Leases

ASU 2016-02, *Leases (Topic 842)*

Hospitality Financial &Technology Professionals Webinar – June 6, 2018

RSM

About the Presenters

Adian Kummet, Audit Manager

- Certified Public Accountant
- Member of RSM US, LLP’s Real Estate and Hospitality Industry Group
- Works with clients within the hospitality industry

About the Presenters

Mike Beacom, Audit Partner

- Certified Public Accountant
- Central Region Leader of RSM US, LLP’s Real Estate and Hospitality Industry Group
- Works with clients within the hospitality industry

Objectives

By the end of this presentation, you will be able to:

- Understand the fundamentals of the new Leases standard
- Identify how the new Leases standard could impact your financial reporting and reported financial results

Introduction and background

Introduction and background

- ASU 2016-02 issued in February 2016 (Topic 842)
  - Upon effective date, ASC 842 will replace ASC 840
- Effective date
  - Public business entities and certain not-for-profit entities and employee benefit plans that file with the SEC
    - Fiscal years beginning after December 15, 2018 (and interim periods in those fiscal years)
  - All other entities
    - Fiscal years beginning after December 15, 2019 and interim periods in fiscal years beginning after December 15, 2020.
  - Early adoption permitted for all entities

Introduction and background (continued)

- 2003 SEC report on off-balance sheet activities
  - $1.25 trillion of off-balance sheet commitments for operating leases for SEC registrants
- Lessees
  - Off-balance sheet
  - Limited information regarding operating leases
- Lessors
  - Lack of transparency on residual values
  - Inconsistencies between leasing guidance and revenue guidance

Introduction and background (continued)

- Article from Bloomberg Tax, dated March 1, 2016, emphasis added:
  - The balance sheets of airlines, retailers, many banks, **hotel** and retail chains, telecoms and other companies are **expected to balloon** under the new lease accounting rules issued by the Financial Accounting Standards Board.
  - About **85% of leases aren’t** currently reported on balance sheets globally
  - In U.S., public companies’ operating leases carried off-balance sheet amount to more than **$1 trillion in leasing obligations**

Overview

- Changes for lessees
  - Will record lease liability and right-of-use (ROU) asset for most leases
  - Income statement expense presentation will depend on classification of lease
  - Requires more frequent reevaluation of arrangements
  - Build-to-suit guidance changed significantly
- Changes for lessors
  - Limited changes to lessor accounting model
  - Better alignment with revenue recognition standard (ASC 606)
  - Leveraged lease classification eliminated prospectively

Consideration

- What potential effect will the adoption of this standard have on:
  - Current ratios
  - Debt covenants (e.g. debt to equity ratio)
  - Other financial measurements
  - Start discussions with lenders and other users of the financial statements to avoid surprises

Scope

Scope

- Standard is applicable to all leases except:
  - Leases of intangible assets
  - Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources
  - Leases of biological assets
  - Leases of inventory
  - Leases of assets under construction
- Short-term leases election

Definition of a lease

Definition

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

Determining if a contract contains a lease

- Identified asset
  - The contract specifies an asset (explicitly or implicitly)
    - Physically distinct portions
    - Capacity portions
  - Supplier does not have a substantive right of substitution
    - Warranty/upgrade

- Control
  - Customer has the right to:
    - Obtain substantially all of the economic benefits from using the asset
    - Direct the use of the asset

Potential contracts and leases to consider

- Ground lease
- Computer and network equipment
- Vehicles and shuttle buses
- Kitchen equipment
- Maintenance equipment
- Office equipment and copiers
- Arrangements where the hotel is the lessor: restaurant, retail space, spa

Identified asset

- Is there an identified asset?
  - Is the asset specified in the contract?
    - Can be identified explicitly or implicitly
  - Is the asset physically distinct?
    - Capacity portions
  - Does the supplier have a substantive substitution right?
    - Must have practical ability to substitute throughout period of use
    - Must benefit economically from substitution

RSM

Change from current GAAP – definition of a lease

- Substitution right must economically benefit the supplier
  - Entities will need to consider this criterion
  - If you cannot determine that the substitution right is substantive, you assume that it is not
  - Evaluation of substantive performed at inception

Does customer control the asset?

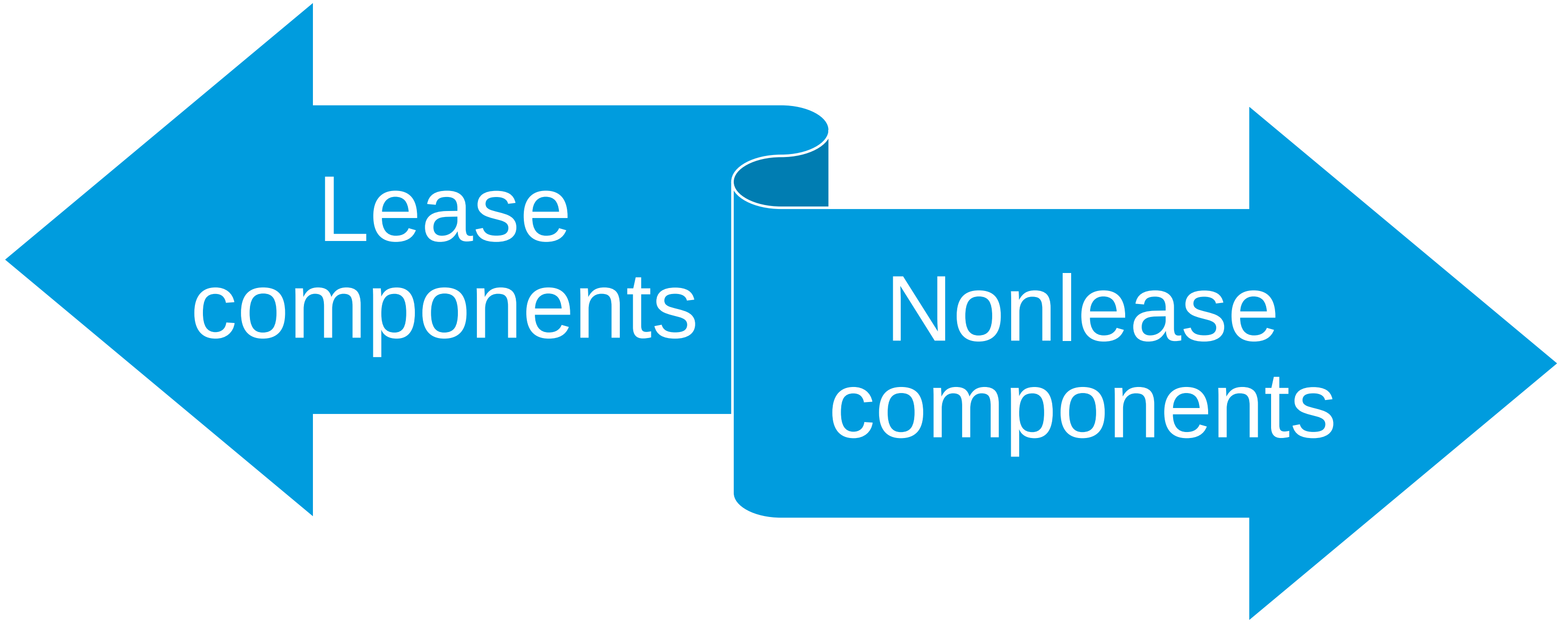
- Does the customer have the right to obtain substantially all of the economic benefits identified?
  - A lease might not grant unlimited/unrestricted use, but might still be a lease
- Does customer have the right to direct the use of the asset?
  - Direct "how and for what purpose" the asset is used
  - Those decisions are predetermined, and at least one of following exists:
    - Entity has the right to operate asset throughout period of use
    - Customer designed the asset in a way that predetermines "how and for what purpose" asset will be used

Change from current GAAP – customer control

- Current GAAP
  - A lease may exist solely based on right to obtain substantially all of the economic benefits
- ASC 842
  - Requires that customer have decision making rights
  - Some contracts that were previously considered leases will no longer meet the definition

Identifying components

Lease and nonlease components



- Separate and allocate based on relative standalone selling price
- Any activities that do not transfer a good or service to lessee are not components
- Lessee accounting practical expedient

Lease and nonlease components (continued)

- Nonlease components
  - Utilities
  - Common area maintenance
  - Maintenance on leased asset
- Examples of non-components
  - Delivery of leased asset
  - Reimbursement of insurance or property taxes

Identify and separate components

- A right to use an underlying asset is a separate lease component if:
  - Lessee can benefit from the right of use on its own or together with other resources readily available
  - Lease is not highly dependent on, nor highly interrelated with, other leases in the contract
- For leases that include a land element, right to use land is a separate lease component unless effect of separate accounting is insignificant
  - Separation would have no effect on lease classification, or
  - Amount that would be recognized for land component is insignificant

Allocation to components

- Lessees: Allocate contract consideration to separate lease components based on relative stand-alone selling prices of components
  - Unless practical expedient is elected
- Lessors: consideration in the contract must be allocated to the lease and nonlease components in accordance with ASC 606-10

Polling question #1

- Lessor and Lessee enter into a five-year lease for space within a building.
- Lessee will pay $13,000 per year, which includes rental, real estate taxes, insurance and common area maintenance.
- How many components are in this arrangement?
  A. 0
  B. 1
  C. 2
  D. 3
  E. 4

Live Content Slide

When playing as a slideshow, this slide will display live content

Poll: How many components are in this arrangement?

SOLUTION #1

- Answer is “C” (2).
- The components are (1) the lease component and (2) the common area maintenance
- Common area maintenance is a nonlease component because the lessor’s activities will transfer a service to the lessee
- Insurance and Taxes are non-components

Change from current GAAP - components

- Current GAAP
  - Equipment required to be separated from real estate
  - But parties generally tend to account for leases of multiple underlying assets on a combined basis if the assets are interdependent
- ASC 842
  - Separate lease components if (a) lessee can benefit from the right of use on its own and (b) not highly dependent
  - Lease and nonlease components need to be separated (unless expedient is elected)

Change from current GAAP – components (continued)

- Current GAAP
  - Land and building elements must be separated when FV of land is 25% or more of total FV of lease at inception
  - Allocation: lease payments equal to FV of land multiplied by incremental borrowing rate allocated to land element
- ASC 842
  - Allocation based on standalone selling price

Concepts and definitions

Commencement date

- Date on which the lessor makes the underlying asset available to lessee

Change from current GAAP – commencement date

- Current GAAP
  - Initial measurement occurs at inception
  - Classification assessed at inception
  - Recognition at commencement
- ASC 842
  - Initial measurement occurs at commencement
  - Classification assessed at commencement
  - Recognition at commencement

RSM

Lease term

Noncancellable period

Optional renewal periods if lessee is *reasonably certain* to exercise

Lease term

Periods covered by options to extend/not terminate exercisable by lessor

Periods after a termination option if lessee is *reasonably certain* <u>not</u> to exercise

Lease term (continued)

- No stated term/evergreen
  - Consider if it is “reasonably certain” that lessee will continue to use the asset
- Lessees reassess lease term
  - When there is a significant event or change in circumstances within control of lessee
  - An event is written into contract requiring renewal or termination
  - Lessee elects to exercise an option that had previously not been “reasonably certain” of exercise (or inverse)
  - Lessors do not reassess unless lease is modified.

Lease payments

- Fixed payments (including “in-substance”)
- Purchase options (if exercise is reasonably certain)
- Termination options (if exercise is reasonably certain)
- Residual value guarantees (if probable of being owed)
- Variable lease payments that depend on an index or rate

Variable lease payments

- Lease payments only include variable lease payments that depend on an index or rate
  - Derived using rate or index at commencement
  - Remeasure only when lease payments are remeasured for another reason
- Exclude other variable lease payments
- Excluding variable payments from lease payments
  - Smaller liability and ROU asset
  - More likely to result in operating lease classification
  - More likely to result in “straight line accounting”

Change from current GAAP - residual value guarantees (RVG)

- Current GAAP
  - Minimum lease payments include <u>full amount</u> of RVG provided, rather than amount likely to be owed
- ASC 842
  - Lease payments include amount likely to be owed
  - Likely to reduce lease liability and ROU asset for finance leases (compared to capital leases)

RSM

Initial direct costs

- Incremental costs of a lease that would not have been incurred if the lease had not been obtained
- Typical initial direct costs include:
  - Commissions
  - Payments made to an existing tenant to incentivize that tenant to terminate the lease
- Typical initial direct costs do not include:
  - Legal fees
  - Costs of evaluating prospective lessee’s financial condition
  - Costs of negotiation
  - General overheads/allocations

Polling question #2

- Lessee and lessor enter into a lease. Lessor incurs the following costs:
  1. $30,000 in allocated costs of salaries of employees that negotiated the lease
  2. $35,000 external legal fees for negotiating and drafting the lease
  3. $40,000 Commissions payable to the listing agent
- Which of the above qualify as initial direct costs?
  - A. None
  - B. All
  - C. Allocated costs
  - D. External legal fees
  - E. Commissions

Live Content Slide

When playing as a slideshow, this slide will display live content

Poll: Which of the above qualify as initial direct costs?

SOLUTION #2

- Answer is “E”—only the commission qualifies
- The commission qualifies because it would not have been incurred if the lease had not been obtained
- The employee salaries would have been paid whether the lease was obtained or not
- Similarly, the external legal fees would have been incurred even if the lease had not been executed

Change from current GAAP - initial direct costs

- Current GAAP
  - Includes other incremental costs incurred directly as a result of the lease (including some fees that would have been incurred even if lease was not executed)
  - Many costs related to negotiating and arranging the lease
- ASC 842
  - Significantly narrower definition
  - Will likely result in higher origination costs recognized

Discount rate

- Use the rate implicit in the lease unless that rate cannot be readily determined
  - In that case, use incremental borrowing rate
- Rate determined at lease commencement
- Policy election: lessee that is not a public business entity may use a risk-free discount rate for all leases
- Likely will result in use of incremental borrowing rate
  - Must use a <u>secured</u> incremental borrowing rate (“collateralized” basis)

Lessee accounting

Lease classification criteria

1. Does the lease transfer ownership to the lessee by the end of the lease term?
2. Does the lease contain a purchase option that the lessee is *reasonably certain* to exercise?
3. Is the lease term for the *major part* of the remaining economic life of the asset?
4. Is the sum of the present value of the lease payments and any residual value guaranteed by the lessee equal to or greater than *substantially all* of the fair value of the asset?
5. Is the underlying asset of a specific nature such that it would have no alternative use to the lessor?

Similar to current criteria, but without bright lines

RSM

Polling question #3

- Lessor and Lessee enter into a three-year contract under which a specific piece of equipment will be customized for Lessee's use.
- After three years, Lessor would have to incur significant costs to repurpose the equipment to be able to see or lease.
- There are no transfers of ownership and no renewal/purchase options.
- The present value of the lease payments does not represent substantially all of the FV.
- Remaining economic life of equipment is seven years.
- How should Lessee classify the lease?

  A. Operating

  B. Finance

Live Content Slide

When playing as a slideshow, this slide will display live content

Poll: How should Lessee classify the lease?

SOLUTION #3

- Answer is “B”—Lessee should classify the lease as a finance lease
- The fact that the equipment has no alternative use to Lessor results in finance lease classification, regardless of other terms and conditions of the lease

Initial recognition and measurement

- Recognize a lease liability and right-of-use (ROU) asset at lease commencement
  - Unless short-term exception is available and applied
- Lease liability = PV of unpaid lease payments
- *ROU* asset *calculation*:

  Initial measurement of lease liability

  + Initial direct costs

  + Prepaid lease payments

  - Lease incentives received

Subsequent measurement - finance leases

- Lease liability measured on amortized cost basis
  - Increase for interest; decrease for payments
- ROU asset measured at cost less accumulated amortization and impairment losses
  - Amortize on a straight-line basis
- Income statement recognition
  - Amortization of ROU asset
  - Interest on lease liability
  - Variable lease payments incurred
  - Impairment of ROU asset

RSM

Change in current GAAP - finance lease vs capital lease

- Current GAAP
  - No reassessment criteria

- ASC 842
  - Must reassess for significant events that change lease term or other items
  - Remeasure lease liability and ROU asset upon reassessment
  - Modifications

Subsequent measurement - operating leases

- Lease liability measured at PV of unpaid lease payments
  - Use discount rate determined at commencement, unless a remeasurement has occurred
- ROU asset (if not impaired) measured at:

  Lease liability amount

  + Unamortized initial direct costs

  + (or –) prepaid (accrued) lease payments

  - Unamortized balance of incentives received
- Income statement recognition
  - Single lease cost
  - Variable lease payments
  - Impairment

RSM

Lease reassessments

- A lease modification or reassessment that is not accounted for as a separate contract often leads to remeasurement
- Five situations can lead to remeasurement
  - Lease modification not accounted for as a separate contract
  - Upon a triggering event
    - Change in lease term
    - Change in assessment of likelihood of lessee exercising a purchase option
  - When facts and circumstances change
    - Change in amount probable of being owed under RVG
    - Variable lease payments become lease payments (after contingency resolution)

Lease reassessments (continued)

- In remeasuring, the following are updated:
  - Lease payments
  - Contract consideration
  - Allocation of consideration
  - Discount rate
  - Lease classification
- Lease modification not treated as new contract: update all
- Change in lease term/option exercise: update all
- Change in amount probable under RVG/resolution of contingency for variable lease payments: do not update discount rate or classification

Lease reassessments (continued)

	Term	Option	RVG	Contingency
Remeasure consideration and reallocate to remaining components	Yes	Yes	Yes	Yes
Remeasure liability using revised payments (Term and Option: use updated rate; RVG and Contingency: use original rate)	Yes	Yes	Yes	Yes
Adjust ROU asset	Yes	Yes	Yes	Yes
Reassess classification (using circumstances at reassessment date)	Yes	Yes	No	No

RSM

Lessor accounting

Lessor classification

- If any of the five lessee classification tests is met, lessor classifies as a sales-type lease
- If none are met, classify as a direct financing lease if <u>both</u> of following are met:
  - PV of the sum of lease payments and any residual value guarantees equals or exceeds substantially all of the FV of the underlying asset, and
  - It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a RVG
- If one or both of these additional criteria are not met, classify as an operating lease

Changes to lessor accounting

Lease classification (sales type and direct financing)	• Classification no longer driven by existence of profit or loss • Now dependent on transfer of risks and benefits • A lot of leases that would be classified as DFL under 840 will be classified as ST under 842 • Selling profit in DFL will be deferred and recognized over lease term
Allocation of consideration	• Apply ASC 606; different guidance for variable consideration
Collectibility	• Uncertainty will no longer drive classification • More leases will qualify for sales type classification
Variable lease payments	• Leases with mostly variable payments might be classified as sales type or direct financing
Initial direct costs	• Significantly fewer costs will qualify as IDC • Higher cost recognition prior to lease commencement
Leveraged leases	• Eliminated prospectively
Leases of real estate	• Special rules eliminated

Lease modifications

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"
  - Add or terminate a right to use one of the underlying assets
  - Extend or shorten the contractual lease term
- Determine if the modification should be accounted for as a separate contract or as a change to existing contract
  - Modification grants the lessee an additional right-of-use not included in the original lease, and
  - Lease payments increase commensurate with the standalone price for the additional right of use

Lease modifications (continued)

- If not a separate contract, the lessee must:
  - Remeasure the lease liability as of the effective date of the modification as if the modification were a new lease commencing on that date
  - Remeasure the right-of-use asset
  - Reassess the lease classification

Disclosures

Lessee disclosures - qualitative information

- Nature of leases
  - General description
  - Terms and conditions of variable lease payments
  - Existence, terms and conditions of extension or termination options and residual value guarantees
  - Restrictions/covenants imposed by leases
- Significant judgments and assumptions used in lease accounting
  - E.g., Allocation, discount rate, whether contract contains a lease
- Related party leases
- Practical expedients and short-term exception

Lessee disclosures - quantitative information

- Finance leases: amortization of ROU assets and interest
- Operating leases: lease cost
- Short-term lease cost
- Variable lease cost
- Sublease income
- Net gains/losses on sale-leaseback transactions
- Weighted-average remaining lease term
- Weighted average discount rate (operating and finance)
- Maturity analysis

RSM

Lessor disclosure - qualitative information

- Nature of leases
  - General description
  - Terms and conditions of variable lease payments
  - Existence, terms and conditions of extension options, termination options and lessee purchase options
- Significant assumptions and judgments
- Related party leases
- Significant changes in certain net investment accounts
- Information on management of residual value risk

Lessor disclosure - quantitative information

- Table of lease income
- Carrying amounts of components of the aggregate net investment in sales-type and direct financing leases
- Maturity analyses

Transition

Transition

- Modified retrospective approach
  - Other than for short-term leases
- Applied as of the beginning of the earliest comparative period presented
  - Apply to all leases that exist at, or commence*(d)* after, the beginning of the earliest period presented

Transition - practical expedients

- “Package”—if elected, must be elected as a package and applied to all leases
  - Need not reassess whether any expired or existing contracts are or contain leases
  - Need not reassess lease classification for any expired or existing leases
  - Need not reassess initial direct costs for any existing leases
- Hindsight—can be elected individually
  - Can elect to use hindsight to determine lease term and in assessing impairment of ROU assets

QUESTIONS AND ANSWERS

THANK YOU FOR YOUR TIME AND ATTENTION

RSM US LLP

One South Wacker Drive, Suite 800
Chicago, IL 60606
312.634.3400

+00 (1) 800 274 3978
www.rsmus.com