

Leases - Topic 842

Summary



Recap of Old Guidance



Understanding of New Guidance



Example of Accounting



Financial Statement Impact

Recap of Current Lease Guidance (ASC 840)

- ▶ Leases are currently classified in two categories: operating leases and capital leases.
 - ▶ Operating lease accounting: not recognized on balance sheet, payments are considered rent expense
 - ▶ Capital lease: the asset and the required payments are recognized on the balance sheet, payments reduce the liability with a portion considered interest expense (treated as a financed transaction)
- ▶ If any of the four criteria below are met then it is a capital lease.
 - ▶ Ownership is transferred to lessee at the end of the lease term.
 - ▶ A bargain purchase option for the leased asset exists.
 - ▶ The lease term is equal to 75 percent or more of the estimated economic life of the leased asset.
 - ▶ The present value of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased asset at inception.

Purpose of the New Guidance (ASC 842)

- ▶ Increase transparency and comparability between entities
- ▶ Concern that the financial statements did not represent a faithful presentation of lease transactions, specifically in regards to operating leases
- ▶ Numerous requests from users to update the accounting requirements
- ▶ Main issues were revolved around lessee accounting of operating leases.
- ▶ Lessor accounting remained fundamentally unchanged

Effective Dates and Commencement Date

Effective Date:

- ▶ Public Companies - 2019 (this year)
- ▶ All Other Organizations - 2020 (next year)
- ▶ Early application - permitted for all organizations.

New Guidance: Recognizing the Asset and Liability - Lessee

- ▶ Lease - A contract, or part of a contract, that conveys the right to control the use of identified property, plant, and equipment (an identified assets) for a period of time in exchange for consideration.
- ▶ Two classifications: Finance leases and operating leases
- ▶ A lease is classified as a finance lease if the lease meets any of the following criteria:
 - ▶ Transfer of ownership of the asset by the end of the lease term
 - ▶ There is an option to purchase and exercising that option is reasonably certain
 - ▶ The term of the lease represents the major part of the economic life of the asset
 - ▶ The PV of the lease payments equals or exceeds substantially all of the asset FV
 - ▶ Specialized asset being leased is not expected to have alternative use

New Guidance: Recognizing the Asset and Liability - Lessee

- ▶ Recognizing the asset and liability
 - ▶ Lease liability - measured at the PV of the remaining lease payments. The discounted value is based on the implicit or incremental borrowing rate.
 - ▶ Right-of-use asset - measured at the lease liability at beginning of lease, less any payments made to lessor and plus any initial direct costs
- ▶ Short Term Exception
 - ▶ Permits a lessee to elect not to recognize a lease that, at the commencement date has a lease term of 12 months (do not have to record the asset or liability).
 - ▶ And does not have an option to purchase.

New Guidance: Continuing Accounting - Lessee

▶ Lease Accounting Overview

▶ Finance Lease

- ▶ Recognize interest on the lease liability
- ▶ Amortization expense from the right-of-use asset (straight-line basis)
- ▶ The lease liability is reduced as payments are being made toward it
- ▶ The right-of-use asset is reduced with the recognized amortization expense

▶ Operating Lease

- ▶ Recognize a single lease expense, calculated so that the cost of the lease is allocated over the lease term on a generally straight- line basis
- ▶ The lease liability is reduced as payments are being made toward it
- ▶ The right-of-use asset is reduced by accumulated amortization

Transition for Existing Leases and related Practical Expedients

- ▶ Modified retrospective approach for leases in existence at the beginning of the earliest comparative period presented in addition to leases entered into during the periods presented.
 - ▶ Practical Expedient:
 - ▶ Allows the Company, at the time of adoption, to not reassess:
 - ▶ Whether any expired or existing contract are, or contain, leases
 - ▶ The Lease classification for any expired or existing leases
 - ▶ Initial direct costs for any existing leases.
 - ▶ If the Company elects to use any of the three practical expedients, it must use all three and must apply them to all leases in existence upon adoption.
 - ▶ For each lease classified as an operating lease before and after the adoption, the Company will record a lease liability equal to the present value of the remaining minimum payments

Example - Lessee

Lessee Corp enters into a lease of non-specialized equipment with Lessor Corp.

Lease term

3 years (no renewal option)

Economic life

5 years

Purchase option

None

Rent payments

**\$100, paid in arrears, escalating
\$3 annually**

Interest rate

7%

Residual value guarantee

None

Example provided by the AICPA

Example - Finance Lessee

Initial recognition entry

Dr. Right-of-use asset	270
Cr. Lease liability	270

Year	Asset	Liability		Principal	Expense
	Amortization A	Payment B	Interest C		A+C
1	90	100	19	81	109
2	90	103	13	90	103
3	90	106	7	99	97
	270	309	39	270	309

Year 1 entry to record the lease payment and expense

Dr. Interest expense	19 C
Dr. Amortization expense	90 A
Dr. Lease liability	81 D
Cr. Cash	100 B
Cr. Accumulated amortization	90 A

Example provided by the AICPA

Example - Operating Lessee

Initial recognition entry

Dr. Right-of-use asset	270
Cr. Lease liability	270

Year	Expense	Liability			Asset
	A	Payment B	Interest C	Principal D	Amortization A-C
1	103	100	19	81	84
2	103	103	13	90	90
3	103	106	7	99	96
	309	309	39	270	270

Year 1 entry to record the lease payment and expense

Dr. Lease expense	103 A
Dr. Lease liability	81 D
Cr. Cash	100 B
Cr. Accumulated amortization	84 A-C

Example provided by the AICPA

Example Balance Sheet - Operating Lessee

Old Guidance

Assets	
Cash	50
Accounts receivable	200
Inventory	300
Other Assets	50
Current assets	600
Fixed assets, net	75
Total assets	675
Liabilities and Stockholders' Equity	
Accounts payable	250
Accrued expense	100
Current liabilities	350
Long-term debt	150
Retained earnings	175
Liabilities and stockholders' equity	675

New Guidance

Assets	
Cash	50
Accounts receivable	200
Inventory	300
Other Assets	50
Current assets	600
Fixed assets, net	75
Operating lease right-of-use asset	186
Total assets	861
Liabilities and Stockholders' Equity	
Accounts payable	250
Accrued expense	100
Operating lease liability, current	90
Current liabilities	440
Operating lease liability, LT	99
Long-term debt	150
Retained earnings	172
Liabilities and stockholders' equity	861

Example Ratios - Operating Lessee

- ▶ Below are example ratios (before and after) based on the example balance sheet on the previous slide:

Ratio	Old	New
Current ratio (=CA/CL)	1.71	1.36
Debt-to-equity (=L/SE)	2.9	4.0
Tangible net worth (=A-L)	175	172

- ▶ The financial ratios were all negatively impacted due to the recognition of the right-of-use asset and lease liability

Summary



Recap of Old Guidance



Understanding of New Guidance



Example of Accounting



Financial Statement Impact

Questions?

Thank you!

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***Presentation available on our website in the "Blog" section

