2022 GAAP Update

Welcome

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ASC 842 Leases

Identifying a Lease

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

IDENTIFIED ASSET

Is the asset specified and are there substitution rights?

CONTROL

Are you receiving all the economic benefits?

Do you have decision making rights?

Is the control for a specified period of time?

Substantive Substitution Rights

- Contracts that don’t contain an identified asset.
- Even though an asset is specified, the supplier has the right to substitute because:

  a. The supplier has the practical ability to substitute alternative assets throughout the period of use

  AND

  b. The supplier benefits from the exercise of its right to substitute (the economic benefits of substitution exceed the costs associated with substituting the asset)

Substantive Substitution Rights (Cont.)

- Common examples to consider but not limited to: scissor lifts, small tools, fencing, traffic barriers, portable restrooms, dumpsters, etc.

Transition Reliefs

Optional Practical Expedients and Policy Elections	
Transition Election: Package of Three	At adoption, don’t reassess expired or existing contracts for: 1) embedded leases 2) proper lease classification or 3) capitalization of initial direct costs
Hindsight	May elect to apply hindsight to existing leases to determine lease term and asset impairment
Land Easements	At adoption, don’t reassess whether existing or expired land easements contain a lease
Short-Term Leases	A lessee may elect to exclude leases of 12 months or less from the new accounting requirements in ASC Topic 842
Capitalization Threshold	Immaterial leases don’t need to be accounted for under ASC Topic 842
Lease and Nonlease Components	Lessees and lessors may make an accounting policy election to choose not to separate nonlease and lease components
Discount Rate Portfolio Approach	A lessee may apply single discount rate to a portfolio of leases if it doesn’t result in a materially different PV than using an individual discount rate for each lease
Risk-Free Discount Rate	A lessee may apply the risk-free discount rate to assets of selected asset classes

Leasing Arrangements

Typical Construction Leasing Arrangements

- Tower crane
- Job trailers
- Scaffolding
- Construction elevators
- Vehicle fleets

Typical Arrangements Not Subject to Leasing Standard

- Scissor lifts
- Small tools
- Dumpsters
- Temporary fencing and traffic barriers
- Portable restrooms

Consideration of De Minimis Leases

- Copy machines
- Postage machines
- Vending machines
- Water coolers
- Coffee machines

Note: consider the practical expedients for a capitalization threshold and/or discount rate portfolio approach

Other Areas to Consider for Embedded Leases

- IT Contracts
- Service Contracts
- Supply Contracts
- Inventory Management, Warehousing Services & Systems
- Fabrication of Unique Items
- Transportation of Materials on Trucks, Railcars & Barges
- Tower Cranes

Tips for Identification

Tip 1	Tip 2	Tip 3	Tip 4
If decentralized locations, send surveys to managers and have them assess contracts that meet the company's capitalization policy	Should ask whether any service contracts involve the use of specific assets	Review recurring vendor payments or contracts	Physical inspection of assets to identify leased assets versus owned

Lease Components

- If one or both aren’t met, the right to use is considered a single lease component
  - Lessee can benefit from the right of use on its own or together with readily available resources
  - Right of use isn’t highly dependent on, not highly interrelated

- If one or both aren’t met, the right to use is considered a single lease component

Non-Lease Components

Distinct elements of a contract that aren't related to securing the use of the leased asset.

- Operating the leased asset on behalf of the lessee (operator of tower crane or other specialized equipment)
- Training lessee personnel to operate the asset
- Repair or maintenance of leased asset
- Management services
- Included parking spaces
- Common area maintenance (CAM)
- Landscaping services
- Security services
- Consumables and supplies

Non-Lease Components (Cont.)

There isn't a clear list in the standard and management must create an internal process to identify non-lease components.

Lease versus Non-Lease Component Types

Consideration	Type	Reasoning	Examples
Fixed payments for use of the asset	Lease component	Rent payments directly transfer the right to use the underlying asset	Base rent to use space in a building or to use a piece of equipment
Variable payments for use of the asset	Lease component	Rent payments directly transfer the right to use the underlying asset	Usage or mileage-based payments on a vehicle or piece of equipment
Common area maintenance (CAM)	Non-lease component	Transfers a good or service to the lessee but doesn’t relate directly to the underlying asset	Building HVAC, public space lighting, parking lot maintenance
Other services	Non-lease component	Transfers a good or service to the lessee but doesn’t relate directly to the underlying asset	Security, janitorial services, administrative services
Reimbursement of lessor expenses	Non-lease component	Landlord is required to pay but the lessee doesn’t directly receive a good or service	Property taxes or insurance
Administrative tasks to initiate the lease	Non-lease component	Lessor isn’t receiving a good or service	Legal fees, contracting costs

https://leasequery.com/blog/lease-non-lease-components-under-asc-842/

Discount Rate

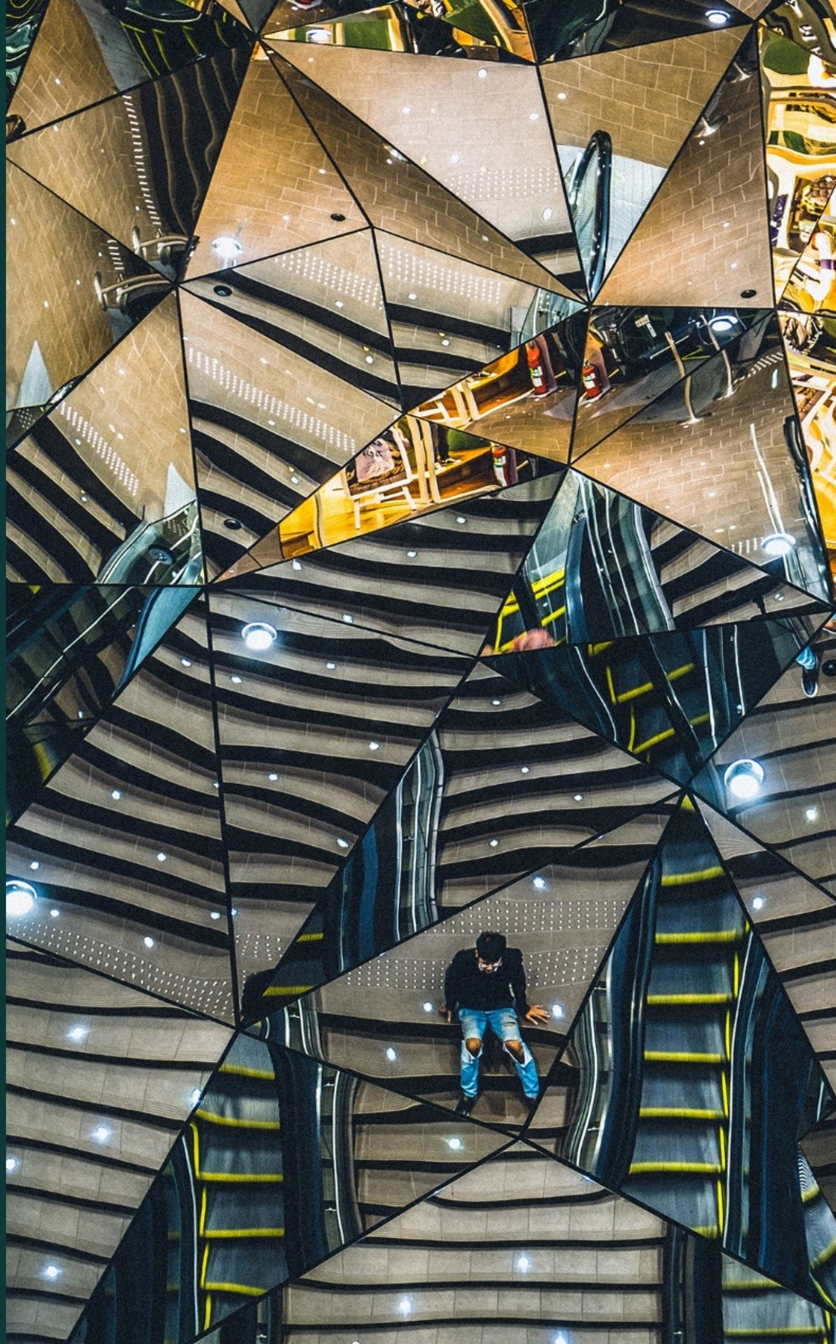
- Needed to calculate the present value of future lease payments
- Generally, the rate isn't implicit in the lease so the Incremental Borrowing Rate (IBR) should be used
- Examples of IBR:
  - Loans funded near the lease commencement date
  - Obtaining the cost of borrowing from a lender
  - Developing a rate based on creditworthiness

Discount Rate (Cont.)

- May opt to apply a single discount rate to a portfolio of new leases if using a single rate isn’t materially different than applying individual discount rates to each lease
- Practical expedient allows for the use of the risk-free rate on all leases by asset class, however this will generally be lower and result in a higher liability recorded

Related Party Leases

- Key change impacting related party leases
- ASC 840: economic substance
- ASC 842: legally enforceable terms and conditions
- Intent of FASB was to simplify, but what's legally enforceable can be difficult to determine without legal counsel



Expired Related Party Lease

- Could require legal consultation on enforceability
- Risks acceleration of leasehold improvement depreciation
- We advise related party leases are put in writing with terms that approximate economic substance

Month to Month Leases

- Not enforceable if both lessee and lessor can terminate without permission with no more than an insignificant penalty
- If enforceable, must determine renewal and term options exercisable by both parties
  - Economic incentives must exist to determine exercise of options is reasonably certain
  - Consider facts and circumstances to identify implicit terms, meaning, significant leases hold improvements on property with short related-party lease term

Financial Statement Presentation

INCREASED LIABILITIES (Current & Non-Current)

- Operating leases will result in negative impact to working capital and related ratios (for example, current ratio)
- Operating lease liabilities aren't *debt or debt-like*

INCREASED ASSETS

- Lower return on assets
- Lower equity to total asset ratios

CASH FLOW & PROFITABILITY

- Finance lease: larger expenses in earlier years compared to operating leases, but larger EBITDA add-back
- Operating lease: all flows through cash flows from operations

ASC 848 Reference Rate Reform

Reference Rate Reform

EFFECTIVE DATES

The optional expedients and accounting relief in Topic 848 were effective for all entities upon issuance of ASU 2020-04 on March 12, 2020, and will remain effective until December 31, 2022.

Reference Rate Reform (Cont.)

EFFECTIVE DATES (CONT.)

This means the practical expedients can be applied to contract modifications and eligible hedging relationships that:

- Existed as of the beginning of the interim period that includes March 12, 2020
- Were entered into after March 12, 2020, and through December 31, 2022

Reference Rate Reform (Cont.)

EFFECTIVE DATES (CONT.)

The optional expedients and exceptions only apply to contracts or hedging relationships that are affected by reference rate reform and that reference LIBOR or another reference rate expected to be discontinued due to reference rate reform.

Reference Rate Reform (Cont.)

CONTRACTS THAT QUALIFY UNDER TOPIC 848

Additionally, the relief is limited to changes being made to the terms of the contract that include:

- The direct replacement of a reference rate being discontinued
- Other modifications to terms that are considered related to the replacement of a reference rate

Reference Rate Reform (Cont.)

CONTRACTS THAT DON'T QUALIFY UNDER TOPIC 848

If a contract modification includes both a reference rate change and other substantive changes that are unrelated to reference rate reform, the contract won't qualify for the practical expedients or accounting relief provided for in the reference rate reform standard.

Reference Rate Reform (Cont.)

CONTRACTS THAT DON’T QUALIFY UNDER TOPIC 848 (CONT.)

The optional expedients and accounting relief don’t apply to modifications that occur in the ordinary course of business or for reasons unrelated to reference rate reform, such as borrowing base redeterminations, extensions, and covenant remedies.

Reference Rate Reform (Cont.)

CONTRACTS THAT DON'T QUALIFY UNDER TOPIC 848 (CONT.)

The optional expedients may not be applied to a modification made to a term that changes, or has the potential to change, the amount or timing of contractual cash flows is unrelated to the replacement of a reference rate—with the exception of a modification to the interest rate used for margining, discounting, or contract price alignment.

https://www.mossadams.com/articles/2021/03/reference-rate-reform-accounting-relief

Questions?

THANK YOU

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