Overview of New Lease Accounting Standard – Impact on the Retail Industry

Accounting Standards Update 2016-02
ASC 842 Leases

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AGENDA

- Overview of ASC 842
- Example Balance Sheet Impact
- Scope and Key Terms
- Classification of Leases
- Financial Statement Impacts
- Looking Ahead – Transition Timing and Methods

OVERVIEW: ASC TOPIC 842

Lessees will record assets and liabilities for almost every lease on the balance sheet as either:

- Finance (formerly – Capital)
- Operating

An accounting policy election can be made for short-term leases (12 months or less), with certain caveats.

Scope & key terms

Classification

Recognition & measurement

Disclosures & transition

EXAMPLE BALANCE SHEET IMPACT

	January 28, 2016	Capitalize Leases and ROU	January 28, 2016
Assets			
Cash and cash equivalents	115,000		$ 115,000
Receivables	6,000		6,000
Inventories	65,000		65,000
Total current assets	186,000		186,000
Fixed Assets	87,000		87,000
Right-of-use asset	-	235,000	235,000
Goodwill and other intangibles	13,000		13,000
Total long-term assets	100,000		335,000
Total assets	286,000		$ 521,000
Liabilities and Shareholders' Equity			
Trade accounts payable	25,000		$ 25,000
Accrued payroll and payroll taxes	8,000		8,000
Current portion of lease laibility	-	30,000	30,000
Deferred rent and tenant allowances	13,000	(13,000)	-
Total current liabilities	46,000		63,000
Notes payable	15,000		15,000
Long-term deferred rent and tenant allowances	27,000	(27,000)	0
Lease liability	-	230,000	230,000
Total long-term liabilities	42,000		245,000
Total liabilities	88,000		308,000
Shareholders' equity	198,000	15,000	213,000
Total liabilities and shareholders' equity	286,000		$ 521,000
Debt to Equity	**0.44**		**1.45**
Tangible net worth	**185,000**		**(35,000)**
Debt to TNW	**0.48**		**(8.80)**

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SCOPE & KEY TERMS

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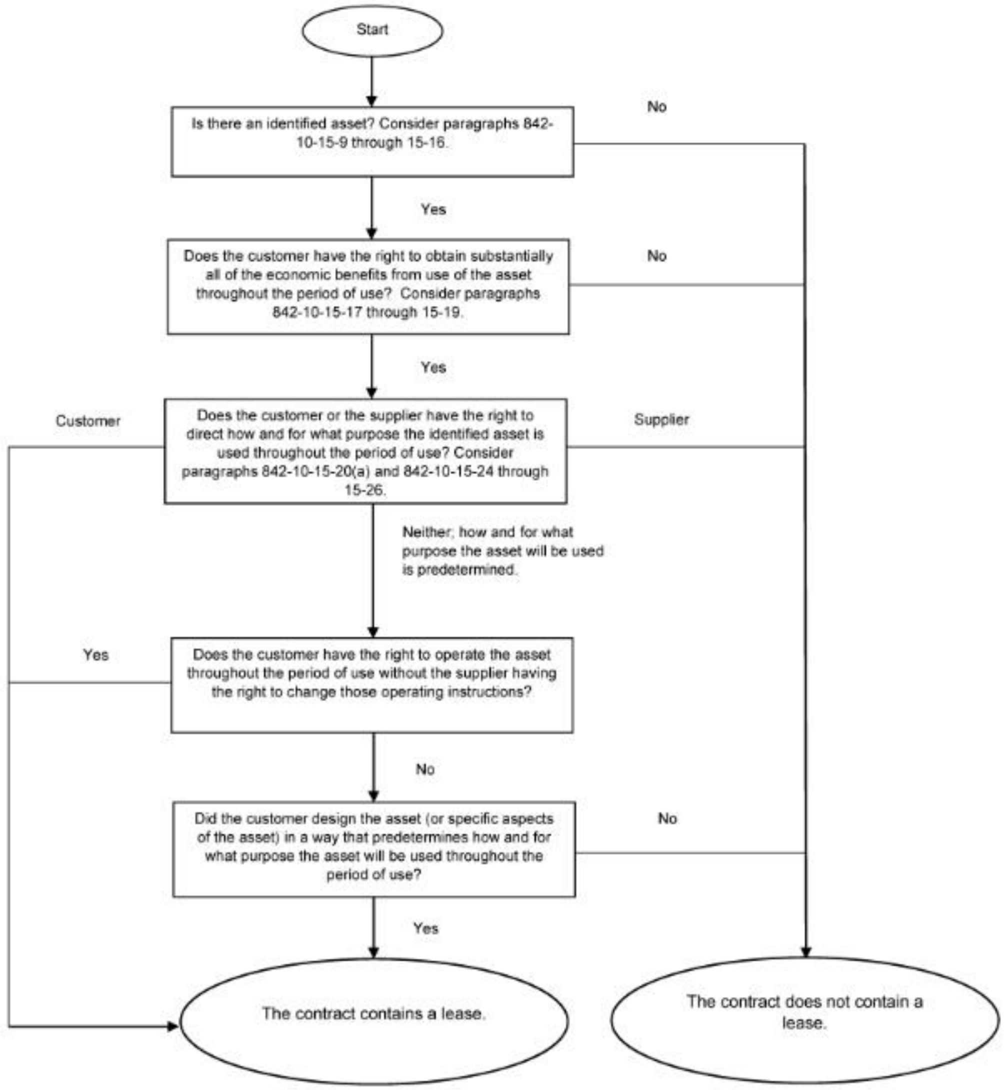
DOES THE CONTRACT CONTAIN A LEASE?

IDENTIFIED ASSETS	• Explicitly or implicitly • Supplier has no practicable ability to substitute and would not benefit from substitution
RIGHT TO CONTROL	• Direct the use of the identified asset • Ability to obtain substantially all of the economic benefit from the use of the asset

DOES THE CONTRACT CONTAIN A LEASE?



This flowchart was provided by the FASB to depict the decision process to follow in identifying whether a contract is or contains a lease.

WHAT INFORMATION IS NEEDED?

Focus on These Key Terms

Under the ASC 840, classification was one of the more important aspects of lease accounting since the results impacted whether a lease was on-balance sheet. Since most leases are now on balance sheet, classification could become less of a factor making these key terms more relevant going forward. However, classification under ASC 842 affects how expenses are recorded and may affect the non-GAAP measure of EBITDA depending on how it is defined in contracts or agreements.

- Lease term
- Non-lease components
- Lease payments
- Discount rate

POLLING QUESTION #1

Has your company began analyzing the impact of the new lease standard?

1. Yes, we have completed our analysis.
2. No, but it’s in process.
3. No, but we will start soon.
4. No plans have been made yet.
5. What new lease standard?

IDENTIFYING THE LEASE TERM

Initial Measurement

Consider all relevant factors that create an economic incentive to renew the lease	Include if **reasonably certain** to exercise when under lessee's control

Subsequent Measurement

Reassess upon occurrence of a significant change in circumstances that is within control of lessee	Reassess upon an event written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease.

NON-LEASE COMPONENTS

Allocate consideration

Identifying non-lease components, such as service elements, is a critical factor for lessee accounting and will require judgment when market information is not readily available.

Examples of Non-Lease Components:

- Maintenance / Repairs
- Janitorial Services

Observable stand-alone prices

Estimate if not readily available

Accounting policy election to treat as single component

LEASE PAYMENTS: PRESENT VALUE OVER LEASE TERM

Lessee includes purchase options or termination penalties if they are reasonably certain to be exercised.

EXAMPLE: Charlie's Apparel enters into a building lease with a noncancelable term of four years and has a four year renewal purchase option (at market pricing). Charlie's Apparel also makes leasehold improvements that are expected to have significant value at the end of the initial lease term, but can only be realized through continued occupancy. What is the lease term?

- Fixed payments
- Purchase options
- Termination penalties
- Residual value guarantees

VARIABLE LEASE PAYMENTS

- Two common examples of variable payments:
  - Rents that change annually based on an index (e.g. CPI)
  - Payments contingent on achieving sales or net income figures (e.g. 4% of sales in excess of $500,000)
- Generally accounted for as period expenses
  - Increase not included in lease payment liability or ROU asset
    - Use the index at the lease commencement date
  - If the lease liability is re-measured for any other reason, would update the variable lease payments to the current rate/index.

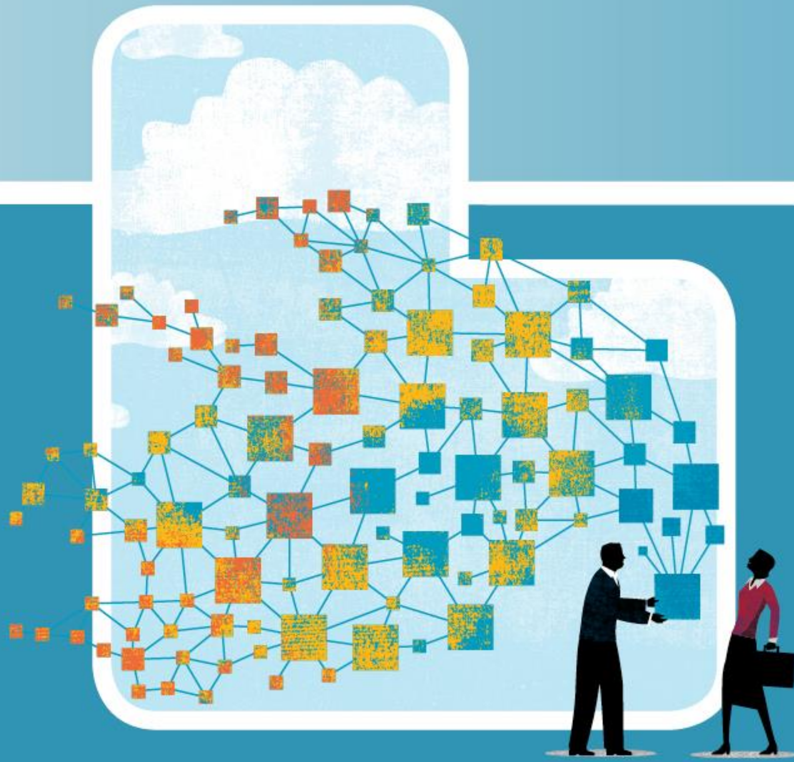
DISCOUNT RATE: LEASE-BY-LEASE BASIS

Implicit rate is the rate that causes the present value of the lease payments to equal the sum of the fair value of the underlying asset and initial direct costs of the lessor.

Initial direct costs include only incremental costs associated with originating the lease.

- Rate implicit in lease
- Incremental borrowing rate
- Risk free rate
- Reassessment

CLASSIFICATION



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FASB'S DUAL MODEL

	Balance Sheet	Income Statement	Cash Flows
Finance	Right-of-use asset Lease liability	Amortization expense Interest expense	Principal payments in financing - Interest payments in operating
Operating	Right-of-use asset Lease liability	Single lease expense on a straight line basis (Operating expense)	Cash paid for lease payments included in operating

LESSEE ACCOUNTING

Finance or Operating Lease

Classification criteria:

- Five items to consider for finance lease classification
- Four are similar to the existing lease guidance
- Fifth criterion: Highly specialized asset that cannot be used without major modification (e.g. no alternate future use)

If lease does not meet the criteria for finance, then considered an operating lease

Transfer of ownership by end of lease term

Significant economic incentive to exercise purchase option that is ***reasonably certain*** to be exercised

Lease term is for ***major part*** of remaining economic life

PV of lease payments and any RVG amount ***exceeds substantially all*** of the asset's fair value

Highly specialized asset that cannot be used without major modification (e.g. no alternate future use)

RECOGNITION AND MEASUREMENT

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BRINGING LEASES ON BALANCE SHEET

Recognition & Measurement

ROU asset equals sum of lease liability, prepaid rent, and initial direct costs, less lease incentives paid.

Lease liability equals present value of lease payments.

Finance leases will result in a front loaded expense vs. straight line for operating leases.

- Commencement date
- Right-of-use asset (ROU)
- Lease liability
- Expense patterns

SAMPLE OPERATING LEASE

ABC Retail Office Lease

Annual Payments

Classification: Operating

	Initial	Year 1	Year 2	Year 3	Total
Income Statement					
Lease expense		$16,000	$16,000	$16,000	**$48,000**
Balance Sheet					
Right-of-use asset	$45,000	$30,483	$15,489	-	
Lease liability	$45,000	$30,483	$15,489	-	
Statement of Cash Flows					
Cash payments – (Operating Cash Flows)		$16,000	$16,000	$16,000	**$48,000**

Assumes: Three year retail office lease with annual payment amount of $16,000 due at end of each year, approximate interest rate of 3.25%, equals present value of $45,000

SAMPLE FINANCE LEASE

ABC Retail Equipment Lease

Annual Payments

Classification: Finance

	Initial	Year 1	Year 2	Year 3	Total
Income Statement					
Interest expense		$1,483	$1,006	$511	**$3,000**
Amortization expense		$15,000	$15,000	$15,000	**$45,000**
Total period expense		$16,483	$16,006	$15,511	**$48,000**
Balance Sheet					
Right-of-use asset	$45,000	$30,000	$15,000	-	
Lease liability	$45,000	$30,483	$15,489	-	
Statement of Cash Flows					
Interest cash payments (Operating)		$1,483	$1,006	$511	**$3,000**
Principle cash payments (Financing)		$14,517	$14,994	$15,489	**$45,000**
Total cash payments		$16,000	$16,000	$16,000	**$48,000**

Assumes: Three year equipment lease with annual payment amount of $16,000 due at end of each year, approximate interest rate of 3.25%, equals present value of $45,000

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 a lease.

Accounted for as an entirely new contract when both:

- The modification grants the lessee an additional right of use, and
- The lease payments increase commensurate with the stand-alone price for the additional right of use.

Company should reassess the classification of the lease and remeasure the lease liability using the discount rate determined at the effective date of the modification. This could result in:

1. Adjustment to the ROU asset (e.g., both ROU and payments increase),
2. A gain or loss being recognized (e.g., full or partial lease termination), or
3. Lease classification changed from financing to operating.

<u>Failed criteria:</u>

POLLING QUESTION #2

How do you anticipate your company will allocate resources to address the initial implementation efforts of the new leasing standard?

1. Utilize internal accounting department personnel.
2. Leverage off existing leasing software.
3. Purchase new leasing software to leverage internal resources.
4. Utilize external consultants.
5. Not sure yet.

IMPACT ON FINANCIAL INFORMATION

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POTENTIAL IMPACTS (LESSEE)

- Increased liabilities (current and non-current)
  - Technically, operating lease liabilities are not "debt"; unclear if creditors will share this view
  - Impact to working capital ratios (e.g. current ratio) and debt ratios
- Increased assets
  - Lower return on assets

POTENTIAL IMPACTS

- How do these changes provide incentives or penalties?
  - Will financing leases be more attractive, given all leases are on the balance sheet?
  - Will entities be put-off by upfront earnings hit, or will the EBITDA add-back balance this out?
  - How will creditors and equity investors view balance sheet metrics and other ratios?
  - Will negotiating covenants be more difficult, or will there be a soft transition?
  - When will the regulators catch up?

TAX CONSIDERATIONS

- Recognition of lease-related assets and liabilities that are not on the balance sheet today would affect many aspects of accounting for income taxes, such as:
  - Recognition and measurement of deferred tax assets and liabilities
  - Assessment of the recoverability of deferred tax assets (i.e., the need for and measurement of a valuation allowance)
- Uncertainty around whether the right-of-use asset would be:
  - State and local tax: included in the property factor for apportionment of income
  - Sales and use tax: subject to sales tax
  - Property tax: included in property tax base subject to property taxes
- Federal income tax review
  - No effect on current classification for federal income tax purposes
  - Many taxpayers follow book and may use this opportunity to review classification for federal income tax purposes.
    - Method change issues

FINANCIAL STATEMENT PRESENTATION

Operating Lease	Finance Lease
Gross presentation of ROU assets and lease liabilities for operating and finance leases (comingling prohibited)	
Single SL lease expense	Front-loaded interest and SL amortization expense
Operating cash flow classification for all payments	Financing and operating cash flow classification
Operating lease liability isn't debt	

DISCLOSURES IN FOOTNOTES

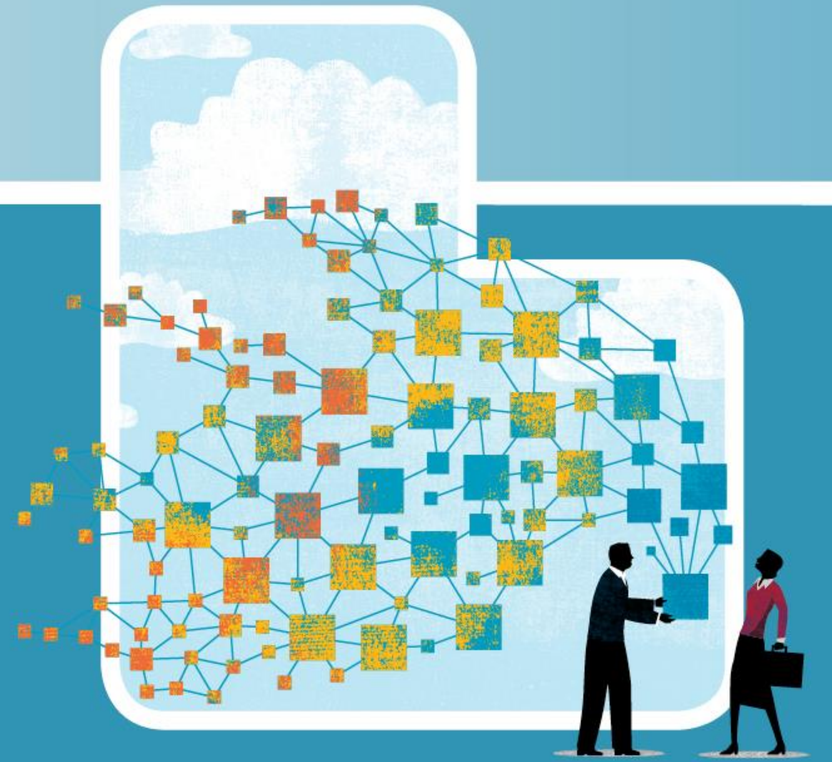
Quantitative	Qualitative
Periodic lease expense, ROU asset amortization, interest costs	Terms and conditions, purchase options and termination penalties
Short-term, variable leases, sublease income, cash and non-cash flows	Accounting policy elections, areas of significant judgment, assumptions
Weighted average discount rate for both finance & operating	Residual value guarantees
Weighted average remaining lease term for both finance & operating	Significant judgments & assumptions

POLLING QUESTION #3

What do you believe will be the biggest impact of the new lease standard to your company?

1. Identification of all the contracts now subject to the new leasing standard.
2. The effort required to analyze the policy elections and accounting related to implementing the new standard.
3. Impacts related to the Company’s internal reporting / metrics.
4. Impacts to the Company’s bank covenants.

LOOKING AHEAD



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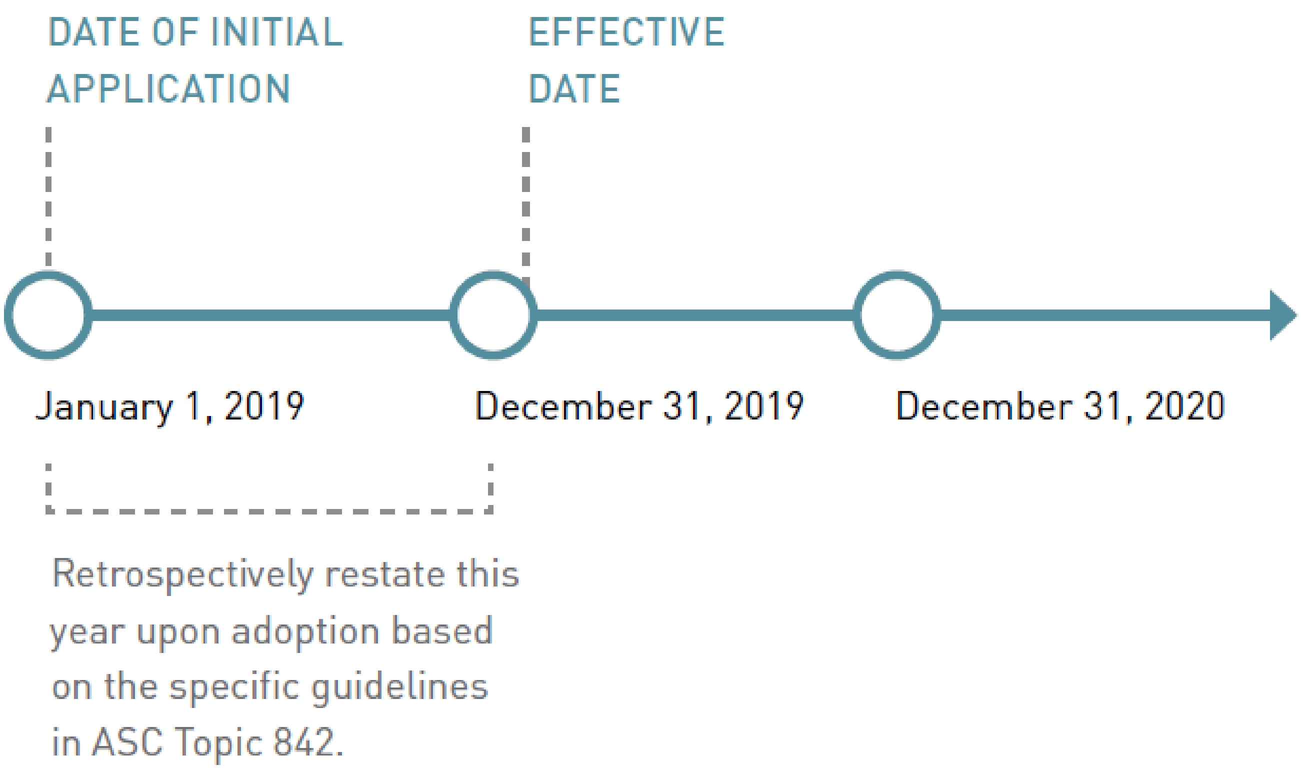
EFFECTIVE DATES

Public

Retrospectively restate these two years upon adoption based on the specific guidelines in ASC Topic 842.

EFFECTIVE DATES

Private



POLLING QUESTION #4

Do you see any benefit to potentially early adopting the new leasing standard?

1. Yes.
2. No.
3. Not sure yet.

THINGS TO CONSIDER

- Various policy elections to be made under ASC 842.
- Current capabilities and system resources may not be sufficient to identify and capture all leases to apply new standard, if not, consider the need to identify or expand on current lease accounting systems and related internal controls
- Internal and external financial reporting metrics may need to be revised to account for changes in balance sheet and income statement classification
  - ➢ Educate internal and external parties – how are your creditors looking at this?
- Accounting for book-tax differences going forward

THINGS TO CONSIDER

- Ensure controls and processes are properly designed and implemented across all functional areas (IT, legal, procurement, treasury, accounting)
- Consider third party software solutions to manage lease accounting and reporting vs. traditional spreadsheets
- Begin process now to review contracts to ensure all leases have been identified and properly accounted for
- Communicate findings and results to internal and external stakeholders

FOR MORE INFORMATION…

- Financial Accounting Standards Board
  - www.fasb.org
    - ASU 2016-02
- Moss Adams – Lease Guide
  - https://mossadamsproduction.blob.core.windows.net/cmsstorage/mossadams/media/documents/special/moss-adams_lease-accounting-guide.pdf

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THANK YOU!

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