

# Topic 842- Leases Making The Transition

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# AGENDA

1. Recap of New Standard
2. Transition Guidance
3. Lease Examples
4. Review of Tax Rules



# Effective Dates

**Public business entities:** Interim and annual periods beginning after Dec. 15, 2018.

**All other entities:** Annual periods beginning after Dec. 15, 2019



**All entities:** Early adoption is permitted for all entities.



# Exceptions

**Applies to all leases and subleases except:**

- Leases of intangible assets
- Leases for exploration of certain natural resources (minerals, oil, natural gas etc...)
- Leases of biological assets
- Leases of inventory
- Leases of assets under construction



# Exceptions

Lessees will be permitted to make an accounting policy election to not recognize lease assets and liabilities for **short-term leases**

(that is, lease terms that are 12 months or less, subject to certain conditions contained in the definitions of “short term lease” and “lease term”).



Leases with a lease term of 12 months or less will not require capitalization on the balance sheet, and lease payments will be expensed on a straight-line basis over the lease term, which is similar to current rules for an operating lease.

# **New Lease Standard**

**ASU 2016-02**



**A Brief Recap**

# Lease Definition

A lease contract is defined as a contract, or part of a contract, that conveys the right to control the use of an identified asset for a time period in exchange for consideration.



# Lease Definition

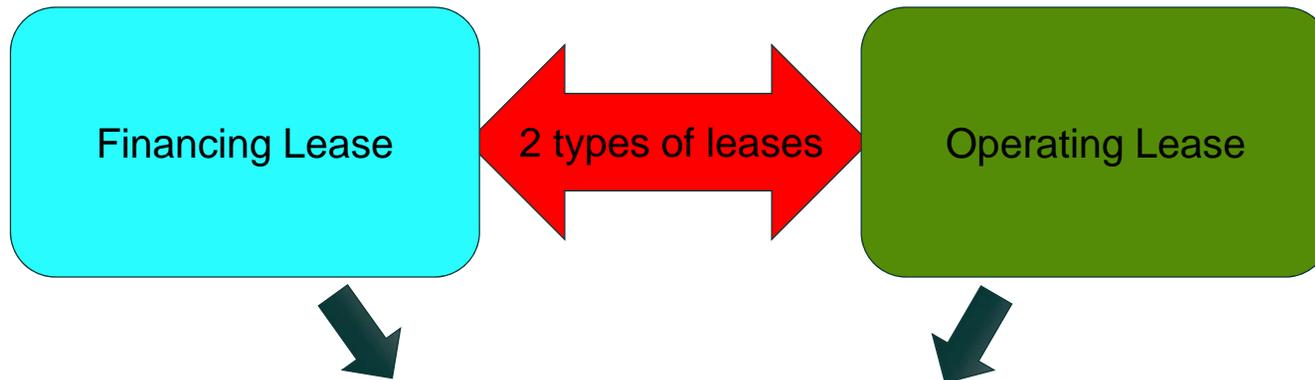
**A lease exists:** if the right to control the use of property, plant, or equipment has been transferred

Including a determination of whether “the right to obtain substantially all of the economic benefits from use of the identified asset” and “the right to direct the use of the identified asset” have been transferred to the customer.

\*\*Consider whether the supplier has the right of substitution



# Lease Classification



**Balance Sheet**  
as of Dec. 31 2013 (in millions)

<b>ASSETS</b>		<b>1,221.00</b>	<b>LIABILITIES</b>		<b>731.00</b>
<b>Current Assets</b>		589.00	<b>Current Liabilities</b>		281.00
Cash in Bank		242.00	Accounts Payable and Accrued Expenses		192.00
Accounts Receivable		168.00	Interest Payable		12.00
Inventory		90.00	Taxes Payable		32.00
Prepaid Expenses		12.00	Short-term Notes		5.00
Short-term Investments		45.00	Current Portion of Long-term Debt		14.00
Deferred Income Taxes		32.00	Accrued Retirement		26.00
Other Current Assets		0.00	Other Current Liabilities		0.00
<b>Fixed Assets</b>		547.00	<b>Long-term Liabilities</b>		450.00
Machinery and Equipment		250.00	Bank Loans Payable		150.00
Furniture and Fixtures		32.00	Notes Payable to Stockholders		100.00
Leasehold Improvements		45.00	Other Long-term Debts		200.00
Land and Buildings		200.00	<b>Shareholder's Equity</b>		
Other Fixed Assets		0.00	Capital Stock		150.00
Accumulated Depreciation		20.00	Retained Earnings		340.00
<b>Other Assets</b>		85.00			
Intangibles		25.00			
Deposits		15.00			
Goodwill		45.00			
Other		0.00			

Both types are capitalized on the balance sheet, but expense recognition is treated differently



# New Lease Classification Criteria

Financing Lease

Operating Lease



A lessee shall classify a lease as a **finance lease** when the lease meets any of the following criteria at lease commencement:



# Lease Classification

## Financing Lease

### Criteria

1. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
2. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
3. The lease term is for the major part of the remaining economic life of the underlying asset.



# Lease Classification

## Financing Lease

### Criteria

4. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset
5. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.



# Expense Recognition

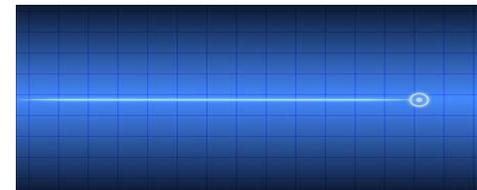
## Financing Lease

Ⓐ For a finance lease, the lessee will recognize amortization of the ROU asset on a straight-line and interest expense on the lease liability using the effective interest method



## Operating Lease

For an operating lease, a single lease expense will be recognized, and it will include total lease payments and total initial direct costs over the lease term on a straight-line or other systematic basis.



# ASC 842 Financial Statement Effects

	Balance Sheet	Income Statement	Cash Flow Statement
Finance Lease	ROU Asset Lease Liability	Amortization Expense Interest Expense	Principal Payments = Financing Interest Payments=Operating
Operating Lease	ROU Asset Lease Liability	Single Lease Expense on Straight Line Basis	Lease Payments = Operating



Additional Footnote Disclosures are also required.

# Transition Guidance

Upon adoption of the leases standard, lessees and lessors are required to apply a modified retrospective transition approach to each lease that existed at the beginning of the earliest comparative period presented in the financial statements, as well as leases entered into after that date.



# Transition Guidance

## Transition Reliefs

1. An entity need not reassess whether any expired or existing contracts are or contain leases.
2. An entity need not reassess the lease classification for any expired or existing leases

(that is, all existing leases that were classified as operating leases in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as finance leases).

3. An entity need not reassess initial direct costs for any existing leases.



**Must be elected as a package and applied by an entity to all of its leases**

# Transition Guidance

## Transition Reliefs

1. To use hindsight in determining the **lease term** (that is, when considering lessee options to extend or terminate the lease and to purchase the **underlying asset**) and in assessing impairment of the entity's **right-of-use assets**.

 This practical expedient may be elected separately or in conjunction with the practical expedients discussed in the previous slide



# Transition Guidance

## Existing Operating Leases

1. If a lease was classified as an operating lease under the guidance in ASC 840 and will continue to be classified as an operating lease under the new leases standard, the lessee should recognize a right-of-use asset and lease liability at the later of the
  1. earliest period presented or
  2. the lease commencement date.
2. The lease liability should be calculated as the present value of the sum of:
  1. the remaining minimum rental payments (as defined under ASC 840) and
  2. any amounts probable of being owed by the lessee under a residual value guarantee.



# Lease Examples

See Handouts



# Finance Lease-Example 1

## Lease Terms

- Lease Term – 3 years
- Lease Payments:
  - Year 1: \$100,000
  - Year 2: \$110,000
  - Year 3: \$125,000
- Discount Rate: 5.51%

	Year 1	Year 2	Year 3	Total
Interest expense	\$16,535	\$11,935	\$6,530	\$35,000
Amortization expense	\$100,000	\$100,000	\$100,000	\$300,000
Total expense	\$116,535	\$111,935	\$106,530	\$335,000
Operating cash flows <sup>5</sup>	\$16,535	\$11,935	\$6,540	\$35,000
Financing cash flows <sup>6</sup>	\$83,465	\$98,065	\$118,470	\$300,000
Total cash flows	\$100,000	\$110,000	\$125,000	\$335,000



# Operating Lease-Example 2

## Lease Terms

- Lease Term – 3 years
- Lease Payments:
  - Year 1: \$100,000
  - Year 2: \$110,000
  - Year 3: \$125,000
- Discount Rate: 5.51%



	Year 1	Year 2	Year 3	Total
"Interest component"	\$16,535	\$11,935	\$6,530	\$35,000
"Amortization component"	\$95,132	\$99,732	\$105,137	\$300,000
<b>Total single lease expense</b>	<b>\$111,667</b>	<b>\$111,667</b>	<b>\$111,667</b>	<b>\$335,000</b>
<b>Operating cash flows</b>	<b>\$100,000</b>	<b>\$110,000</b>	<b>\$125,000</b>	<b>\$335,000</b>

# Transition of an Existing Operating Lease Example 3

- Lease Term – 4 years
- Lease Payments:
  - Year 1: \$33,000
  - Year 2: \$33,000
  - Year 3: \$33,000 (Year of Adoption)
  - Year 4: \$33,000
- Discount Rate: 6 %

Lessee has elected the package of practical expedients, as such, Lessee accounts for the lease as an operating lease, without reassessing whether the contract contains a lease or whether classification of the lease would be different in accordance with this Topic.



# What Should You Do Now?

- Understand and evaluate the transition effects
- Form a lease implementation group
- Evaluate existing leases
- Evaluate the impact on your financial statements
- Evaluate the impact on your covenants and communicate with lenders



# Review of tax rules



# Tax Lease Accounting

**Tax Lease (True Lease)** - Section 162(a)(3) provides that business expenses include “rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.”



# Tax Lease Accounting

A lease is NOT considered a True Tax Lease by the IRS if ANY of the following are true:

1. Any part of the lease payment is applied to an equity position in the asset leased.
2. The lessee will, by default, acquire ownership (title) of the equipment upon payment of a specified amount of "rental payments" he or she makes.
3. Over a short period of time the equipment is used, the total amount which a lessee pays is an exceedingly large proportion of the total sum required to outright buy the equipment.
4. The agreed upon payments exceed the current fair rental value.
5. At the time any purchase option may be exercised, the title to the equipment may be acquired for an exceedingly small purchase option price in relation to the actual value of the equipment.
6. Any portion of the lease payments are specifically designated as interest (or its equivalent.)



# Tax Lease Accounting

## Book v. Tax Accounting

1. Classification rules are similar for book and tax.
2. Operating lease for GAAP maybe Capital lease for Tax or vice versa.
  - Timing difference reflected in the deferred tax schedule



# Tax Lease Accounting

New Potential Book-to-Tax Differences under new rules

1. An operating lease for both book and tax that is now on the balance sheet, could result in a deferred tax item.
2. On day 1 of the lease, the ROU asset and the lease liability offset.

- However, they will not track at the same rate
- Effective interest method for the liability
- Amortization of the asset will increase over time
- This will result in a deferred tax item for operating leases



# Tax Lease Accounting

## State Apportionment

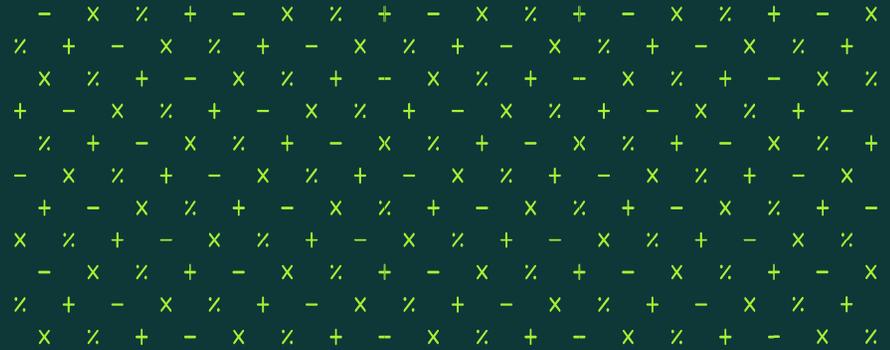
### 1. Property factor

Rent expense on the G/L might be misleading

Be wary of picking up rent expense at 8x and also the asset in the property factor



### 2. Potential problem following prior year method



# Thank you

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