

2021 Summer CPE Series

Changes in Lease Accounting Are Coming. Are you Ready?

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Cohen & Co[®]



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Learning Objectives

- Obtain a basic understanding of the new lease accounting rules
- Illustrate impact on financial presentation and disclosure requirements
- Explore decisions that will need to be made upon transition
- Identify challenges likely to be encountered during implementation
- Discuss steps to take to prepare for these new rules

Background

- Timeline – Almost a decade in the making
- Why the change?
 - › Old rules conflict with GAAP principles
 - › Increase transparency and comparability
 - › Reduced opportunities to structure contracts to avoid balance sheet recognition

Effective Dates

- Public Companies
 - › Fiscal years beginning after December 15, 2018 (**already effective**)
- Private Companies
 - › Fiscal years beginning after December 15, 2021 (**after two delays**)
- Early adoption is permitted

Polling Question

- Have you early adopted, or do you plan to early adopt the new leasing standard?
 - › Yes, already adopted
 - › Yes, plan to early adopt
 - › No, will adopt when required

Polling Question

- Where in the implementation process are you?
 - › Haven't started
 - › Started thinking about it
 - › Almost ready
 - › Already implemented

Basic Terminology

Term	Definition
<ul style="list-style-type: none"><li data-bbox="147 591 384 639">▪ Lessee	<ul style="list-style-type: none"><li data-bbox="715 591 2158 796">▪ An entity that enters into a contract to <i>obtain</i> the right to use an underlying asset for a period of time in exchange for consideration.
<ul style="list-style-type: none"><li data-bbox="147 933 377 982">▪ Lessor	<ul style="list-style-type: none"><li data-bbox="715 933 2125 1145">▪ An entity that enters into a contract to <i>provide</i> the right to use the underlying asset for a period of time in exchange for consideration.

Basic Terminology

Term	Definition
<ul style="list-style-type: none"><li data-bbox="147 675 545 801">▪ Right-of-Use Asset<li data-bbox="147 951 580 1011">▪ Lease Liability	<ul style="list-style-type: none"><li data-bbox="715 675 2053 801">▪ An asset that represents a lessee's right to use the underlying asset for the lease term.<li data-bbox="715 951 2079 1153">▪ A lessee's obligation to make lease payments arising from a lease, measured on a discounted basis.

What is a Lease?

- Old definition
 - › An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.
- New definition
 - › 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.

Polling Question

- Do you have concerns that you may have embedded leases not currently identified as a lease?
 - › Yes
 - › No

Criteria for Operating/Finance Classification - Lessee

Criteria	Description
Ownership transfer	Ownership of the asset transfers to the lessee, typically at the end of the lease term
Option to purchase	Lessee has an option to purchase the asset (lessee must be reasonably certain to exercise)
Lease payments	PV of lease payments* is equal to or more than substantially all of the FV of the asset
Lease term	Lease term is for a major part of the life of the asset
Specialized nature	Asset is expected to have no alternative use to the lessor at end of the lease

Criteria for Operating/Finance Classification - Lessee (Cont'd)

- A lease is classified as operating under ASC 842 unless it meets one of the previous criteria
- Criteria differences from old rules
 - › No more bright-line tests
 - › Specialized nature – new criteria
- Judgment will play a role in classification

Financial Statement Impact Summary - Lessee

Lease Classification	Balance Sheet	Income Statement	Cash Flow Statement
Finance Lease	Right-of-use (ROU) asset / Lease liability	Amortization expense; Interest expense	Cash paid for principal and interest payments
Operating Lease	Right-of-use (ROU) asset / Lease liability	Single lease expense on a straight-line basis	Cash paid for lease payments

Polling Question

- How many leases do you have?
 - › None
 - › Under 10
 - › 10-49
 - › 50 or greater

Polling Question

- How do you currently track and maintain your leases?
 - › No tracking
 - › Excel
 - › Third-party software
 - › Some other method

Calculation of ROU Assets and Liabilities



Important Calculation Considerations

- Reasonably certain – How to gauge?
- Discount rate – Whose rate? How do you choose?
- Initial direct costs – What do you include?
- Lease payments – What do you include?
- Lease term – How far out should you look?
- Purchase options – What if I don't know?

Polling Question

- Do you expect to have a need for the use of specialized software to assist you in accounting for leases under the new standard?
 - › Yes
 - › No
 - › Unsure

Transition

- ASC 842 requires a modified retrospective transition method, offering two options:
 - › Effective Date Method
 - Cumulative-effect adjustment to the opening balance of retained earnings on the date of adoption (January 1, 2022, for calendar year nonpublic entities NOT early adopting); new guidance applied only to 2022 year
 - › Comparative Method
 - Cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the earliest comparative period presented in the financial statements (January 1, 2021, for calendar year nonpublic entities not early adopting); new guidance applied to both years presented in the financial statements (2021 & 2022)

Effective Date Method

Advantage

- Simplify transition
- Reduce costs of transition

Disadvantage

- Does not restate comparative periods (reduces comparability and could be confusing to the f/s reader)

Comparative Method

Advantage

- Comparability of all periods presented

Disadvantages

- More complex
- More costly

Transition & Accounting Policy Elections - Summary

Transition (Entity-wide – all Leases)

- Practical expedient package
 - › Lease identification
 - › Lease classification
 - › Initial direct costs
- Hindsight
- Land easements

Accounting Policy Elections

- Separation of lease and non-lease components
- Portfolio approach
- ST lease exemption
- Discount rate

Transition Relief - Practical Expedients

- The Package of 3
 - › Offers relief from implementing transition provisions by permitting a lessee OR lessor to elect NOT to reassess:
 - Whether any expired or existing contract is or contains a lease
 - The lease classification of any expired or existing leases
 - Initial direct costs for any existing leases

Transition Relief - Practical Expedients (Cont'd)

- The Package of 3 (continued)
 - › ALL or NONE
 - › Cannot be applied on a lease-by-lease basis
 - › If any entity does not elect the package of 3, it must reassess the classification of its existing leases
 - As of the commencement date of the lease or, if later...the date of the last lease modification that, under 840, required the entity to reassess the classification.
 - › Effect of electing or not electing this package may be significant for entities that incur significant lease origination costs

Transition Relief - Practical Expedients (Cont'd)

- Hindsight Practical Expedient
 - › Allows the use of hindsight in evaluating the lease term (renewal, termination, and purchase options for existing leases) and impairment of the ROU asset
 - › Requires an entity to reevaluate the lease term and the assessment of any lessee purchase options on the effective date
 - › If an entity elects BOTH the package of 3 and the use of hindsight, it is NOT required to reassess lease classification if hindsight results in a change to the lease term or the assessment of a lease purchase option. This doesn't **override** the package of 3, but an entity is NOT precluded from doing so.

Accounting Policy Elections

- Separation of Lease & Non-lease Components
- Accounting for Leases at a Portfolio Level
- Short-term Lease Recognition Exemption
- Use of Risk-free Discount Rate

Lease & Non-lease Components (Lessee)

- Lessee may elect NOT to separate non-lease components from the lease components to which they relate (account for as a single lease component)
 - › An accounting policy election THAT MUST BE DISCLOSED (disclosure must include which class or classes of underlying assets applying to)
 - › Elected by class of underlying asset (e.g. office equipment, vehicles, etc.)
 - › Can be used regardless of the significance of the non-lease components; however, is more unlikely to be used if they are sizable due to the impact of recording additional lease liabilities
 - › Can be applied to existing leases
 - But should be consistent going forward for new leases of underlying assets within the same class

Accounting for Leases at a Portfolio Level

- A lessee is permitted to account for its leases at a portfolio level as long as:
 - › Leases commenced at or around the same time, AND
 - › The resulting accounting at this level would not differ materially from the accounting at the individual lease level
- Expected when leases are similar in nature (for similar underlying assets) and have identical or nearly identical contract provisions

Short-Term Lease Recognition Exemption

- A lessee may elect NOT to apply the recognition requirements to short-term leases
- Definition: A lease that, at the commencement date, has a lease term of 12 months or less AND does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise
- THIS MUST BE DISCLOSED as does the amount of short-term lease commitments

Short-Term Lease Recognition Exemption

- A lessee electing the exemption for short-term leases does NOT apply the transition requirements to those leases
 - › Short-term lease is a lease with a TOTAL term of 12 months or less (INCLUDING periods before the effective date); is NOT a lease with a REMAINING lease term of 12 months or less at the effective date
 - › How to handle unrecognized short-term leases in transition:
 - Recognize minimum rental payments as lease cost, on a straight-line basis over the lease term (consistent with 840), and
 - Apply new requirements in 842 if, on or after the effective date, it is modified and that modification is not accounted for as a separate contract or there is an event that would require re-measurement of the lease liability if it were recognized (for example a change in lease term or in assessment of a lessee purchase option)

Discount Rate

- Nonpublic entities are permitted, as a policy election, to use a risk-free discount rate in lieu of their incremental borrowing rate when assessing lease classification and measuring lease liabilities
 - › May reduce complexities BUT...
 - › May have unintended consequences
 - Results in LARGER lease liability and ROU asset
 - Could result in a PV calculation that may equal or exceed substantially all of the FV of the underlying leased asset, causing the lease to be classified as a finance lease rather than an operating lease

Polling Question

- Have you begun to have discussions with your bank regarding expected impact on presentation of your financial statements and any potential impact on covenants?
 - › Yes
 - › No
 - › Expect no impact

Disclosures - Overall

- Disclosure of any election of practical expedients must be made.
- Under the Comparative method, an entity presents disclosures for all periods presented in accordance with Topic 842.
- Under the Effective Date method, an entity only presents disclosures for periods subsequent to the effective date in accordance with Topic 842. However, the entity must carry forward all of the disclosures that were required under Topic 840 for any comparative periods presented in the post-adoption financial statements.
- Disclosures of future operating and capital lease commitments was only required under Topic 840 for the last annual balance sheet date presented in the lessee's financial statements. However, under the effective date method, these disclosures must be made as of the last balance sheet prepared under Topic 840 for statements issued in the year of adoption.

Lessee Disclosure Requirements - Summary

- Information about the nature of the entity's leases (including subleases)
- Leases that have not yet commenced
- Significant assumptions and judgments
- Amounts recognized in the financial statements, segregated between those for finance and operating leases
- Maturity analysis of finance and operating lease liabilities
- Lease transactions with related parties
- Disclosures relating to use of practical expedients and/or policy elections

Key Points on Disclosures

- New and expanded requirements
- Significantly more comprehensive
- Like 606 – should not take a “one-size-fits-all” approach to disclosure...need to evaluate against an individual entity’s leasing activities
- Materiality and relevance should both be considered when determining which disclosures to provide

Polling Question

- What do you expect to be the most difficult aspect of implementation?
 - › Identify leases (including embedded leases)
 - › Calculating lease assets and liabilities
 - › Evaluating transition practical expedients and policy election options
 - › Formulating disclosures
 - › Something else

Challenges in New Lease Accounting

- Maintenance / Other costs included in a lease
- Variable rates and escalation clauses
- Modifications
- Related party leases (form over substance)
- Lease inception vs. lease commencement
- Financial ratios / debt covenants

Other Topics

- Lessor accounting
- Sale – Leaseback transactions
- Leveraged leases
- Subleases
- Lease terminations

How to Prepare

- Become familiar with the standard
- Inventory your current leases – what resources are needed?
- Plan for future lease / amendments
- Get processes in place
- Document / update related party leases
- Determine impact (if any) on debt terms with bank – discuss with bank as necessary

How We Can Help

- Lease classification / calculations
- Embedded lease identification
- Financial statement disclosure development
- Training assistance
- Software selection and/or implementation
- Formal documentation of lease policies
- Evaluating impact to other areas of the business

Questions?



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Be sure to join us next Tuesday at 12:00 p.m. EDT for An Update on the Employee Retention Tax Credit: Eligibility and Tax Benefit. More information at www.cohencpa.com.