

# ASC 842: *Leases*

Presented by:  
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June 15, 2018



## The New Lease Standard – FASB ASC 842, *Leases*

- **Supersedes FASB ASC 840, *Leases***
- **Effective for calendar year-end public companies in 2019; and for calendar year-end non-public companies in 2020**
- **Entities that hold numerous operating equipment and real estate leases will be most affected by this new guidance.**
- **Industries expected to be most affected: large drugstore chains, telecommunications, retail store chains, restaurant chains, airlines, banks, and grocery stores.**
- **Will add lease-related assets and liabilities to the lessee's balance sheet for operating leases. This could affect compliance with contractual agreements and loan covenants.**
- **Retains a distinction between finance leases and operating leases.**

## The New Lease Standard – FASB ASC 842, *Leases*

- Lessee is permitted to make an accounting policy election not to recognize lease assets and lease liabilities for leases with a term of 12 months or less.
- Applies to leases of property, plant, and equipment based on a contract that conveys control to the lessee for a period of time. Does not apply to:
  - Leases of intangible assets; leases to explore for or use minerals, oil, natural gas, and similar resources; leases of biological assets; leases of inventory; and leases of assets under construction
- Under the old standard, the critical determination was whether a lease was a capital or operating lease. Under the new standard, the critical determination is whether a contract is or contains a lease.

## The New Lease Standard – FASB ASC 842, *Leases*

- **Previous US GAAP definition of a lease:**
  - **An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.**
- **New definition under FASB ASC 842:**
  - **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.**
- **The right to control the use during the lease term:**
  - **Decision-making authority over the use of the asset.**
  - **The ability to obtain substantially all economic benefits from the use of the asset.**

## The New Lease Standard – FASB ASC 842, *Leases*



- Lessee is required to measure and record both of the following on the commencement date (date lessor makes underlying asset available for use by the lessee):
  - Lease liability at the present value of the lease payments not yet paid, using the discount rate for the lease.
    - If not determinable, the entity should use its incremental borrowing rate.
  - The right-of-use asset
- Renewal options – include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to renew the lease.
- Lease term = non-cancellable lease period + periods likely to extend + options to extend controlled by lessor

# The New Lease Standard – FASB ASC 842, *Leases*

Lease Type	Balance Sheet	Income Statement	Cash Flow Statement
Finance	<ul style="list-style-type: none"><li>• Right-of-use asset</li><li>• Lease liability</li></ul>	<ul style="list-style-type: none"><li>• Amortization expense</li><li>• Interest expense</li></ul>	<ul style="list-style-type: none"><li>• Principal – financing</li><li>• Interest - operating</li></ul>
Operating	<ul style="list-style-type: none"><li>• Right-of-use asset</li><li>• Lease liability</li></ul>	<ul style="list-style-type: none"><li>• Single lease expense on a straight-line basis</li></ul>	<ul style="list-style-type: none"><li>• Lease expense – usually operating</li></ul>

## FASB ASC 842, *Leases* – Operating Leases

- Lessee accounting for operating leases:
  - Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the balance sheet.
  - Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis.
  - Classify all cash payments within the operating activities in the Statement of Cash Flows.
- Capitalization Threshold?
  - Entities will *likely* be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, which should reduce the costs of applying the guidance.

## FASB ASC 842, *Leases* – Finance Leases

- **Key differences from previous standard:**
  - **No “bright lines” incorporated into the criteria (however, 75% of useful life and 90% minimum lease payment thresholds are “one reasonable approach” per ASC 842.**
  - **The guidance no longer uses the term “bargain purchase option.”**
  - **There are now five capital lease criteria instead of four.**





## FASB ASC 842, *Leases* – Finance Leases



- Finance Lease Criteria:
  - Ownership of underlying asset transfers to lessee by end of lease term.
  - Lease grants lessee an option to purchase underlying asset that lessee is reasonably certain to exercise.
  - Lease term is the major part of the remaining economic life of the underlying asset.
  - Present value of sum of lease payments and residual value guarantees by lessee not already reflected in lease payments equals or exceeds substantially all of the fair value of the underlying asset.
  - *Underlying asset is of such specialized nature, it is expected to have no alternative use to lessor at end of lease term.*

## Implementation of FASB ASC 842, *Leases*

- **Effective for calendar year-end public companies in 2019; and for calendar year-end non-public companies in 2020.**
  - **Modified retrospective adoption**
- **Practical Expedients:**
  - **These must be elected as a package and consistently applied to all leases – an entity need not reassess each of the following:**
    - **Whether any expired or existing contracts are or contain leases**
    - **The lease classification for any expired or existing leases (existing leases that were operating under ASC 840 will be operating under ASC 842 and those that were capital leases under ASC 840 will be finance leases under ASC 842)**
    - **Initial direct costs for any existing leases**
  - **An entity may use hindsight in determining the lease term and in assessing impairment of an entity's right-of-use assets. Must be applied consistently to all leases.**

# Example Balance Sheet Presentation

## BALANCE SHEET DECEMBER 31, 2016

### ASSETS

#### CURRENT ASSETS:

Cash and cash equivalents	\$ 2,501,790
Accounts receivable	344
Inventories	1,420,528
Prepaid expenses and other current assets	458,239
Total current assets	4,380,901

PROPERTY AND EQUIPMENT, net 24,057

**OPERATING LEASE RIGHT-OF-USE ASSET, net 252,699**

**FINANCE LEASE RIGHT-OF-USE ASSET, net 8,847**

INTANGIBLE ASSETS, net 88,023

**TOTAL \$ 4,754,527**

### LIABILITIES AND MEMBERS' CAPITAL

#### CURRENT LIABILITIES:

Accounts payable	\$ 603,596
Accrued expenses	413,830
State income taxes payable	37,751
Deferred revenue	446,776
<b>Current portion of operating lease obligation</b>	<b>176,810</b>
<b>Current portion of finance lease obligation</b>	<b>3,014</b>

Total current liabilities 1,681,777

**OPERATING LEASE OBLIGATION, net of current portion 91,744**

**FINANCE LEASE OBLIGATION, net of current portion 5,684**

Total liabilities 1,779,205

MEMBERS' CAPITAL 2,975,322

# Example Income Statement Presentation



## STATEMENT OF INCOME YEAR ENDED DECEMBER 31, 2016

SALES, net	\$ 15,576,375
COST OF SALES	<u>6,558,692</u>
GROSS MARGIN	9,017,683
OPERATING EXPENSES:	
Sales and marketing	3,988,117
Salaries and employee benefits	2,684,693
Office	343,154
Professional services	182,279
Operating lease	<u>171,782</u>
Travel and entertainment	128,152
Other	<u>137,496</u>
Total operating expenses	<u>7,635,673</u>
INCOME FROM OPERATIONS	1,382,010
OTHER INCOME (EXPENSE):	
Interest expense	(219)
Other income	<u>28,206</u>
Total other income, net	<u>27,987</u>
INCOME BEFORE INCOME TAXES	1,409,997
STATE INCOME TAX EXPENSE	<u>28,940</u>
NET INCOME	<u><u>\$ 1,381,057</u></u>

## FASB ASC 842, *Leases* - Implications

- Leverage ratios based on current US GAAP could be violated upon the adoption of the new lease standard since liabilities will be increased under most definitions of liabilities in debt agreements.
- Debt to equity increases
- Potential EBITDA increases
  - EBITDA (not US GAAP defined) typically included rent expense, will it include the new “lease expense”?
- Current ratio decreases
- Leases which embed payments for taxes and insurance in the fixed lease payment may wish to consider revising the lease to make these variable (pass-through), otherwise the payments for taxes and insurance will be capitalized.

# Q&A and Contact Information



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