# Accounting for Leases: Right of Use Model

August 11, 2016

Building a better working world

# Agenda

- Welcome and objectives
- Lease Accounting – New leases standard
  - Overview
  - Scope and scope exceptions
  - Key concepts
  - Lessee accounting
  - Lessor accounting
  - Effective date and transition

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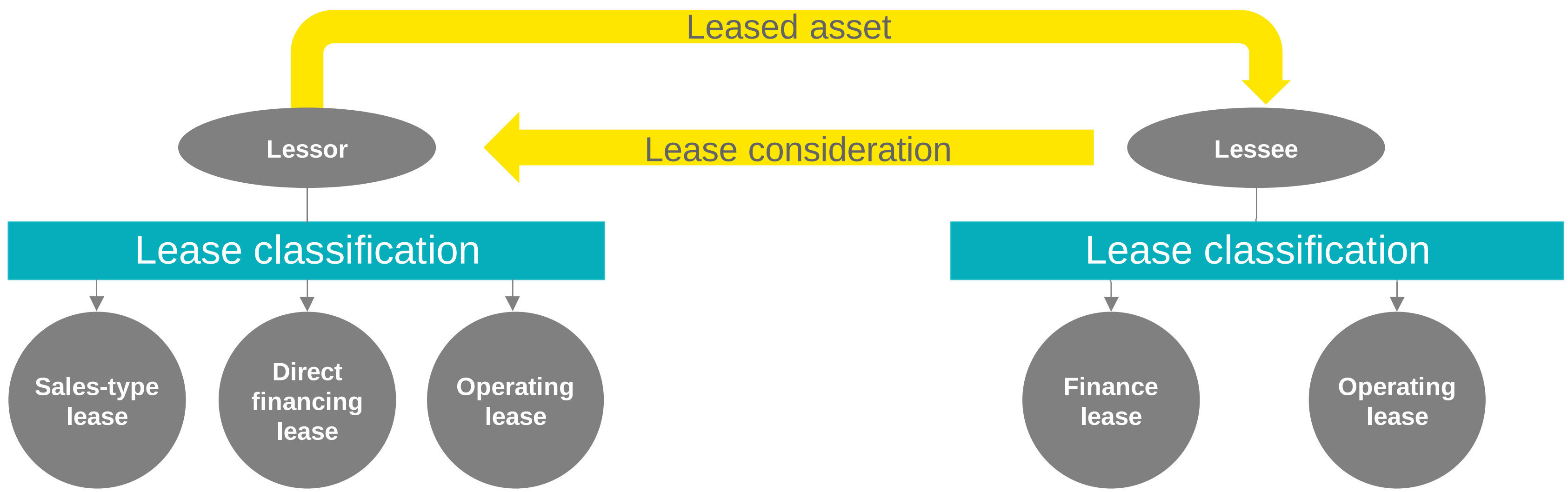
# Overview

## Right-of-use model




*Lessor: similar to current GAAP with some changes*

- Certain concepts would be aligned with the revenue recognition standard
- Changes to what would be considered initial direct costs
- Leveraged lease accounting would be eliminated for new leases after the effective date

### Balance sheet

- Right-of-use asset
- Lease liability

### Income statement

- Finance lease – generally “front-loaded” interest and amortization expense
- Operating lease – generally straight-line lease expense

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# Scope and Scope Exceptions

## General

- The scope of the new guidance is limited to leases of property, plant and equipment and does not apply to any of the following:
  - Leases of intangible assets
  - Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources, including the intangible rights to explore for those natural resources and rights to use the land in which those natural resources are contained (unless those rights of use include more than the right to explore for natural resources)
    - Leases of equipment used to explore for natural resources are not part of this scope exception (i.e., they are in scope of ASC 842)
  - Leases of biological assets, including timber
  - Leases of inventory
  - Leases of assets under construction
- Service concession arrangements within the scope of ASC 853, *Service Concession Arrangements*, are excluded from the scope of ASC 842

# Scope and Scope Exceptions

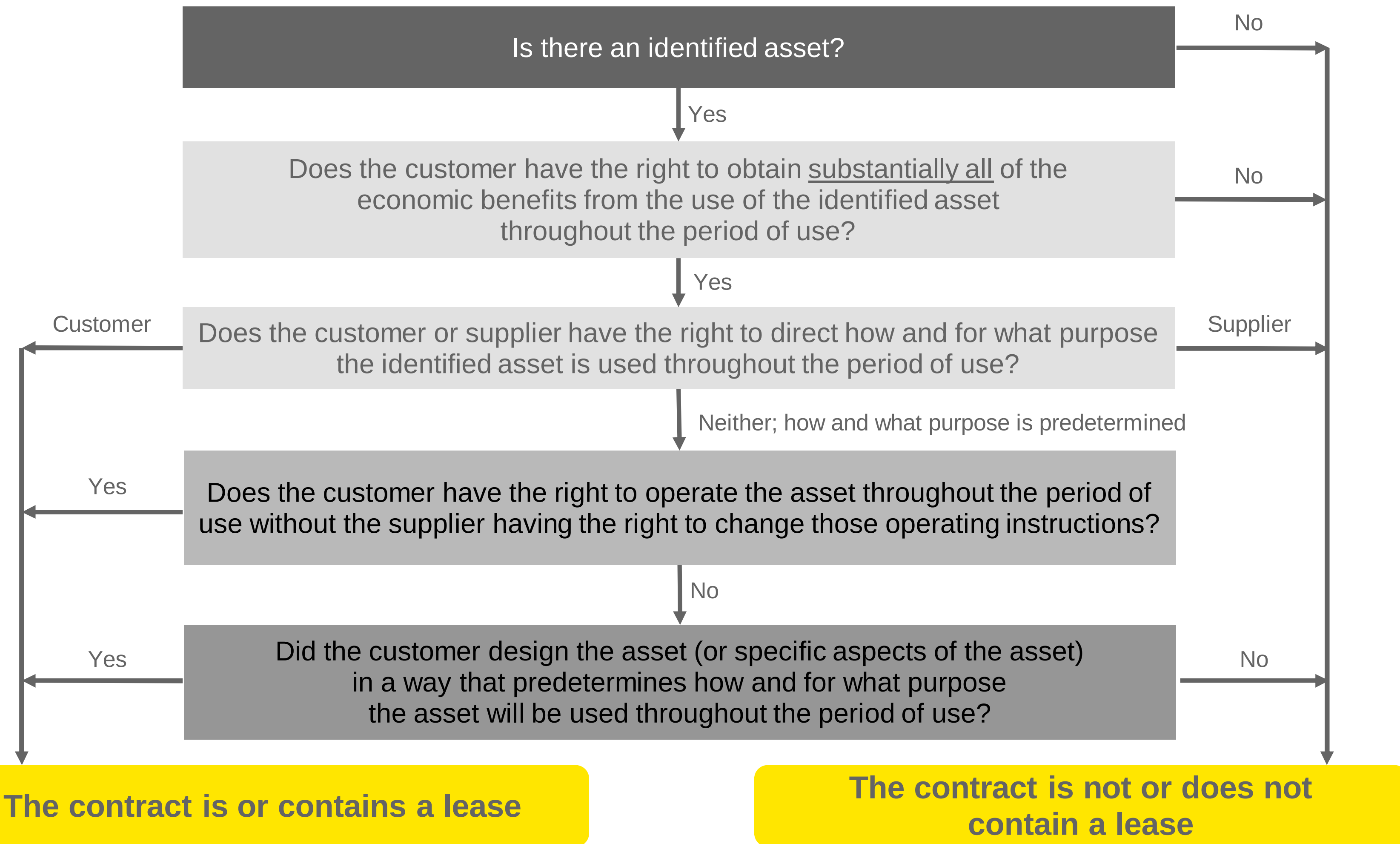
## Determining whether an arrangement contains a lease

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

- The assessment of whether a contract is or contains a lease will be straightforward in most arrangements
- Judgment will be required in applying the definition of a lease to certain arrangements
  - For example, the assessment may be complex when an arrangement contains a significant service component

# Scope and Scope Exceptions

## Determining whether an arrangement contains a lease (cont.)



# Scope and Scope Exceptions

## Illustrative example: fact pattern

- Customer enters into a contract with property owner (Supplier) to use Retail Unit A for a five-year period. Retail Unit A is part of a larger retail space with many retail units.
- Supplier can require Customer to relocate to another similar retail unit and could benefit economically from relocating the Customer; however, the rate required to create an economic benefit to the Supplier is highly susceptible to factors outside Supplier's influence.
- The contract requires Customer to use Retail Unit A to operate a specific store brand during the hours that the larger retail space is open.
- Customer controls physical access to the unit and makes all of the decisions about the use of the retail unit during the period of use. E.g., the mix of goods sold, the pricing of the goods sold, and the quantities of inventory held.
- The contract requires Customer to make fixed payments to Supplier as well as variable payments that are a percentage of sales from Retail Unit A.
- Supplier provides cleaning and security services as well as advertising services as part of the contract.

# Scope and Scope Exceptions

## Illustrative example: analysis and conclusion

- Retail Unit A is an identified asset — explicitly specified in the contract, and the supplier does not have substantive substitution rights
- Customer has the right to direct the use
  - a. Customer obtains substantially all of the economic benefits over the period of use (the variable payment represents consideration that Customer pays Supplier for the right to use the unit, and does not prevent Customer from having the right to obtain substantially all of the economic benefits).
  - b. Customer has the right to direct the use of Retail Unit A. The contractual restrictions on the goods and hours of operation define the scope of the Customer's right to use Retail Unit A. Customer makes the relevant decisions about how and for what purpose Retail Unit A is used within the scope defined in the contract. Customer has the right to change these decisions during the five-year period of use.

Retail Unit A Illustrative example modified from 842-10-55-63 through 70

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# Key Concepts

## Lease term and lease payments

- Lease term includes any non-cancelable periods
  - Reasonably certain is a high threshold for including optional periods (e.g., options to extend or terminate a lease)
  - Reasonably certain = reasonably assured
- Lease payments consistent with the lease term determination

| | | | | |
|---|---|---|---|---|
| Fixed payments, including in-substance fixed payments | Exercise price of a purchase option* | Payments for penalties for terminating the lease** | Variable lease payments that depend on an index or rate | Residual value guarantees – amounts probable of being owed (lessees only) |

* Include only if reasonably certain of exercise

** Include unless reasonably certain not to be exercised

- Also includes fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction



EY

# Key Concepts

## Lease payments (cont.)

| Types of variable lease payments | |
|---|---|
| Dependent on an index or rate | Not dependent on an index or rate |
| Included in the initial measurement of lease payments? | |
| **Yes** | **No** |
| ► Examples include: Consumer Price Index or market interest rate<br>► Measured based on prevailing index or rate at the measurement date (e.g., the commencement date for purposes of lease classification and determining the amounts of assets and liabilities lessees and lessors recognize)<br>► Lessees and lessors recognize changes to index- and rate-based variable lease payments in profit or loss in the period of the change | ► Examples include: performance- or usage-based payments<br>► For lessees, recognize expense in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable<br>  ► Any recognized variable lease expense is reversed when it is probable that the specified target will no longer be met<br>► For lessors, recognize income in the period when the changes in facts and circumstances on which the variable lease payments are based occur |

# Key Concepts

## Lease and non-lease components

- Many contracts contain leases (lease components) and agreements to purchase or sell other goods or services (non-lease components)
  - Non-lease components are identified and accounted for separately under other applicable Generally Accepted Accounting Principles (GAAP)
- Lessees allocate consideration in the contract to lease and non-lease components, on a relative standalone price basis, unless practical expedient is elected
  - Lessees can make a policy election (by class of underlying asset) to account for each lease component and its related non-lease component as a single lease component
- Lessors allocate consideration in the contract using the new revenue recognition standard (ASC 606)

**Maintenance activities are considered non-lease components**

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# Lessee Accounting

## Recognition and measurement

| | Finance leases | Operating leases |
|---|---|---|
| **Initial recognition and measurement** | Initially measures the ROU asset[1] and lease liability at the present value of the lease payments to be made over the lease term | |
| **Subsequent measurement – lease liability** | Accretes the lease liability based on the interest method using the discount rate determined at lease commencement[2] and reduces the lease liability by the payments made | Measures the lease liability at the present value of remaining lease payments using discount rate determined at lease commencement[2] |
| **Subsequent measurement – ROU asset** | Amortizes the ROU asset, generally on a straight-line basis over the shorter of lease term or the useful life of the ROU asset and records any impairment of the ROU asset | Measures the ROU asset at the amount of remeasured lease liability, adjusted for the remaining balance of any lease incentives received, any cumulative prepaid or accrued rents (i.e., uneven rent payments), any unamortized initial direct costs and any impairment of the ROU asset |
| **Income statement effect** | Generally "front-loaded" expense | Generally straight-line expense |

1 Initial measurement of the ROU asset also includes the lessee's initial direct costs and prepayments made to the lessor at or before the commencement date, less lease incentives received from the lessor

2 As long as the discount rate has not been updated as a result of a reassessment event

# Lessee Accounting

## Short-term leases

- Lessees can make an accounting policy election, by class of underlying asset to which the right of use relates, to use the short-term lease exception
  - Applies to leases with a lease term of 12 months or less that do not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise
- Lessees do not recognize a ROU asset or lease liability for qualifying leases and recognize lease payments as expense on a straight-line basis
- Exception is not available for lessors

**Example:** Noncancellable lease term of nine months with a four-month renewal option (assume no purchase option)

**A: Exercise of option is reasonably certain = not short-term lease**

Nine months | Four months

**B: Exercise of option is not reasonably certain = short-term lease**

Nine months | Four months

Noncancelable lease term

Optional renewal period

# Lessee Accounting

## Lease modifications

A change to the terms and conditions of a contract that results in a change in the scope of or the consideration for the lease

- A lease modification results in a separate contract if **both** of the following criteria are met:
  - The modification grants the lessee an additional right of use that is not included in the original lease (e.g., a right to use an additional underlying asset)
  - The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract
- If both criteria for a separate contract are met, lessees account for two contracts
  - The unmodified original contract
  - A separate contract, which is accounted for in the same manner as any new lease
- A lease modification that grants the lessee the right to use the existing leased asset for an additional period time does not result in a separate contract

# Lessee Accounting

## Presentation

| Balance sheet | | |
|---|---|---|
| | **ROU asset** | ► Lease ROU are assets presented either separately or together with other assets (e.g., owned assets)<br>► If presented together with other assets, disclose line items that include ROU assets and their amounts<br>► Finance lease ROU assets must be presented separately from operating lease ROU assets<br>► ROU assets are subject to same classification as other nonfinancial assets |
| | **Lease liability** | ► Lease liabilities presented either separately or together with other liabilities<br>► If presented together with other liabilities, disclose the line items that include lease liabilities and their amounts<br>► Finance lease liabilities must be presented separately from operating lease liabilities<br>► Lease liabilities are subject to classification as current and noncurrent, similar to other financial liabilities |

# Lessee Accounting

## Presentation (cont.)

| | |
|---|---|
| **Income statement** | **Finance leases**<br>► Lease-related amortization and lease-related interest expense presented in a manner consistent with how the entity presents depreciation or amortization of similar assets and other interest expense<br>**Operating lease**<br>► Lease expense included in income from continuing operations |
| **Statement of cash flows** | **Finance leases**<br>► Principal payments within financing activities<br>► Interest payments in accordance with ASC 230, *Statement of Cash Flows*<br>**Operating leases**<br>► All payments within operating activities, except for payments that represent costs to bring another asset to the condition and location necessary for its intended use (investing activities)<br>**Both lease types**<br>► Lease payments for short-term leases and variable lease payments (not included in the lease liability) within operating activities<br>► Supplemental noncash disclosures |

# Lessee Accounting

## Disclosures

- Disclosure objective – to enable financial statement users to assess the amount, timing and uncertainty of cash flows arising from leases
- Required qualitative and quantitative disclosures include:

| Qualitative |
| --- |
| ► Information about the nature of leases<br>  ► Basis and terms and conditions on which variable lease payments are determined<br>  ► Extension, termination and purchase options<br>    ► Options that are and aren't recognized as part of ROU assets and lease liabilities<br>  ► Restrictions or covenants imposed by leases<br>► Significant assumptions and judgments made in accounting<br>► Information about leases that have not yet commenced but that create significant rights and obligations for the lessee<br>► Lease transactions between related parties |

# Lessee Accounting

## Disclosures (cont.)

### Quantitative

- Finance lease cost, segregated between the amortization of the ROU assets and interest on the lease liabilities
- Operating lease cost
- Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less
- Variable lease cost
- Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense
- Net gain or loss recognized from sale and leaseback transactions
- The following items, separately by lease type:
  - Cash paid for amounts included in the measurement of lease liabilities
  - Supplemental noncash information on lease liabilities arising from obtaining ROU assets
  - Weighted-average remaining lease term
  - Weighted-average discount rate
- Maturity analysis of lease liabilities, separately by lease type, as of the reporting date
  - Reconciliation of undiscounted cash flows to lease liabilities, separately by lease type

Lessees may need to exercise judgment to determine the appropriate level at which to aggregate or disaggregate disclosures.

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# Lessor Accounting

## Initial recognition and measurement

| | |
|---|---|
| **Sales-type leases** | ► Collectibility is probable<br>► Derecognizes underlying asset<br>► Recognizes net investment in the lease<br>► Recognizes any selling profit or loss<br><br>► Collectibility is not probable<br>► Does not derecognize underlying asset as sale is deferred |
| **Direct financing leases** | ► Derecognizes underlying asset<br>► Recognizes net investment in the lease<br>► Recognizes any selling loss<br>► Defers any selling profit and includes it in the initial measurement of net investment in the lease<br><br>Note: Initial collectibility assessment affects classification |
| **Operating leases** | ► Continues to recognize the underlying asset<br>► Collectibility assessment affects subsequent recognition |

# Lessor Accounting

## Subsequent measurement

**Sales-type leases–collectibility is probable and Direct financing leases**

- Recognizes interest income over the lease term in an amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease including:
  - Interest on the lease receivable
  - Accretion of the unguaranteed residual asset
  - Amortization of any deferred selling profit (direct financing leases)
- Reduces net investment in the lease for lease payments received, net of interest income
- Separately recognizes income for variable lease payments that do not depend on an index or rate when the changes in facts and circumstances on which the variable lease payments are based occur
- Recognizes changes to variable lease payments that depend on an index or a rate in profit or loss in period of the change
- Recognizes any impairment of the net investment in the lease

# Lessor Accounting

## Subsequent measurement

| Sales-type leases– collectibility is <u>not</u> probable |
| --- |

- Accounts for the underlying asset under other US GAAP (e.g., depreciates the asset)
- Recognizes lease payments and variable lease payments that do not depend on an index or rate received as a deposit liability until the earlier of:
  - Collection of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, becomes probable
  - The lessor repossesses the underlying asset and has no further obligation to the lessee under the contract, and the lease payments received from the lessee are nonrefundable
  - The contract is terminated, and the lease payments received from the lessee are nonrefundable

# Lessor Accounting

## Subsequent measurement (cont.)

| Operating leases |
| --- |

- Collectibility is probable
  - Recognizes lease income, generally on a straight-line basis, over the lease term
  - Separately recognizes income for variable lease payments that do not depend on an index or rate when the changes in facts and circumstances on which the variable lease payments are based occur
  - Recognizes changes to variable lease payments that depend on an index or a rate in profit or loss in period of the change
- Collectibility is not probable
  - Lease income is limited to the lesser of (1) the income that would have been recognized if collection were probable, including income from variable lease payments and (2) the lease payments, including variable lease payments, that have been collected from the lessee
- If the collectibility assessment changes to probable after the commencement date, any difference between the lease income that would have been recognized if collectibility had always been assessed as probable and the income recognized to date is recognized as a current-period adjustment to lease income
- If the collectibility assessment changes to not probable after the commencement date, lease income is reversed if the lease payments, including variable lease payments, that have been collected from the lessee are less than the income recognized to date

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# Effective Date and Transition

## General

| Effective date for calendar-year companies | | |
|---|---|---|
| **Public business entities and certain other entities*** | **All other entities** | **Early adoption?** |
| 2019 and interim periods within that year | 2020 and interim periods in 2021 | Yes |

- Standard is applied as of the beginning of the earliest comparative period presented in the financial statements
- Lessees and lessors are required to adopt the new standard using a modified retrospective transition approach
  - Certain transition relief is available
- Certain disclosures are required in accordance with ASC 250, *Accounting Changes and Error Corrections*

* Public business entities, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an-over-the-counter market, and employee benefit plans that file or furnish financial statements with or to the SEC.

# Effective Date and Transition

Lessees and lessors

- All entities may elect to apply *all* of the following practical expedients (elected as a package and applied to *all* leases) not to reassess:
  - Whether contracts are or contain leases
  - Lease classification
  - Initial direct costs (i.e., whether those costs would have qualified for capitalization under the new leases standard)
- All entities can elect for all leases to (1) use hindsight in determining the lease term when considering lease options to extend or terminate the lease and to purchase the underlying asset and (2) assess impairment of ROU assets
  - Election could be made separately or in conjunction with the package of practical expedients above

# Thank you!

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