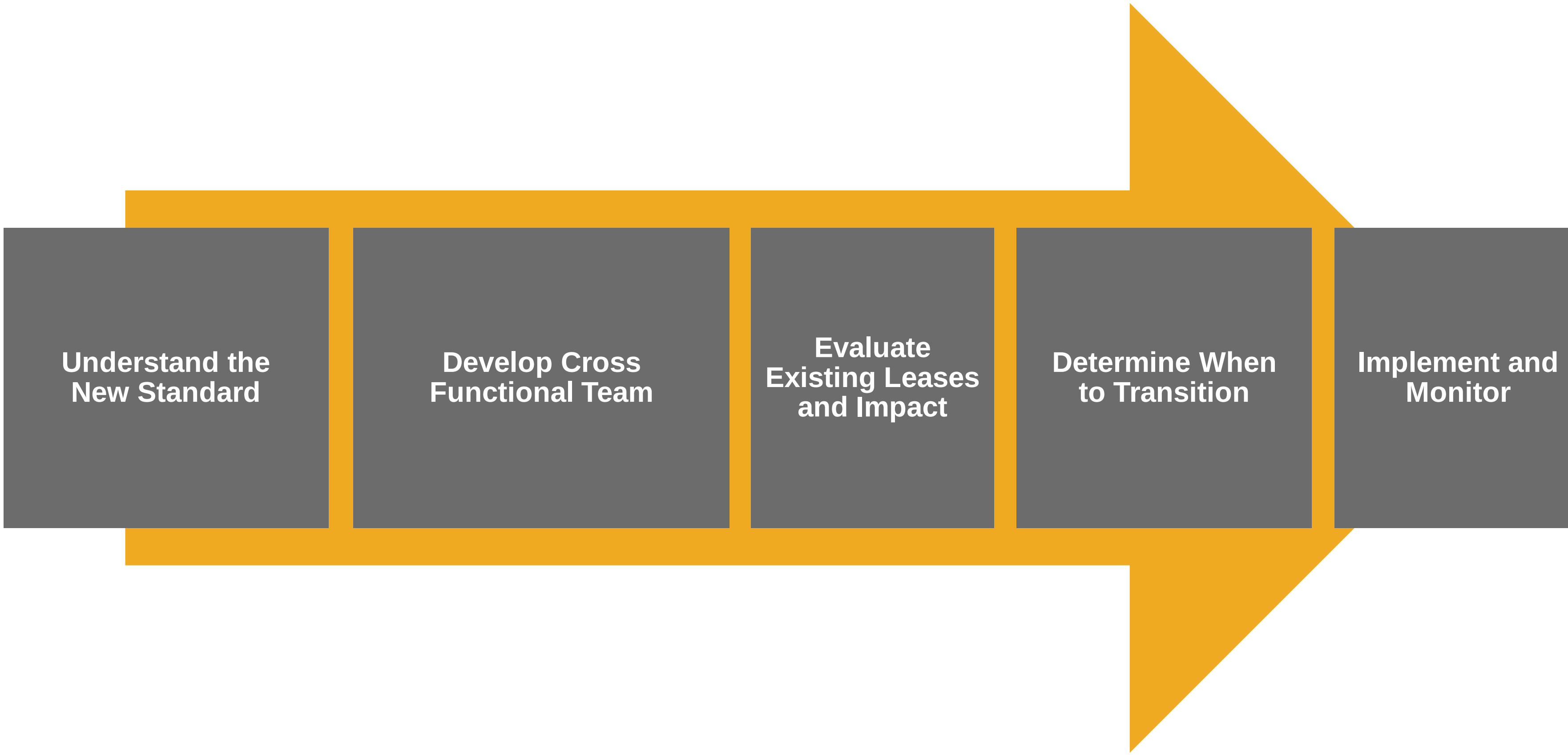
- To adjust the lease liability to the present value of the remaining lease payments at the end of Year 1, with an offset to the right-of-use asset. The adjustment of $2,993 is calculated as the initially recognized lease liability ($45,000) less the present value of remaining lease payments ($42,007) at the end of Year 1.

Let's walk through a hypothetical lease…

A summary of the lease contract's accounting (assuming no changes due to reassessment, lease modification, or impairment) is as follows:

	Initial	Year 1	Year 2	Year 3	Year 4
Cash lease payments:		$ 6,000	$ 14,000	$ 16,000	$ 18,000
Income statement					
Lease expense (straight-line)		13,500	13,500	13,500	13,500
(Accrued) prepaid rent for period		$ (7,500)	$ 500	$ 2,500	$ 4,500
Balance sheet					
Lease liability	$ (45,000)	$ (42,007)	$ (30,814)	$ (16,873)	$ -
Right-of-use asset					
Lease liability	$ 45,000	$ 42,007	$ 30,814	$ 16,873	$ -
Add: cumulative (accrued) prepaid rent	-	(7,500)	(7,000)	(4,500)	-
	$ 45,000	$ 34,507	$ 23,814	$ 12,373	$ -

Implementation Framework



Other Topics – Implementation considerations (continued)

Other practical considerations

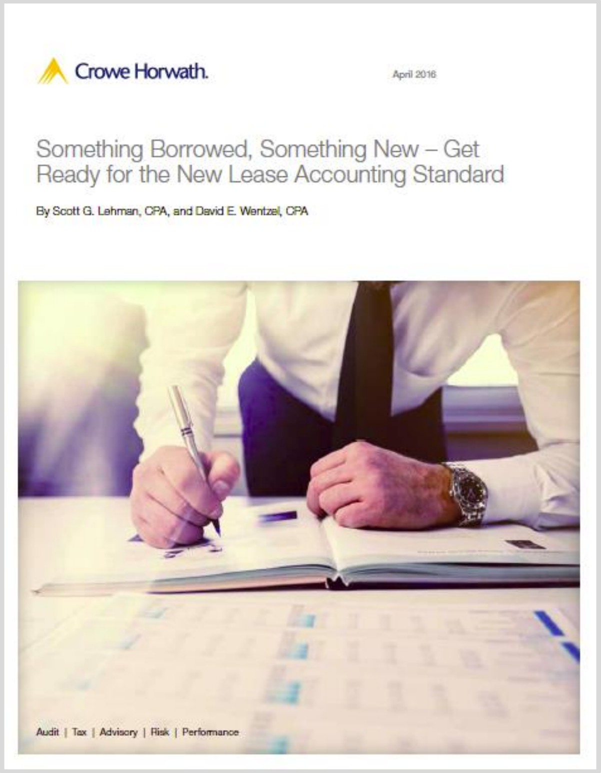
- Non-PBEs – Consider whether it makes sense to elect a policy to use the risk-free rate. Ease of application versus smaller lease liability and lease asset.
- Establish a methodology to determine the organization's incremental borrowing rate
- Separating lease and non-lease components – Ease of application versus smaller lease liability and lease asset.
- Consider the availability and practicality of other practical expedients offered as a package at transition. An entity may elect, as a package, to not reassess
  - Whether any expired or existing contracts are, or contain, leases (as defined in Topic 842)
  - The lease classification for any expired or existing leases
  - Previous capitalization of initial direct costs for any existing leases
- Entities can also make an election to use hindsight in determining the lease term (generally regarding options to extend or terminate the lease, or purchase the leased asset) and in assessing impairment of ROU assets. This may be elected separately or in conjunction with the above practical expedients, and must be applied consistently to all leases.

Resources

Resources

Crowe Newsletter, "Something Borrowed, Something New: Get Ready for the New Lease Accounting Standard"

- Issued April 8, 2016
- 16 pages
  - Background
  - Who Will Be Effected
  - Sale and Leaseback Transactions
  - Effective Dates
  - Transition
  - Disclosures



https://www.crowehorwath.com/insights/asset/borrowed-new-lease-accounting-standard/

Questions

?

Thank you

Jim Hannan

Phone +1 312 899 5309
Jim.Hannan@crowehorwath.com

Scott Sachs

Phone +1 916 492 5108
Scott.Sachs@crowehorwath.com