



# Understanding the New Lease Standard

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## JENNIFER PUTNAM, CPA, DIRECTOR

Jennifer has over 13 years of experience auditing non-profit organizations, public schools, independent schools, colleges and universities, and other nonprofit organizations, including prior experience in public accounting working for an international accounting firm. She is currently a part of the CliftonLarsonAllen National Assurance Technical Group, where she serves as a technical resource for the audit and assurance practice and performs a quality review of assurance and accounting engagements, focusing on non-profit organizations. She holds a BSBA in accounting and a MAcc from Bowling Green State University.





## STEPHANIE MARKERT, CPA, PRINCIPAL

Stephanie is a principal in the accounting and assurance resource group and has been with CliftonLarsonAllen since 2011. Stephanie has more than 15 years of experience in public accounting serving public and small private companies, including a five-year term serving public clients in Munich, Germany. Stephanie has led Sarbanes Oxley projects for public companies in Europe as well as held more traditional public auditor roles for clients with operations in the United States and Europe, primarily in the technology and manufacturing industries. During her assignment in Europe, Stephanie also participated in US GAAP and IFRS convergence projects for US clients with operations in Europe. Stephanie holds a BSBA in accounting from University of Alabama's Culverhouse College of Commerce and Business Administration and a MAcc from the University of Alabama-Birmingham School of Business.



# Learning Objectives

- At the end of this session you will be able to:
  - Understand the changes associated with the new lease standard
  - Recognize the tax impact of the new lease standard
  - Obtain helpful tips on implementation for practitioners and public auditors who communicate with clients







# **Background and Overview of the New Lease Standard**

# An Overview

- Amended guidance issued in February 2016 for the treatment of leases, including subleases
- Affects all industries
- Lessee will be required to recognize a right-of-use asset and lease liability for substantially all operating and finance leases
- Lessor accounting will remain relatively unchanged
- Changes the accounting for sale and leaseback transactions
- Enhanced disclosures for lessees and lessors

# An Overview

The standard **DOES NOT** apply to:

- Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas, and similar non-regenerative resources
- Leases of biological assets, including timber
- Leases of inventory
- Leases of assets under construction

**KNOW THE RULES!**



# Why the Change?

## Lessee

- Most lease assets and liabilities are off-balance sheet
- Limited information about operating leases

## Lessor

- Lack of transparency regarding residual values
- Consistency with leases and revenue recognition

# Why the Change?

- Challenging to gain an accurate understanding of a company's real indebtedness
- Professional investors and Wall Street analysts are able to make estimates. However, they sometimes ***overestimate*** the liabilities arising from those obligations.





# Why the Change?

- Can the average investor get the complete picture?
- The confusion, the *SEC determined*, was a big problem.
- Now what? SEC asked FASB and IASB to work a new, global, converged standard.
  - ASU No. 2016-02 Leases (Topic 842)



# Why the Change?

- Some compare the implementation similar to the roll-out of Sarbanes-Oxley (SOX)
- The goal of SOX was to protect investors from corporate fraud
- The new lease accounting standards bring a much higher level of transparency to leases



# Effective Dates

- Fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for any of the following:
  - A public business entity;
  - A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market;
  - An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission (SEC).



# Effective Dates

- Fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020:
  - All other entities
- Early application is permitted for all entities





# Lease Determination



# What is a Lease?

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.



# Lease Determination

- An identified asset
  - Can be explicitly or implicitly specified
  - Supplier has no practical ability to substitute
  - Supplier receives no economic benefit from substituting
- The right to control the use during the lease term
  - Decision making authority over the use of the asset
  - Ability to obtain substantially all economic benefits from the use of the asset



# An Identified Asset: Explicitly or Implicitly Identified

- Explicit; but contains contractual terms allowing the supplier to fulfill the control without actually using the identified asset
- Must consider substitution rights
- Implicit Examples:
  - Only one asset can be used to fulfill contract
  - Feasibility of substitution



## Example: Implicitly Identified Assets

- ABC Bank enters into lease contract with Supplier Corporation.
- Lease contract does not explicitly identify equipment
- ABC Bank imposes restrictions on the equipment to be used due to security of customer data
- Supplier Corp. has multiple data centers and can service multiple customers at one time
- Contract specifies type of equipment, restriction on access and substitution for duration of contract



## Example: Implicitly Identified Assets

- Does the contract explicitly or implicitly identify an asset to be used to fulfill the contract?
- Yes. Although the assets used to fulfill the contract are not explicitly identified, the assets are implicitly identified as a result of the contractual requirements.





# Physically Distinct

- A physically distinct asset may be an entire asset or a portion of an asset
- For example, a building is generally considered physically distinct, but one floor within the building may also be considered physically distinct if it can be used independent of the other floors
- Assets that can be used by more than party
  - Capacity in a pipeline



# Substantive Substitution Rights

- Based upon facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception, are not considered likely to occur. Examples include:
  - An agreement by a future customer to pay an above-market rate for use of the asset
  - Introduction of new technology that is not substantially developed at contract inception
  - A substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at contract inception
  - A substantial difference between the market price of the asset during the period of use and the market price considered likely at contract inception



# Substantive Substitution Rights

- A supplier's right to substitute an asset is substantive only if both of the following conditions exist:
  - The supplier has the practical ability to substitute alternative assets throughout the period of use
  - The supplier would benefit economically from the exercise of its right to substitute the asset



# Substantive Substitution Rights

- The supplier's right or obligation to substitute an asset for repairs and maintenance does not preclude the customer from having the right to use the identified asset
- If the customer can not readily determine whether there is a substantive substitution right, presume that any substitution right is not substantive



## Example: Substantive Substitution Rights

- Building Corp owns a large building that can be subdivided into numerous subsections by inserting removable walls.
- It leases out different portions as storage space
- ABC Corp. contracts with Building Corp to reserve 1500 square feet for inventory in an identified location (explicitly stated)
- Per the contract, Building Corp. can shift inventory at it's discretion as long as it's 1500 sq. ft.





## Example: Substantive Substitution Rights

- Building Corp often reorganizes its space to meet the needs of new contracts.
- The cost of reallocating space is low compared to the benefits of being able to accommodate more customers
- Does the contract explicitly or implicitly identify an asset to be used to fulfill the contract?



## Example: Substantive Substitution Rights

- No.
- The asset is not identified because Building Corp has a substantive substitution right.
- Building Corp has agreed to provide a specific level of capacity within its warehouse but has the unilateral right to relocate the inventory without significant cost.



# Right to control

- Asset has been identified...now what?
- Evaluation of whether control exists over the period of use
- If no control – Service or Supply Contract
- Both requirements are needed:
  - The right to obtain substantially all of the economic benefits from use of the identified asset
  - The right to direct the use of the identified asset



# A Closer Look at Control: Decision-Making Rights

## Yes

- Right to change type of output produced
- Right to change when the output is produced
- Right to change where the output is produced
- Right to change whether the output is produced and the quantity of that output

## No

- Rights that are limited to operating and maintaining the asset

## Example: Control of Identified Asset

- Restaurant Franchise enters into a contract with Supplier Corp for airplane transportation on an identified asset for executives over a four-year period.
- Restaurant tells Supplier dates and location 2 weeks in advance of meetings
- Restaurant Franchise will pay Supplier Corp a \$125,000 fee per month for use of the airplane.
- Supplier Corp provides the airplane, crew, and pilot



## Example: Control of Identified Asset

- Which party has the right to control the use of the identified asset during the period of use?
- *Analysis*
- Restaurant Franchise!
  - It can decide how and when the plane will be utilized during the period of use
  - The frequency and distance traveled are more relevant to the overall economic benefits
- Supplier Corp only makes operational decisions about the flight plan



## Example 1 – Concession Space

- A coffee company enters into a contract with an airport operator to use space in the airport to sell its goods for a 3 year period
- Contract specifies the amount of space. The space may be located at any of several boarding areas.
- Supplier can change the location of the space at any time during the period of use with minimal cost to the supplier
- Customer owns and uses a kiosk that can easily be moved
- Does the contract contain a lease?



# Example 1 – Concession Space

- NO!
- There is no identified asset.
  - The contract is for space in the airport, but it can change at the discretion of the supplier
- Supplier has the substantive right to substitute the space
  - Practical ability to change
  - Would benefit economically from substitution
    - ◇ Minimal cost
    - ◇ Substituting allows the supplier to make the most effective use of the space at boarding areas as circumstances change





## Example 2 – Contract for Energy/Power

- A utility company (customer) enters into a contract with a power company (supplier) to purchase electricity produced by a new solar farm for 20 years
- Solar farm is explicitly identified in the contract and the supplier has no substitution rights
- Solar farm is owned by the supplier and the energy can not be provided to the customer from another asset
- Customer designed the solar farm and supplier must build to those specifications as well as operate and maintain the farm
- Does the contract contain a lease?



## Example 2 – Contract for Energy/Power

- YES!
- Customer has the right to use the solar farm for 20 years
- There is an identified asset
  - Explicitly identified in the contract
  - No right of substitution



## Example 2 – Contract for Energy/Power

- Customer has the right to control the use of the solar farm throughout the 20 years
  - Right to obtain substantially all of the economic benefits from the use of the solar farm
  - Exclusive use of the solar farm
  - Right to direct the use of the solar farm
    - ◇ Customer does not operate the solar farm. Supplier makes decision regarding operating. However, the customer design of the solar farm has given it the right to direct the use of the farm
    - ◇ Design of the solar farm predetermined how and what for what purpose the asset will be used, which is substantively no different from the customer controlling those decisions



## Example 3 – Contract for Energy/Power

- A customer enters into a contract with a power supplier to purchase all of the power produced by an explicitly specified power plant for three years
- Power plant is owned and operated by the supplier and the supplier is unable to provide power to the customer from another plant
- The contract sets out the quantity and timing of power that the power plant will produce, which can not be changed
- Supplier designed the power plant and the customer had no involvement in the design
- Does the contract contain a lease?



## Example 3 – Contract for Energy/Power

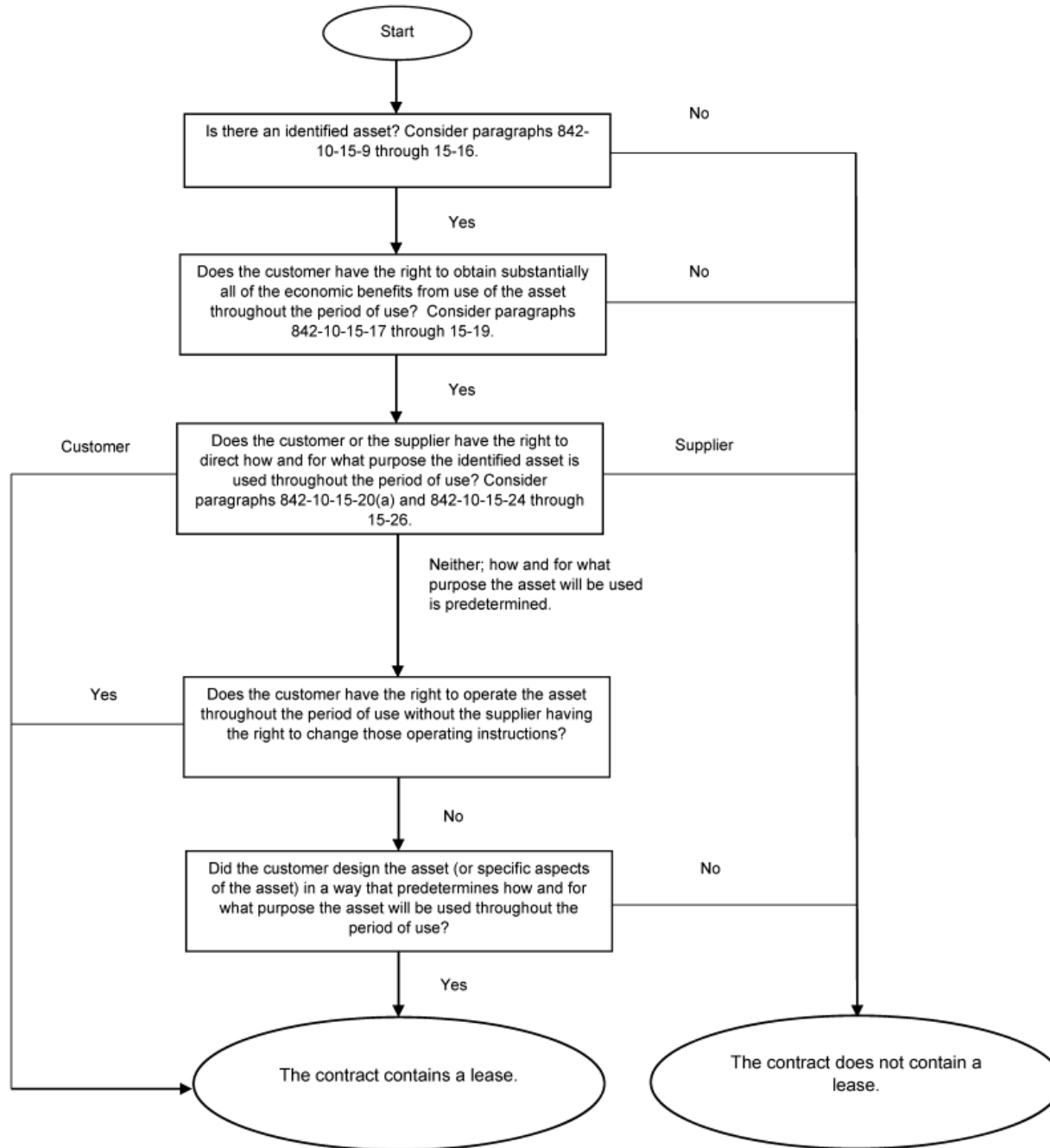
- NO!
- There IS an identified asset
  - Power plant is explicitly identified
  - Supplier does not have the right to substitute
- Customer DOES have the right to obtain substantially all of the economic benefits
- Customer DOES NOT have the right to control the use of the power plant
  - Does not have right to direct its use



## Example 3 – Contract for Energy/Power

- Customer DOES NOT have the right to control the use of the power plant
  - Does not have the right to direct or change how and for what purpose the plant is used
    - ◇ Predetermined in the contract
  - Does not have other decision-making rights about the use of the power plant during the period of use
    - ◇ It does not operate the power plant and did not design the power plant





# Contract Components



- Once it has been identified that a contract contains a lease, an entity must separate the lease components in the contract
- Lease component if **BOTH** criteria are met:
  - Lessee can benefit from the ROU either on its own or together with other readily available resources
  - The ROU is neither highly dependent, nor highly interrelated with other right(s) to use underlying assets in the contract
- Consideration in the contract should be allocated to each separate lease component and nonlease component of the contract



# Contract Components – Example 1

- Lease for a bulldozer, truck, and a crane to be used for three years
- Lessor agrees to maintain each piece of equipment throughout the lease term



# Contract Components – Example 1

- Are the leases of the bulldozer, truck, and crane each separate lease components?
  - Lessee can benefit from each piece on its own or together with readily available resources
  - The machines are not highly dependent on or highly related to each other
- Non-lease maintenance service components accounted for separately
  - Not a part of the lease!!



# Contract Components – Example 1

- Lessor allocation of consideration:
  - Apply guidance in Topic 606
- Lessee allocation of consideration:
  - Allocated based upon observable standalone prices for similar equipment and services



## Contract Components – Example 2

- Payments for taxes and insurance are included in a contract
- Annual lease payments are fixed at \$10,000 per year
- Real estate taxes and insurance payments are variable and will be billed to the lessee each year



## Contract Components – Example 2

- Are the real estate taxes and insurance components of the contract?
- Contract contains a single lease component
  - The right to use the building
- Lessee payments are a reimbursement of the lessor's costs
  - Not a payment for goods or services in addition to the right to use the building



## Contract Components – Example 3

- Payments for taxes and insurance are included in a contract
- Annual lease payments are fixed at \$13,000 per year
- Contract components are itemized
  - \$10,000 for rent
  - \$2,000 for real estate taxes
  - \$1,000 for insurance



## Contract Components – Example 3

- Are the real estate taxes and insurance components of the contract?
- Contract contains a single lease component
  - The right to use the building



## Contract Components – Example 4

- Payments for taxes, insurance, and common area maintenance are included in a contract
- Annual lease payments are fixed at \$13,000 per year and include rent, taxes, insurance, and building maintenance





## Contract Components – Example 4

- Real estate taxes and insurance are still not components of the contract
- What about the common area maintenance?
- Lessee receives a service from the lessor
  - A second component of the contract (non-lease component)
  - Consideration is allocated among the two components



# Contract Components – In Summary

## Lessee

- Separate lease components from non-lease components
- Allocate the consideration on a relative standalone basis
  - Use observable standalone prices wherever available
- May elect practical expedient to not separate the non-lease component
  - Accounting policy

## Lessor

- Allocate the transaction price to separate performance obligations
  - Follows the new revenue recognition standard





# Lease Classification

# Lease Classification: What changed?

- Before ASU 842
  - Lease classification determined asset or liability recognition
    - ◇ Specific criteria, including specific bright lines
    - ◇ Numerous interpretations
- ASU 842
  - The terms of a lease arrangement
    - ◇ Either operating or financing
    - ◇ All leases on the balance sheet
    - ◇ Income statement recognition



# Operating or Financing

- When the terms of a lease effectively transfer control of the underlying asset, the lease is, in substance, a financed purchase (sale) of an asset and the lease is classified as a finance lease by the lessee and a sales-type lease by the lessor.
- All other leases are classified as operating leases



# Lease Classification – Lessee

- Financing lease if ANY of the following 5 conditions are met:
  - Transfer of ownership
  - Option to purchase is reasonably certain
  - Lease term is a major part of the economic life
  - Present value of lease payments is substantially all of the fair value of the underlying asset
  - The underlying asset is of a specialized nature
- If none of the above are met, the lease is operating



# Lease Classification – Lessee

- Lease term is a “major part” of the economic life
  - 75% or more of remaining economic life of the underlying asset
  - A commencement date that falls at or near the end of the economic useful life refers to a commencement date that falls within the last 25% of the total economic life
- Present value of lease payments is “substantially all” of the fair value of the underlying asset
  - 90% or more of the fair value of the underlying asset



# Lease Term – Initial Measurement

- Slightly new definition
  - Noncancellable period for which lessee has right to use the underlying asset, plus periods covered by:
    - ◇ Option if lessee reasonably certain to extend
    - ◇ Option to terminate if lessee is reasonably certain not to exercise
    - ◇ Option to extend (or not terminate) controlled by lessor
- Reasonably certain
  - Must consider all relevant factors that create an economic incentive for the lessee to exercise the option





# Lease Term – Subsequent Measurement

## Lessee

- Reassess only upon the occurrence of a significant event/change in circumstances that is within the control of the lessee
  - Absent a modification

## Lessor

- Not required to reassess
  - Absent a modification



# Lease Term – Other Considerations

- Related party leases must follow contractual provisions
- Beware of potential impact on leasehold improvement amortization



## Lease Term Example

- Lessee Corp enters into an agreement to lease an warehouse for 15 years. The lease grants Lessee Corp the option to renew the lease for an additional 15 years. Although Lessee Corp has a history of exercising renewal options for other warehouses, per the lease arrangement, the rental costs adjust to current market rents for equivalent warehouses space upon exercise of the renewal option.
- What is the lease term?



## Lease Term Example

- Since the rents at the beginning of the renewal period will adjust to market rents, the renewal option does not create an economic incentive for Lessee Corp. Even though Lessee Corp historically renews similar leases, they will likely conclude, at the lease commencement date, that the option is not reasonably certain of exercise.
- Accordingly, the lease term would be 15 years



# Lease Classification – Lessor

- Sales-type lease if ANY of the following 5 conditions are met:
  - Transfer of ownership
  - Option to purchase is reasonably certain
  - Lease term is a major part of the economic life
  - Present value of lease payments is substantially all of the fair value of the underlying asset
  - The underlying asset is of a specialized nature
- If none of the above are met, the lease is either a direct financing lease or an operating lease



# Lease Classification – Lessor

- Direct financing lease if BOTH of the following conditions are met:
  - PV of the sum of the lease payments plus any residual value guaranteed by the lessee not already reflected in the lease payments and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset
  - It is probable that the lessor will collect lease payments plus any amount necessary to satisfy the residual value guarantee
- If both are not met, the lease is an operating lease





# Recognition and Measurement

Lessee Accounting

# Balance Sheet Impact

## Finance Lease

- Right-of-Use Asset
- Lease Liability

## Operating Lease

- Right-of-Use Asset
- Lease Liability



# Lease Liability – Initial Measurement

- Present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement
- Other than PBEs may elect to use the risk-free rates for measurement of all lease liabilities
  - Simpler, but will likely result in recording a larger asset and liability.
  - Can not pick and choose - it is a package
- Real estate taxes and insurance
  - Sometimes included in lease liability measurement



# Right-of-Use Asset – Initial Measurement

- Consists of all of the following at commencement date:
  - Initial measurement of the lease liability
  - Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received
  - Any initial direct costs incurred by the lessee
    - ◇ Commissions
    - ◇ Payments made to existing tenants
- NOTE: The asset and liability may not always agree to each other!



# Income Statement Impact

## Finance Lease

- Amortization Expense
- Interest Expense

## Operating Lease

- Lease Expense

# Cash Flow Statement Impact

## Finance Lease

- Operating – Cash Paid For:
  - Interest Payments
  - Variable Portions of the Lease Payments
- Financing – Cash paid for:
  - Principal Payments

## Operating Lease

- Operating – Cash Paid For:
  - Lease Payments

# Example – Operating Lease

3 year lease term

Annual rent of \$100, escalating \$3 annually

7% interest rate



# Example – Operating Lease

Initial Recognition:

Dr. ROU Asset           270  
    Cr. Lease Liab               270

Year 1 Entry:

Dr. Lease Exp           103 **A**  
Dr. Lease Liab           81 **D**  
    Cr. Cash               100 **B**  
    Cr. Accum Amort       84 **A-C**

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

NOTE: No amortization expense is recorded! It is a component of the lease expense!

# Example – Finance Lease

3 year lease term

Annual rent of \$100, escalating \$3 annually

7% interest rate



# Example – Finance Lease

Initial Recognition:

Dr. ROU Asset            270  
                                  Cr. Lease Liab                    270

Year 1 Entry:

Dr. Interest Exp            19 **C**  
 Dr. Amort Exp            90 **A**  
 Dr. Lease Liab            81 **D**  
                                  Cr. Cash                    100 **B**  
                                  Cr. Accum Amort            90 **A**

	Asset	Liability			Expense
	Amortiza tion	Payment	Interest	Principal	
Year	A	B	C	D	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

NOTE: No lease expense is recorded. Each component is recorded.





# Lessor Accounting

# What Changed?

- Largely unchanged, however some changes made to align:
  - The lessor accounting guidance with specific changes made to the lessee accounting guidance
    - ◇ Primarily changes to glossary terms applied by both lessees and lessors for consistency
  - Key aspects of the lessor accounting model with the new revenue recognition standard



# Lessor Accounting Model

## Balance Sheet

## Income Statement

## Cash Flow Statement

Sales-Type  
& Direct  
Financing

Net investment in  
the lease

Interest income  
and any selling  
profit on lease

Operating: Cash  
received for  
lease payments

Operating

Continue to  
recognize the  
underlying asset

Lease income

Operating: Cash  
received for  
lease payments

Lessor accounting is largely unchanged

Classification criteria substantially similar to that in previous lease guidance



# Sales-Type Leases—Lessor

- Derecognize the underlying asset and recognize a right to receive lease payments (the lease receivable) and a residual asset (representing the rights the lessor retains relating to the underlying asset)
- Recognize the unwinding of the discount on both the lease receivable and the residual asset as interest income over the lease term
- Recognize any selling profit or loss and initial direct costs relating to the lease at the commencement date
- Exception: if collectability of the lease payments is not probable



# Direct Financing Leases—Lessor

- Derecognize the underlying asset and recognize a right to receive lease payments (the lease receivable) and a residual asset (representing the rights the lessor retains relating to the underlying asset)
- Recognize the unwinding of the discount on both the lease receivable and the residual asset as interest income over the lease term
- Recognize any selling **LOSS** relating to the lease at the commencement date
- Selling **PROFIT** and initial direct costs are deferred and included in the calculation of the net investment in the lease



# Operating Leases—Lessor

- Continue to recognize the underlying asset
- Recognize lease income over the lease term typically on a straight-line basis





## Other Considerations

# Transition - Overview

- Modified Retrospective Approach - REQUIRED
  - Requires application at the beginning of the earliest comparative period presented in the period of adoption
- Package of practical expedients
- Change in classification (between operating and capital/finance)
- Existing leveraged leases are grandfathered





# Transition – Package of Practical Expedients

- An entity need not reassess:
  - Whether any expired or existing contract are or contain embedded leases
  - Lease classification of any expired or existing leases
  - Initial direct costs for any existing leases



# Transition – Package of Practical Expedients

- Applies to leases that commenced **BEFORE** the effective date
- Must apply as a package to all leases
  - Can not pick and choose which leases
  - Can not pick and choose which practical expedients
- Hindsight can also be elected as a practical expedient
  - Determination of lease term
  - Impairment of right-of-use assets
  - Can be used separately or in conjunction with package
  - Must apply consistently to all leases



# Transition – Change in Classification

- Operating to finance
  - Measure the ROU asset as the applicable proportion of the lease liability at the commencement date
    - ◇ Lease liability = PV of remaining minimum rental payments plus any amounts probably of being owed under a residual value guarantee
    - ◇ Applicable portion = remaining lease term at the beginning of the earliest comparative period presented
  - Adjust the ROU asset recognized by the carrying amount of any prepaid or accrued lease payments and the carrying amount of any liability recognized



# Transition – Change in Classification

- Operating to finance
  - Write-off, as an adjustment to equity, any unamortized initial direct costs that do not meet the definition of an initial direct cost in this topic at the LATER of:
    - ◇ The beginning of the earliest period presented in the financial statements OR
    - ◇ The commencement date of the lease



# Transition – Change in Classification

- Capital to operating
  - Derecognize the carrying amount of any capital lease asset and capital lease obligation
    - ◇ Later of the beginning of the earliest comparative period presented or the commencement date of the lease
    - ◇ Any difference between the carrying amounts should be accounted for in the same manner as prepaid or accrued rent
  - Recognize ROU asset and lease liability
    - ◇ Measurement will depend upon when lease commenced
      - If commenced before beginning of earliest period presented vs. after the beginning of the earliest period presented



# Transition – Change in Classification

- Capital to operating
  - Account for the operating lease in accordance with the rest of the guidance
  - Write-off, as an adjustment to equity, any unamortized initial direct costs that do not meet the definition of an initial direct cost in this topic at the LATER of:
    - ◇ The beginning of the earliest period presented in the financial statements OR
    - ◇ The commencement date of the lease



# Leveraged Lease Arrangements

- Existing leveraged leases are grandfathered
- The lessor model has been carried forward substantially unchanged
- Netting of non-recourse debt previously permitted under the leveraged lease model will no longer be available



# Sale and Leaseback Transactions

- Under the new standard, a sale-leaseback transaction will qualify as a **sale** only if
  - It meets the sale guidance in the new revenue recognition standard;
  - The leaseback is not a finance lease;
  - If there is a repurchase option:
    - ◇ The repurchase price is at the asset's fair value at the time of exercise and
    - ◇ Alternative assets that are substantially the same as the transferred asset are readily available in the marketplace





# Sale and Leaseback Transactions

## Has a Sale Occurred?

- Apply topic 606 (new revenue recognition standard)
- If there is a sale, apply the guidance in this topic for a leaseback
- Finance leasebacks
  - No sale has occurred
- Repurchase options
  - May be a sale given certain criteria are met

## Accounting for the Sale and Purchase

- Seller-lessee
  - Gain or loss on sale recognized the same as the sale of other nonfinancial assets
- Buyer-lessor
  - Account for the purchase the same as other nonfinancial assets



# Accounting for Reassessment

## Indicator to Reassess

## Accounting Treatment

### Lease Term and Purchase Options

Change in the assessment of lessee renewal, termination or purchase options

Reallocate contract consideration between lease and non-lease components

### Residual Value Guarantees

Change in amounts probable of being owed under a lessee provided residual value guarantee

Remeasure the lease liability

### Resolution of Contingency

Contingency resolved - some or all of variable payments become fixed

Adjust the ROU asset

# Lease Modifications

- A change to the terms and conditions of a contract that results in a change in the scope or consideration for a lease. For example:
  - Terminates or adds the right to use one or more underlying assets
  - Extends or shortens contractual lease term
- Remeasure lease payments if modification is not a separate contract
- Reassess classification of the lease upon modification
- The exercise of an existing purchase or renewal option is not a modification, but can result in remeasurement



# Asset Impairment

## Lessee

- Apply guidance for long-lived assets (ASC 360)
- Appropriately write-down the ROU asset
- Amortize the ROU asset on a straight-line basis

## Lessor

- Sales-type and direct financing leases: apply guidance for receivables (ASC 310)
- Operating leases: apply guidance for long-lived assets (ASC 360)



# Variable Lease Payments – Initial Measurement

- A lessee should remeasure variable lease payments that depend on an index or a rate when the lessee is otherwise required to remeasure the lease
  - Remeasurement based on the index/rate as of the remeasurement date
  - Subsequent changes to variable payments based on index/rate are expensed in the period incurred (absent a new requirement to remeasure)



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# Variable Lease Payments – Subsequent Measurement

- A lessee should remeasure if:
  - A contingency associated with a variable lease payment is subsequently resolved
  - There is a change in the amounts expected to be payable under residual value guarantees





# Disclosures and Other Presentation Matters

# Disclosures

- Objective
  - Enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases
- Requirement
  - Enhanced qualitative and quantitative disclosures





# Lessee Disclosures - Qualitative

- Nature of leases
- Leases that have not yet commenced but create significant rights and obligations for the lessee
- Significant assumptions and judgements made in application
- Main terms and conditions of any sale and leaseback transactions
- Whether a policy election was made for short-term lease exemption



# Lessee Disclosures - Quantitative

- Finance lease cost segregated between amortization and interest
- Operating lease cost
- Short-term lease cost
- Variable lease cost
- Sublease income
- Gains/losses from sale and leaseback transactions



# Lessee Disclosures - Quantitative

- Segregate amounts for finance and operating leases for the following:
  - Cash paid for amounts included in the measurement of lease liabilities
  - Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets
  - Weighted-average remaining lease term
  - Weighted-average discount rate



# Lessor Disclosures - Qualitative

- Nature of leases
- Significant assumptions and judgments made in application
- Significant changes in components of net investment in the lease
- Residual value risk mitigation



# Lessor Disclosures - Quantitative

- Table of lease income
- Lease income related to variable lease payments not included in measurement of the lease receivable
- Maturity analysis of undiscounted cash flows that comprise the lease receivable
- Profit or loss recognized at commencement date
- Topic 360 disclosures on PP&E for underlying assets under operating leases



# Balance Sheet Presentation

## ROU Asset

- Permitted to present separately or combined with other assets
- If combined, disclose amount and line items where they are presented
- Presenting finance lease ROU assets with operating lease ROU assets is prohibited

## Lease Liability

- Permitted to present separately or combined with other liabilities
- If combined, disclose amount and line items where they are presented
- Presenting finance lease liabilities with operating lease liabilities is prohibited





# Tax Implications

# General Lease Treatment under Current Tax Law

- General Rule: Lease payments are deductible as rent expense in the tax year paid, unless contract contains provisions resulting in capital lease for tax purposes.
- ✓ New standard does not change the treatment of leases for income taxes.





# Leases Requiring Capitalization for Tax Purposes

- Capital Lease for Tax Purposes:
  - Portion of lease payment designated as interest
  - Bargain purchase option
  - Title passing to lessee at end of lease term
  - Lease payments exceed fair rental value
  - Unreasonably low rental payments upon renewal
- Capital Lease Tax Treatment:
  - Depreciable Tax Basis Capitalized = FMV at Inception of Lease
    - ◇ Typically equal to PV of minimum lease payments
  - Depreciated in same manner as is if asset purchased
    - ◇ Tax life & depreciation method based on underlying asset leased
  - Interest on lease obligation deductible over lease term
    - ◇ If no interest rate stated, use Lessee's incremental borrowing rate



# Other Tax Considerations

- State Apportionment
  - Only applies to states using property factor to apportion taxable income
  - Computation of property factor may be affected to the extent that the property factor is computed based on the GAAP basis of PP&E (e.g. Mississippi)
  - Capital Lease: Right-of-use assets presented on GAAP balance sheet line item other than PP&E
    - ◇ Evaluation under laws of relevant tax jurisdiction required to determine whether such assets are includible in the property factor
  - Operating Lease: Amortization and interest expense reported as rent expense line item on income statement



# Other Tax Considerations

- Other State Tax Considerations:
  - Franchise, Net Worth and Other Non-Income-Based Taxes
  - Personal Property or Real Estate Taxes
  - Sales and Use Tax

❖ **Contact CLA for Assistance**
- Deductible Interest Expense under IRC Section 163(j)
- Transfer Pricing (Related Party Leases)

❖ **Contact CLA for Assistance**
- Foreign Tax Considerations:
  - Some foreign jurisdictions account for lease transactions for tax purposes in accordance with book treatment.

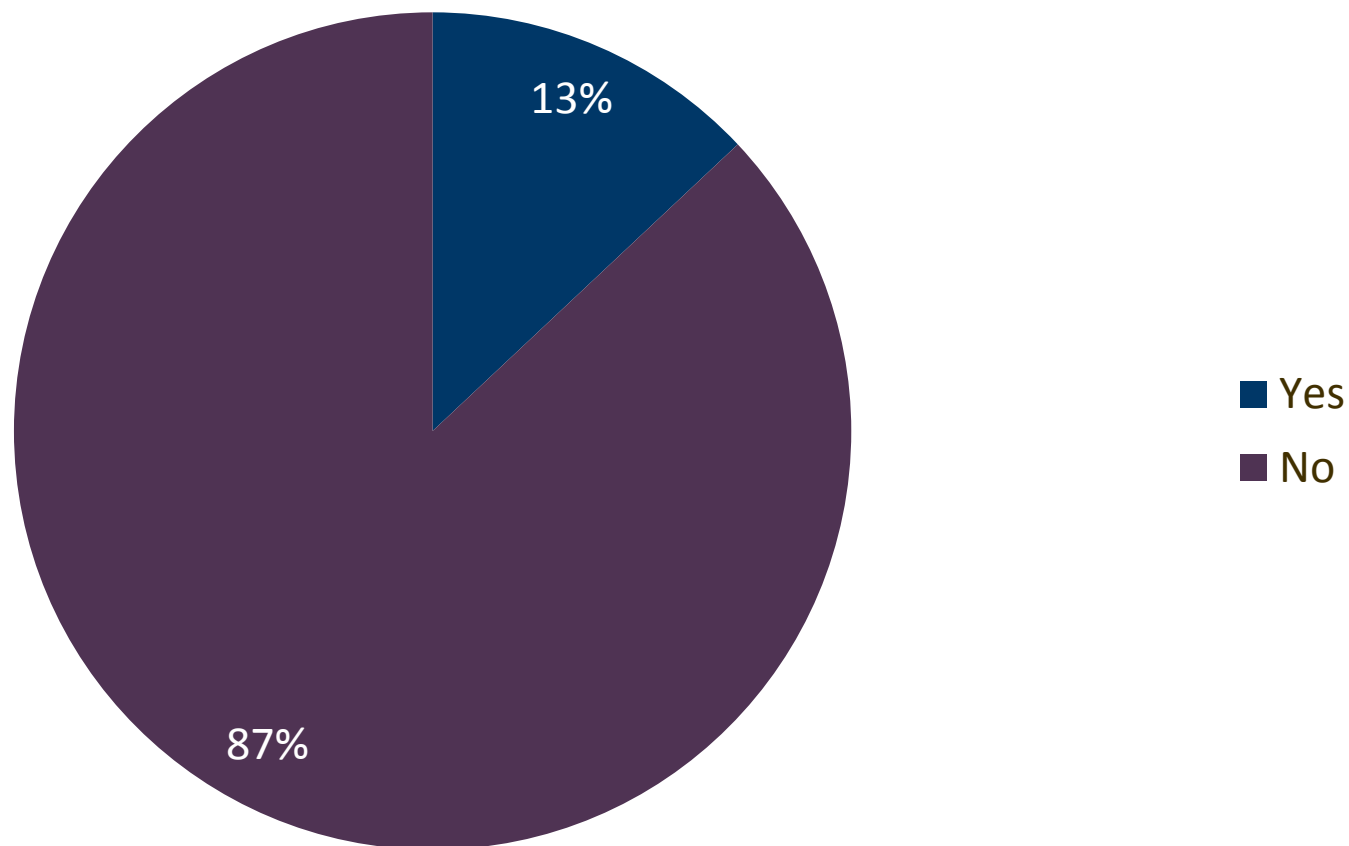
❖ **Contact CLA for Assistance**





## Action Items

# Does Your Company Have a Clear Plan for Implementation?



# What Lessees Should Be Doing Now

- Begin gathering data on the leases you have now
- Evaluate the processes and controls currently in place
- Decide whether or not to elect optional practical expedients



# What Lessees Should Be Doing Now

- Review existing and future debt agreements for covenants
- Consider how the revenue recognition standard will affect your Organization and if you should be implementing the lease standard in conjunction with the revenue recognition standard



# Data Collection and Ongoing Data Management

- Existing systems(e.g., spreadsheets and software) may include some lease information
  - All information required to make the calculations?
  - Judgements (including on going assessments) and information for disclosures?
- Significant effort could be required to manually gather missing lease information





# Data Collection and Ongoing Data Management

- Decentralized lease procurement and administration depending on the business unit, geographic location, or type of leased asset could be a challenge
- Determining the completeness of the lease portfolio, as well as the accuracy and completeness of the lease data, may require considerable effort



# Data Collection and Ongoing Data Management

- Treatment of lease and non-lease components within a contract
  - For contracts with multiple components, a company is required to identify and separate non-lease components (e.g., operations, maintenance services) from the lease component



# IT Systems, Processes and Controls

- Update existing systems or implement new
- Require input, not only from accounting, but also from the lease administration and IT functions, depending on the company's enterprise resource planning (ERP) environment
- Define system requirements and the expectations of relevant stakeholders prior to selecting a vendor



# Accounting Policies and Manuals

- Ensure accurate and consistent policies and processes around areas of judgement and estimates
  - Evaluating whether an arrangement meets the definition of a lease could require judgement
  - Certain arrangements such as those with a significant service component
- Other key decisions requiring judgement include
  - Lease payments and lease term
  - Ongoing evaluations of lease term
  - Accounting for lease modifications



# Lease Procurement and Negotiation

## Accounting vs Economics

- The definition of lease payments excludes certain variable payments
- Lease term includes only those lease term options that are reasonably certain of being exercised
- Lessees may reassess their needs when negotiating their lease terms and payments
- Solutions?
  - Higher proportion of variable payments compared to fixed payments
  - Shorter initial lease terms may result in smaller lease liabilities





# Lease Procurement and Negotiation

## Accounting vs Economics

- Balance lower lease liability from a shorter lease term for a property against the security of longer-term access to the premises
- Lessors may be hesitant to take on the additional risk associated with variable payments and shorter initial lease terms
- Be aware of the accounting consequences associated with these business decisions



# Implementation Considerations





# Minimizing the Impact of New Rules

- Where do I start? Start big!
  - Strategic evaluation of the lease portfolio
  - Start with the largest leases and assess the accounting
  - Pay special attention to those for which there may be a significant economic incentive to exercise a renewal option



# Minimizing the Impact of New Rules

- Reduce spread between a lease's liability and the corresponding ROU asset
- Lease negotiations **pay attention** to
  - Services that have been embedded in the base rent charges
  - Impact of free rent and landlord incentives
  - Rate
  - Timing of rent increases



# Minimizing the Impact of New Rules

- Consider renegotiating leases now — even if they are not up for renewal
- During the negotiations, ensure that any service charges for operating expenses, such as maintenance and taxes, are clearly delineated
- These expenses do not have to be recorded on the balance sheet! If they are rolled into the lease, it is often difficult to separate the expenses from rent
  - Pay attention to variable vs fixed definition for additional expenses

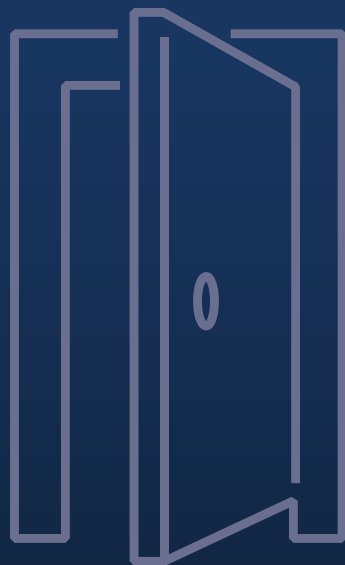


# Minimizing the Impact of New Rules

- Leverage technology specifically designed to assess the impact of new rules along with existing business processes, such as lease analysis and abstracting







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