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Accounting Deep Dive Part 2
The New Lease Standard

WA/AK HFMA Annual Trade Fair and Conference
September 22, 2016

Leases - Summary

- FASB issued Accounting Standards Update (ASU) 2016-02, Leases in February 2016. (Codified in Accounting Standards Codification (ASC) 842)
- Change to lessee accounting
  - All leases will go on the balance sheet as an asset and liability
  - Operating-type leases will be expensed on a straight line basis
  - Financing-type leases will be expensed via amortization of the asset and interest related to the liability
- Effective date: (Early application is permitted)
  - Public entities (includes NFP's with publically trade debt securities): CY 2019 (FY 2019-2020)
  - Nonpublic entities: CY 2020 (FY 2020-2021)

Quick Refresher – Existing U.S. GAAP

- **At inception, each lease must be classified as either:**
  - Capital lease, or
  - Operating lease
- **Capital lease, if meets any one of four criteria:**
  1. Ownership transfers to lessee at end of lease
  2. Lease contains a bargain purchase option
  3. Lease term is 75% (or more) of estimated economic life of the property
  4. Present value of minimum lease payments is 90% (or more) of property's FMV
- **Operating lease, if:**
  - Any lease that is not a capital lease

Quick Refresher – Existing U.S. GAAP (Continued)

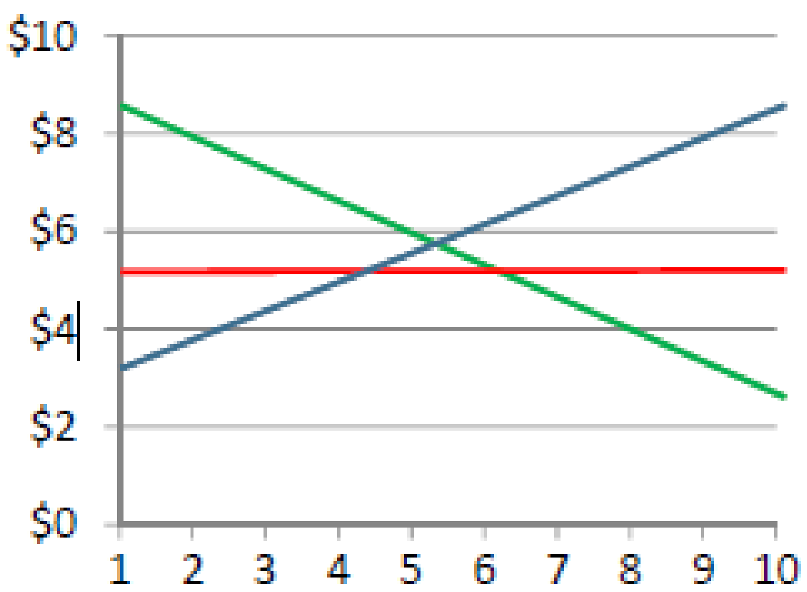
- **Capital leases:**
  - Capital lease **asset** and **liability** are recorded on balance sheet
  - Expense is recognized for **depreciation** and **interest**
- **Operating leases:**
  - No asset or liability is recorded on balance sheet
  - Straight-line **rent** expense is recognized in income statement
- **Companies typically prefer operating lease treatment**
  - Avoids recording a potentially large liability
  - Smooth, straight-line expense recognition pattern

Why a Leases Project?

- **Most lease <u>liabilities</u> are off-balance sheet**
  - $1.25 trillion of off-balance sheet operating lease commitments for SEC registrants
- **Limited information about operating leases**
  - Many users (lenders & analysts) indicate they must make *adjustments* to the financial statements to utilize information
  - Existing treatment is inconsistent with the Concept Statement 6 definitions of assets and liabilities
  - Contractual rights and obligations (assets and liabilities) are not recorded on balance sheet

Initial Exposure Draft issued – 2010

- **<u>All</u> leases would be treated similar to capital leases**
  - Drew significant criticism – 800 comment letters
  - Concern over proposed *front-loading* of expense for <u>all</u> leases



Actual cash rent payments

Existing GAAP expense recognition is SL

Original ED *front-loads* expense recognition

Overview of ASC 842

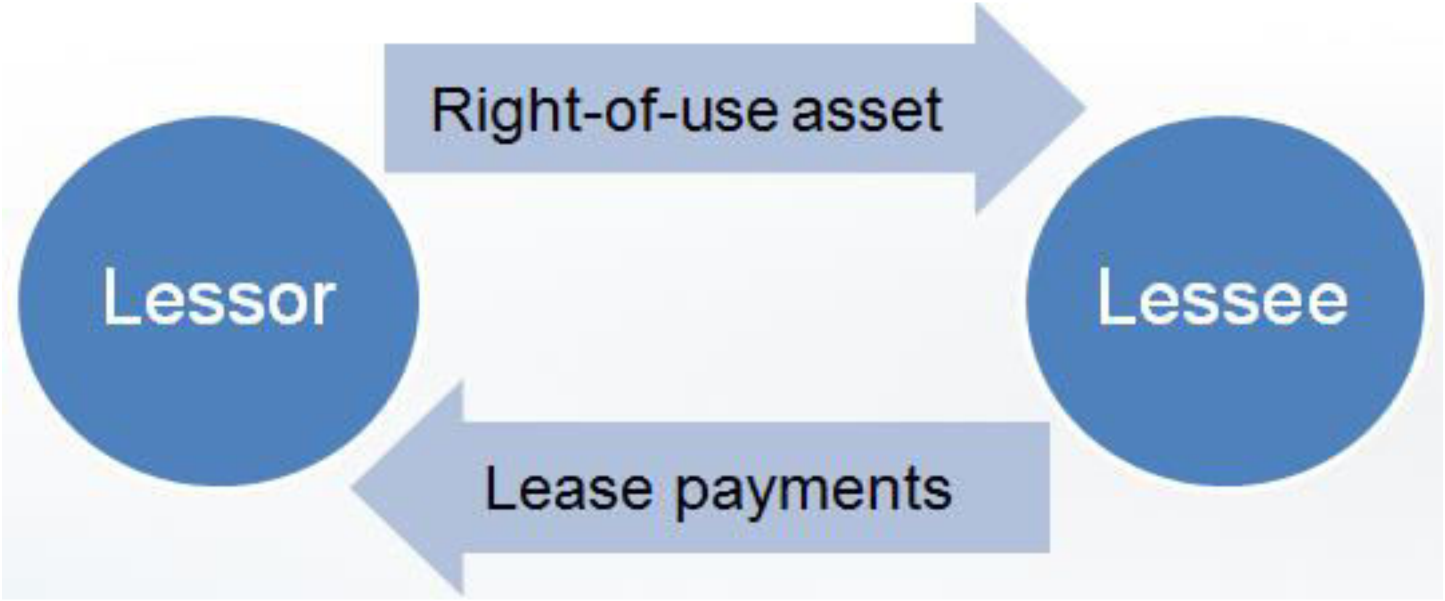
- ASC 842 requires that lessees recognize lease right-of-use (RoU) assets and lease payment liabilities for those leases classified as long-term operating leases
- ASC 842 retains the distinction between finance leases and operating leases
- Applies only to leasing of property, plant and equipment
- Presentation issues for the statement of comprehensive income (income statement) and the cash flow statement are largely unchanged from existing standard.

Overview of ASC 842 (Continued)

- Does not apply to the following:
  - Leases of intangible assets
  - Leases to explore for or use minerals, oil, natural gas, and similar resources
  - Leases of biological assets, including timber
  - Leases of inventory
  - Leases of assets under construction

Right-of-Use Model

A lease contract conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration



Overview Lessee Accounting

- A lessee should recognize the assets and liabilities that arise from leases in the statement of financial position
- All leases create an asset and a liability for the lessee based on the definitions of assets and liabilities in FASB Concept Statement No. 6, Elements of Financial Statements

Overview FASB Concept Statement No. 6

- Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events
- Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events

Overview Lessee Accounting (Continued)

- Recognize a lease payment liability and a RoU asset representing the entity's right to use the underlying asset for the lease term
- When measuring the lease payments to be made in option periods (extend/terminate), the payments must be reasonably certain to be exercised
- Reasonably certain is a high degree of confidence that a future event will take place
- Variable lease payments are excluded unless they depend on an index or rate

Overview Lessee Accounting (Continued)

- Only lease components must be accounted for in accordance with ASC 842
- A practical expedient exist enabling an entity to make an accounting policy election by class of the underlying asset not to separate the lease components from the non-lease components
  - ➢ They will be accounted for together as a single lease component

Overview Lessee Accounting (Continued)

- For leases with a term of 12 month or less:
  - A lessee is permitted to make an accounting policy election, by class of underlying asset, not to recognize lease assets and lease payment liabilities on the balance sheet/statement of financial position
  - Lease expense will generally be recognized on a straight line basis
  - Must consider option to extend when considering election

Overview Lessee Accounting (Continued)

- Finance Leases:
  - Recognize a RoU asset and a lease payment liability, initially measured at the PV of the lease payments, in the balance sheet/statement of financial position
  - Recognize interest on the lease payment liability separeately from RoU asset amortization in the statement of comprehensive income (IS)
  - Classify lease payment liability principal payments as financing activities in the SCF
  - Classify lease payment liability interest payments and variable lease payments in operating activities of the SCF

Overview Lessee Accounting (Continued)

- Operating Leases:
  - Recognize a RoU asset and a lease payment liability, initially measured at the PV of the lease payments, in the balance sheet/statement of financial position
  - Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a straight line basis
  - Classify all cash payments within operating activities in the SCF

Overview Lessor Accounting

- Largely unchanged from existing guidance ASC 840
- Aligns with revenue recognition with the new revenue recognition standard – a lessor is precluded from recognizing selling profit or sales revenue at lease commencement for a lease that does not transfer control of the underlying asset to the lessee
- Lessor accounting does not differentiate between leases of real estate and leases of other assets
- Leases are classified as:
  - Sale-type leases
  - Direct financing leases
  - Operating leases

Defining a Leasing Transaction

- **Lessee:** An entity that enters into a contract to obtain the right to use an underlying asset for a period of time in exchange for consideration
- **Lessor:** An entity that enters into a contract to provide the right to use an underlying asset for a period of time in exchange for consideration

Defining a Leasing Transaction (Continued)

- **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. With enforceable terms and conditions

- Control over the use of the identified asset means the customer has both:
  1. The right to obtain substantially all of the economic benefits from the use of the identified asset
  2. The right to direct the use of the asset exchange for consideration

Lease Classification – Two Types (Continued)

- Financing – Meets any of the following five criteria:
  - The lease transfers ownership of the underlying asset to the lessee by the end of the lease term
  - The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain (probable) to exercise
  - The lease term is for the major part (today 75%) fo the remaining economic life of the underlying asset

Lease Classification – Two Types (Continued)

- Financing – Meets any of the following five criteria (cont'd):
  - The present value of the sum of the lease payments and residual value guarantee equals or exceeds substantially all of the fair value (today 90%) of the underlying asset
  - 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

Lease Classification – Two Types (Continued)

- Operating Lease:
  - Any lease other than a finance lease

Recognition and Measurement - Lessee

- Requires a lessee to record a right-of-use (RoU) asset and a lease payment liability for all leases with a lease term greater then 12 months
- The initial recognition of the RoU asset and the lease payment liability is the same for both finance and operating leases
- Subsequent measurement of the lease payment liability is also the same for both finance and operating leases

Recognition and Measurement - Lessee (Continued)

- The right of use asset however requires different subsequent measurements
- The lease payment (LP) liability is the present value of the lease payments the lessee expects to make over the lease term (including options)
- The LP Liability is classified as long-term with any short-term portion presented separately

Recognition and Measurement – Lessee (Continued)

- Initial RoU asset measurement is at cost consisting of all of the following:
  - The lease payment liability's initial measurement value
  - Any lease payments made to the lessor at or before the lease commencement date
  - Less any lease incentives the lessee receives from the lessor
  - Plus any initial direct costs the lessee incurs
- The RoU is typically classified as long-term and is systematically amortized over time

Recognition and Measurement - Lessee (Continued)

- Lessee Discounted Present Value – Initial Measurement:
  - The discount rate for the lease initially used to determine the present value of the lease payments is the rate implicit in the lease
  - If the rate implicit in the lease is not readily determinable, the lessee will use its incremental borrowing rate
  - A lessee may use a single discount rate to apply to a portfolio of leases assuming the result would not be significantly different than individual lease discount rates

Recognition and Measurement – Lessee (Continued)

- Lessee Discounted Present Value – Initial Measurement (cont'd):
  - Private entities are permitted an accounting policy election to use a risk free discount rate for the lease (normally the federal funds rate)
  - Since this rate will be lower than an effective borrowing rate, private entity lessees should expect the Lease Payment (LP) liability and related RoU asset to be higher if the accounting policy election is selected

Recognition and Measurement – Lessee (Continued)

- Lessee Subsequent Measurement – Finance Lease:
  - The lessee recognizes interest on the lease liability separately from amortization of the RoU asset in the income statement
  - The RoU asset is generally amortized on a straigt line basis
  - The lease payment liability is amortized on an effective interest basis
  - Results in a front loading of lease related expenses

Recognition and Measurement – Lessee (Continued)

- Lessee Subsequent Measurement – Operating Lease:
  - LP liability is reduced by recognizing the present value of the remaining lease payments not yet paid
  - The initial RoU asset balance is reduced by periodically adjusting (plug) the amortization of the RoU asset by the effective interest on the lease payment liability to arrive at a constant straight line expense amount
  - The lessee will recognize a single lease cost

Lessee Accounting Overview

	Balance Sheet	Income Statement	Cash Flow Statement
Financing	Right-of-use asset Lease liability	Amortization expense Interest expense	Cash paid for principal and interest payments
Operating	Right-of-use asset Lease liability	Single lease expense on a straight-line basis	Cash paid for lease payments

Lessor Accounting Overview

	Balance Sheet	Income Statement	Cash Flow Statement
Financing	Net investment in the lease	Interest income and any profit on the lease	Cash received for lease payments
Operating	Continue to recognize underlying asset	Lease income, typically on a straight-line basis	Cash received for lease payments

Lessee Disclosures

- Qualitative Disclosures
  - A general description of its leases
  - The basis, terms and conditions on which variable lease payments are determined
  - The existence and terms of any options to extend or terminate the lease
  - Narrative disclosure about options that are recognized as part of its right-of-use assets and lease liabilities and those that are not

Lessee Disclosures (Continued)

- Qualitative Disclosures (continued)
  - The existence, terms and conditions of residual value guarantees provided by the lessee
  - Any restrictions or covenants imposed by leases (dividends, additional financial obligations, etc.)
  - If the entity has subleases, the entity should identify the information relating to subleases as indicated above

Lessee Disclosures (Continued)

- Lessee must disclose information about lease that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset

Lessee Disclosures (Continued)

- Quantitative disclosures for each period presented
  - A lessee must disclose the following amounts related to a lessee's total lease cost:
    - Finance lease cost segregated between the amortization of the right-of-use assets and interest on the lease liabilities
    - Operating lease cost including its allocation, variable lease payments, and impairments (if any)
    - Short-term lease cost excluding expenses relating to leases of one month or less
    - Variable lease cost

Lessee Disclosures (Continued)

- Quantitative disclosures for each period presented (cont'd)
  - ❑ 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

Lessee Disclosures (Continued)

- Quantitative disclosures for each period presented (cont'd)
  - ❑ Amounts segregated between those for finance and operating leases for the following items;
    - ✓ Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows
    - ✓ Supplemental non-cash information on lease liabilities arising from right-of-use assets
    - ✓ Weighted-average remaining lease term
    - ✓ Weighted-average discount rate

Lessee Disclosures (Continued)

- Additional Quantitative Disclosures:
  - A maturity analysis of the lessee's finance lease liabilities and its operating lease liabilities separately
  - Presenting the undiscounted cash flows on an annual basis for a minimum of five years and a total of the amounts for the remaining years
  - Lessee should present a reconciliation of the undiscounted cash flows to the financial lease liabilities and operating lease liabilities recognized in the SFP
  - Lessee should disclose lease transactions between related parties

Lessee Disclosures (Continued)

- Additional Quantitative Disclosures (cont’d):
  - A lessee that accounts for short-term leases must disclose that fact
  - If the short-term lease expense for the period does not reasonably reflect the lessee’s short-term lease commitments, the lessee must disclose that fact and the amount of its short-term lease commitments
  - A lessee that elects the practical expedient on not separating lease components from non-lease components must disclose its accounting policy election and which class or classes of the underlying assets it has elected to apply the practical expedient

Transition

- In transition, lessees and lessors are required to recognize, measure, and present leases at the beginning of the earliest period presented using a modified retrospective approach
- Modified retrospective approach requires an entity to apply the new guidance to all periods presented in the financial statements
- It also requires the adjustment of previously issued financial statements

Transition (Continued)

- Several Optional Practical Expedients are Available applying the Modified Retrospective Approach:
  - Lease identification and classification that commenced before the effective date
  - Initial direct costs for leases that commenced before the effective date
  - The ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset

Transition (Continued)

- An entity that elects to apply the practical expedients will continue to account for leases that commenced before the effective date in accordance with previous GAAP, except for the following:
  - The lease becomes modified
  - Lessees are required to recognize a right-of-use asset and a lease payment liability for all existing long-term operating leases at each reporting period – present value

Business Implications

- Advance preparation will be essential for an orderly and cost-effective transition
- Consideration should be given as to whether an entity wants to early adopt the revenue and lease standards at the same time
- Developing and managing a data collection process to identify existing leases and future leases

Business Implications (Continued)

- Existing lessee operating leases, that will be converted to finance leases on the adoption date, will experience a different pattern of expense recognition over time
  - Declining balance vs. straight line
- Loan covenants and other longer term contractual credit arrangements may be violated or need to be reset base on this new standard

Business Implications (Continued)

- Lessee's financial performance metrics will change, for example:
  - EBITDA
  - Return on assets will decrease
  - Current ratio will decrease
- Lessee's financial risk metrics will change for example:
  - Debt to equity will increase
  - Interest coverage will decrease

Business Implications (Continued)

- Accounting policies and business implications will need to be addressed for leasing activity. Selected considerations include:

  - Budgeting and planning processes

  - Lease vs. buy decisions

  - Internal controls over lease transactions

Resources

- Clark Nuber Newsletters and Blogs
- Future HFMA Conferences
- NFP Accounting & Tax Update Seminar – Fall 2017
- Client workshops on implementing the new ASU – TBD in 2018
- Lots of information at AICPA NFP and Healthcare Conferences

Questions

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