GALLAGHER, FLYNN & COMPANY, LLP

ASC 842, Leases

Fall 2022

Agenda

Overview

Adoption Steps

Technical Understanding

FAQs

Resources

- Technical guidance
- Calculation Tools

Overview

Key Changes:

- *Lessees*:
  - Balance sheet recognition of substantially all lessee lease assets and liabilities. ***This is a significant change for operating leases.*** Aims to eliminate "off balance sheet" long-term financing.
  - Recognizes a contractual obligation (liability) for the future cash flows and the right to use the asset
  - EBITDA will generally not be significantly impacted.
- *Lessors*: no major changes in most cases.
- Additional disclosure requirements.

Overview

Effective Date:

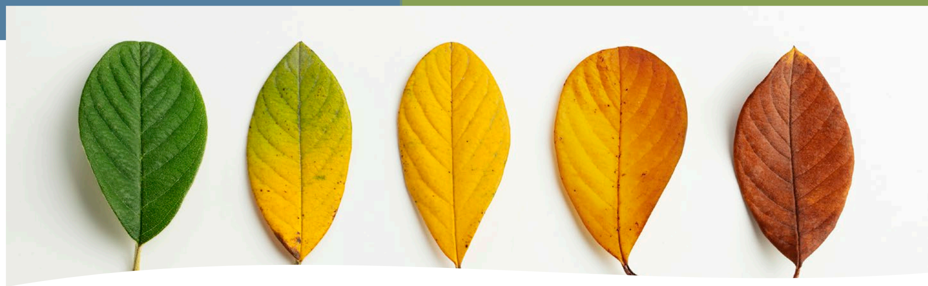
- Fiscal years beginning after 12/15/2021 (private companies). Early adoption permitted.

Transition Methods:

- Adopt for current year or comparatively
- Effective as of the beginning of the respective period

If not adopted and the impact is material, this is a GAAP exception (modified opinion)

Adoption Steps



1. Review new guidance
2. Identify and inventory leases (as lessor and lessee)
3. Consult GFC team regarding implementation; identify process owner
4. Elect / opt out of practical expedients
5. Perform lease calculations
6. Determine transition method
7. Consider effect on debt covenants
8. Record initial and ongoing journal entries
9. Document lease adoption considerations
10. Prepare year-end close and footnote disclosures

Technical Understanding:

Accounting Recognition and Disclosure

BROAD CONCEPTS

Identify & Scope Out Leases

Definition of a lease:

- A contract, or part of a contract, that conveys the right to control the use of an identified asset for a period of time in exchange for consideration.
- Exceptions include intangible assets, inventory, biological assets, assets under construction, and others.
- Includes embedded leases (when a non-lease contract contains lease components). Only includes the components integral to the right to use the asset. Does not generally include maintenance, security, etc.

Entities may scope out leases in the following scenarios:

- Immaterial leases – may adopt a reasonable threshold
- Short-term leases (with terms of 1 year or less, if **practical expedient** is elected)

Practical Expedients

Entities may elect to apply the following practical expedients:

1. ***Package of practical expedients*** (must adopt all or none) – elect not to reassess:
   a) Classification of leases that existed at the adoption date.
   b) Whether any expired or existing contracts are or contain leases
   c) Initial direct costs for existing leases
2. Pass on applying guidance to ***short-term leases***
3. Use of ***risk-free discount rate*** for leases with no implicit interest rate (lessees)
4. ***Use of hindsight*** in determining lease term, including renewal, termination, and purchase options, as well as assessing impairment of ROU assets
5. Reassessment of certain ***land easements***

Transition Method

Entities must apply a *modified retrospective* transition approach.

1. Two overarching options – adjust comparatively or only current period.
2. Applies to leases as of the beginning of the first period to which the standard is applied.
3. Optional "package of **practical expedients**" for existing leases

Example – adopting in calendar year ending December 31, 2022. Two years presented.		
Transition methodology:	**Adjust Comparatively**	**Not Adjusted Comparatively**
Apply to leases that commenced before:	1/1/21	1/1/22
Cumulative Effect Adjustment to Equity/Net Asset:	Yes – as of 1/1/21	Yes – as of 1/1/22
Restatement:	Restate prior period financial statements.	Restatement of prior period financial statements not required, just of equity.
Comparability:	Comparative financials are shown under the same methodology.	Comparative financials are shown under different methodologies.

LESSEES

Classify Leases - Lessee

Classification criteria:

- Similar to old guidance but fewer “bright line” thresholds.
- New criteria related to specialized nature of the asset
- If one or more criteria are met, classify as a finance lease
- **Practical expedient**: option to not reassess classification of existing leases (part of “package of practical expedients”)

Comparability	
ASC 840	*ASC 842*
Operating	Operating
Capital	Finance

Initial Recognition - Lessee

Calculate asset and liability using discounted cash flows:

- ***Liability:*** discounted cash flows for remaining payments at commencement date.
  - Similar to imputing interest on an interest-free loan
- ***Asset:*** liability + prepayments made to lessor + initial direct costs (shipping, sales tax, etc.) - lease incentives received
- Net effect at adoption date: record to retained earnings / net assets
  - If immaterial, may consider recognizing the net difference through the P&L in year of adoption

Initial direct costs

- Incremental costs that would not have been incurred if the lease had not been maintained. Only external costs incurred after lease execution (commissions, legal, lease buyout, etc.)
- Other costs shall be expensed as incurred, including costs incurred prior to signing a lease.
- **Practical expedient**: option to not reassess for existing leases as of adoption (part of “package of practical expedients”)

Initial Recognition - Lessee

Key Assumptions and Inputs:

- ***Interest rate:*** Use implicit rate if determinable. Otherwise, use incremental borrowing rate unless the **practical expedient** to apply the risk-free rate is elected.
- ***Lease term:*** consider whether to include renewal and termination options
  - Include if reasonably certain
- ***Lease commencement date:*** earlier of defined date in the agreement or the date the asset was made available to the lessee (i.e. when lessee takes possession / gains control).
- ***Lease payments:*** fixed and variable amounts payable at, before, or subsequent to lease commencement.
  - Generally excludes CAM and reimbursement to landlord. Includes certain residual value guarantees.
  - Payments based on a rate or index: include in asset/liability measurement based on rate/index as of lease commencement; record differences in P&L as incurred.
  - Payments not based on a rate/index: generally exclude from asset/liability measurement; expense as incurred.

Subsequent Accounting - Lessee

Lease assets are subject to impairment considerations, similar to PP&E.

Operating leases:

- Recognize total lease payments straight-line to ***rent expense*** over lease term. ***P&L recognition is generally similar to former guidance.***
- ***Reduce lease liability*** (lease payment, less portion attributable to interest) – similar to debt
- ***Reduce ROU asset*** (rent expense above, less portion attributable to interest)
- Note: interest expense is not actually recorded as interest in the P&L, it has an offsetting effect through change in asset and liability.

Subsequent Accounting - Lessee

Finance leases:

- ***Recognition is very similar to former guidance for capital leases.***
- Recognize imputed ***interest expense*** in the P&L (effective interest method)
- ***Reduce lease liability*** (lease payment, less portion attributable to interest) – similar to debt
- Recognize ***amortization expense*** (straight-line amortization of ROU asset) – like PP&E
- ***Reduce ROU asset*** (by amortization expense for the period)
- Note: entities may elect to record payments directly against the liability then recognize the effect of the interest / true up the liability during monthly or quarterly close

G/L Accounts - Lessee

Accounts needed to achieve proper recognition and disclosure:

		Operating	Finance
Balance Sheet: *Operating and finance amounts may not be combined on the balance sheet.*			
Asset	ROU asset	Applicable	Applicable
Liability	Lease liability - current		
Liability	Lease liability - noncurrent		
Income Statement:			
Expense	Interest Expense	N/A	Applicable
Expense	Amortization Expense	N/A	Applicable
Expense	Rent Expense	Applicable	N/A

Financial Statements - Lessee

Balance Sheet:

- Separate finance and operating assets and liabilities
- Normal considerations for current vs. long-term
  - Assets are non-current (like PP&E)
  - Liabilities are broken out between current and non-current

Income Statement:

- Continue to present expenses in their appropriate classifications
  - COGS vs G&A
    - Rent expense
    - Amortization
  - Other
    - Interest (finance leases)

Cash Flow:

- Finance leases:
  - Principal repayments – ***financing activities***
  - Variable lease payments – ***operating activities***
- Operating leases:
  - Payments – ***operating activities***
- Non-cash disclosure:
  - New ROU assets and lease liabilities

Key Footnote Disclosures - Lessee

General:

- Nature of leases
- Related party leases
- Weighted-average remaining lease term
- 5 year cash flow schedule with reconciliation to liability (present value)

Transition/Adoption:

- Transition method adopted
- Practical expedients elected
- Significant assumptions and judgments applied
- Incl. weighted-average discount rate

Lease Cost:

Composition of lease cost, including:

- Finance lease amortization and interest
- Operating lease cost
- Short-term lease cost
- Variable lease cost
- Sublease income
- Sale leaseback gain/loss

Most disclosures are required to be separated between finance and operating leases.
See disclosure checklist for a more complete list. This is intended to include the most common scenarios.

Other Considerations

- **Impairment review is an ongoing consideration**
- **Lease modifications**
  - Should be reviewed closely based on facts and circumstances, which dictate treatment as a new lease or reassessment/remeasurement of an existing lease.
  - Remeasurement methodology varies based on circumstances.
  - Renewal of a short-term lease on a long-term basis could require reassessment
  - This is a helpful summary from LeaseQuery
- **Subleases**
  - Treatment may vary, review guidance for your circumstances

FAQ's

1. What if the remaining lease term is 1 year or less?

- For purposes of applying the short-term lease expedient, the lease term is based on the lease commencement date, not the remaining term as of adopting ASC 842. Here is a helpful resource to assess short-term leases.

2. Are CAM / real estate taxes lease components?

- Generally no; do not include in lease calculations.
- See section 4.2 of RSM lessee accounting guide.

3. How should payments that vary based on an index be accounted for?

- Perform initial computations using the lease payment as of commencement. Subsequent adjustments should be expensed/credited to the P&L as incurred and reported as variable lease payments in the footnotes. An exception may exist if a floor or cap is included – may require inclusion of the floor or cap in the lease calculations.
- See section 5.5.3 of RSM lessee accounting guide for further information and examples.

FAQ's (cont'd)

4. **How should leasehold improvements and related landlord reimbursement / incentives be treated if not paid or payable as of lease commencement?**
   - Not addressed in ASC 842
   - Depends on if amount is known or estimable at lease commencement and if considered a lessor or lessee asset.
   - See section 5.5.4 of RSM lessee accounting guide.
   - Non-authoritative summary here
5. **What is the portfolio approach and when can I apply it?**
   - May apply guidance on a portfolio basis to certain groups of similar leases
   - Designed to expedite the application of the new guidance
   - See section 2.7 of RSM lessee accounting guide.

FAQ's (cont'd)

6. **What if I cannot determine the fair value of the underlying asset?**
   - The asset's fair value is used in the calculation for determining one of the classification criteria.
   - The FASB recognized that if this cannot be determined without undue effort, this criteria can be disregarded.
7. **How do I handle lease payments that are based on usage or performance (revenues, etc.)?**
   - Unless these payments are in substance fixed payments, they should generally not be included in the lease calculations and should be reported as variable lease payments (recognize as incurred).
8. **How do I account for the exercise of renewal options not reflected in the initial lease term?**
   - Generally requires reassessment of lease classification and remeasurement of the asset and liability at the modification date based on the revised lease term. Not treated as a separate new lease.

LESSORS

Lessor Leases

Guidance was refined, not overhauled

- Same 3 categories: sales-type, direct financing, operating
- Definition of a lease is the same as for lessees

Classification criteria:

- Same 5 criteria as for lessees. If 1 or more are met = sales-type lease.
- If not a sales-type lease, consider the following two criteria. If **<u>both</u>** are met, treat as direct financing. Otherwise, treat as operating.
  - ✓ Is the present value of lease payments plus any residual value guarantee (from lessee or unrelated third party) substantially all of the fair value of the lease asset?
  - ✓ Is collectability of lease payments is assured, plus amounts necessary to satisfy residual value guarantee?

Lessor Leases

Other notable changes:

- Need to consider ***allocation*** between lease and non-lease components (mirrors guidance in ASC 606)
  - **Practical expedient** to combine components is available to some lessors
- No separate ***real estate*** guidance
- ***Leveraged leases*** – no specific guidance, continue existing treatment until expiration of lease terms. Then apply 842.
- Clearer guidance on lease ***modifications***
- ***Initial direct costs*** – now can only capitalize incremental costs to obtain the lease (similar for lessees)
- Financials statements – necessary use of term “lease” instead of “rent”

Disclosure requirements

- New requirements were added – see disclosure checklist for details.

Lessor Leases

Figure LG 3-2
Overview of lease accounting by lessors

Statement	Sales-type lease	Direct financing lease	Operating lease
Balance sheet	▫ The underlying asset is derecognized and the net investment in the lease (the sum of the present value of the future lease payments and unguaranteed residual value) is recorded ▫ The net investment in the lease is increased by interest income and decreased by payments collected	▫ The underlying asset is derecognized and the net investment in the lease (the sum of the present value of the future lease payments and unguaranteed residual value) is recorded ▫ The net investment in the lease is increased by interest income and decreased by payments collected	▫ The underlying asset remains on the balance sheet ▫ The underlying asset continues to be depreciated over its useful life, which could extend beyond the lease term
Income statement	▫ Selling profit or loss* is recorded at lease commencement ▫ Interest income is recorded based on the effective rate of interest in the lease	▫ Selling profit is deferred and selling loss* is recorded at lease commencement ▫ Interest income is recorded based on the effective rate of interest in the lease	▫ Lease revenue and depreciation expense are presented on a gross basis in the income statement
Statement of cash flows	▫ Cash receipts from all leases should be classified as operating activities except for entities within the scope of ASC 946 (see ASC 842-30-45-5).		

Source: PWC Leases guide *(link)*

Resources

✓ **White papers / educational resources:**

a. RSM high level overview *(link)*

b. PWC Guide *(link)*

c. RSM lessee accounting guide *(link)*

d. Cohen & Co article, “How the New Lease Standard Could Impact Your Compliance with 4 Common Debt covenants” *(link)*

✓ **To perform and maintain your own lease calculations:**

a. LeaseQuery software. Click here for pricing and other information.

b. Excel tools*

✓ **Adoption memo template***

✓ **Disclosure checklist and footnote templates***

***Available on our website under the “Resources” section.*

Thank You!

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& COMPANY, LLP