



# Lease accounting under ASC 842: practice issues and implementation

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# Speakers



**Ryan Brady**

Partner

Accounting Principles

+1 312 602 8741

Ryan.Brady@us.gt.com



**Rahul Gupta**

Partner

Accounting Principles

+1 312 602 8084

Rahul.Gupta@us.gt.com



**Cullen Walsh**

Partner

Accounting Advisory Services

+1 212 624 5313

Cullen.Walsh@us.gt.com



**Carolyn Warger**

Manager

Accounting Principles

+1 617 848 4838

Carolyn.Warger@us.gt.com

# Learning objectives

1

Explain key implementation and practice issues related to the new lease accounting model (ASC 842)

2

Apply ASC 842 to various leasing transactions

3

Prepare to implement ASC 842

# Agenda

1

Definition of a lease

2

Components

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Classification

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Lessee accounting

5

Lessor accounting

6

Effective date and transition


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# Definition of a lease



# Definition of a lease

**Lease:** 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



**Contract:** An agreement between two or more parties that creates enforceable rights and obligations

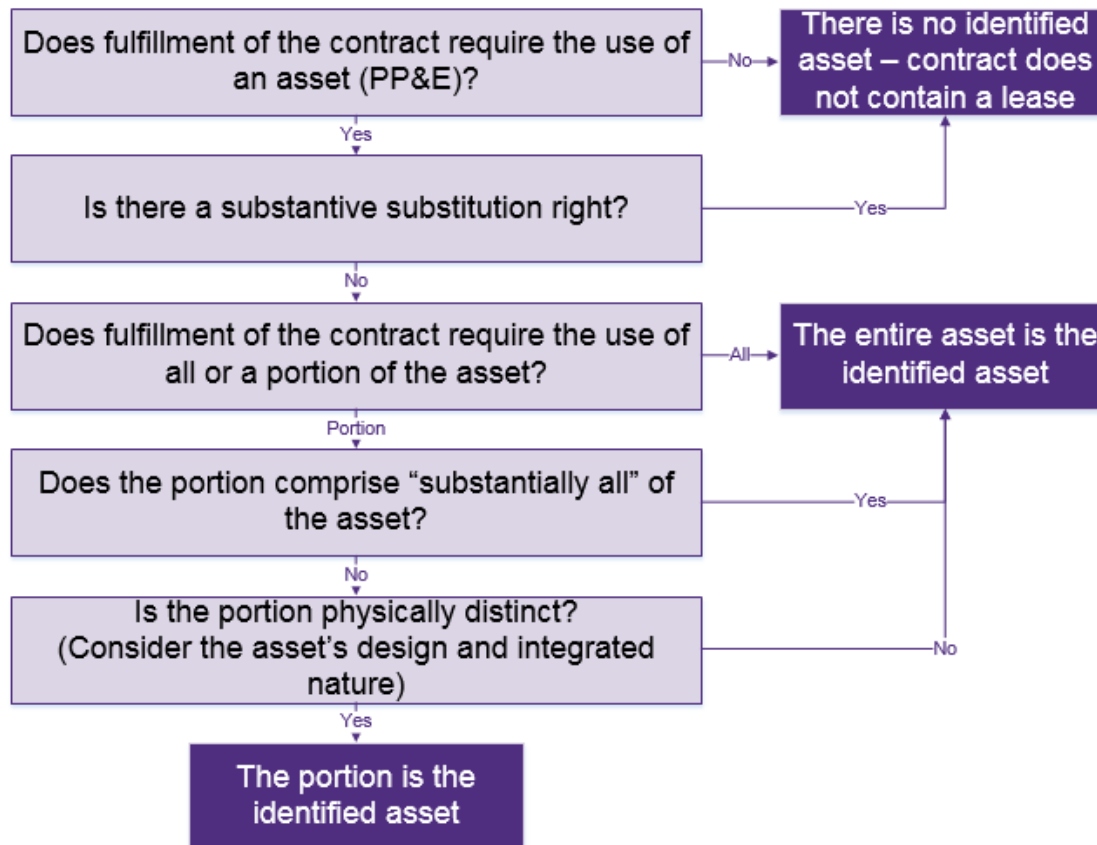


# Definition of a lease

## Three components



# Identified asset



# Physically distinct

**ASC 842-10-15-16 gives two examples**

- Floor of a building
- Segment of a pipeline that connects a single customer to the larger pipeline



# Physically distinct

Highly integrated /  
not designed to be  
distinct

- Utility pole
- Exterior wall of a building

Less integrated /  
designed to be  
distinct

- Cell tower
- Billboard

# Right to control the use

## Right to receive economic benefits

- Substantially all
- Throughout period of use

## Right to direct the use

- How and for what purpose
- Decisions predetermined

# Assets used to deliver a service

## ASC 842-10 Example 10A

- Two year contract for network services at specified quality level
- Supplier installs and configures servers on Customer's premises
- Supplier can reconfigure or replace servers to provide required quality of services



# Assets used to deliver a service

## Identify the assets

- Each server is an identified asset
- Could be explicitly or implicitly identified

## Identify the output of the assets

- Determine output for each identified asset
- Not predetermined – supplier decides

## Identify relevant "how and for what purpose" decisions

- Type of output
- Quantity of output
- When / whether output is produced

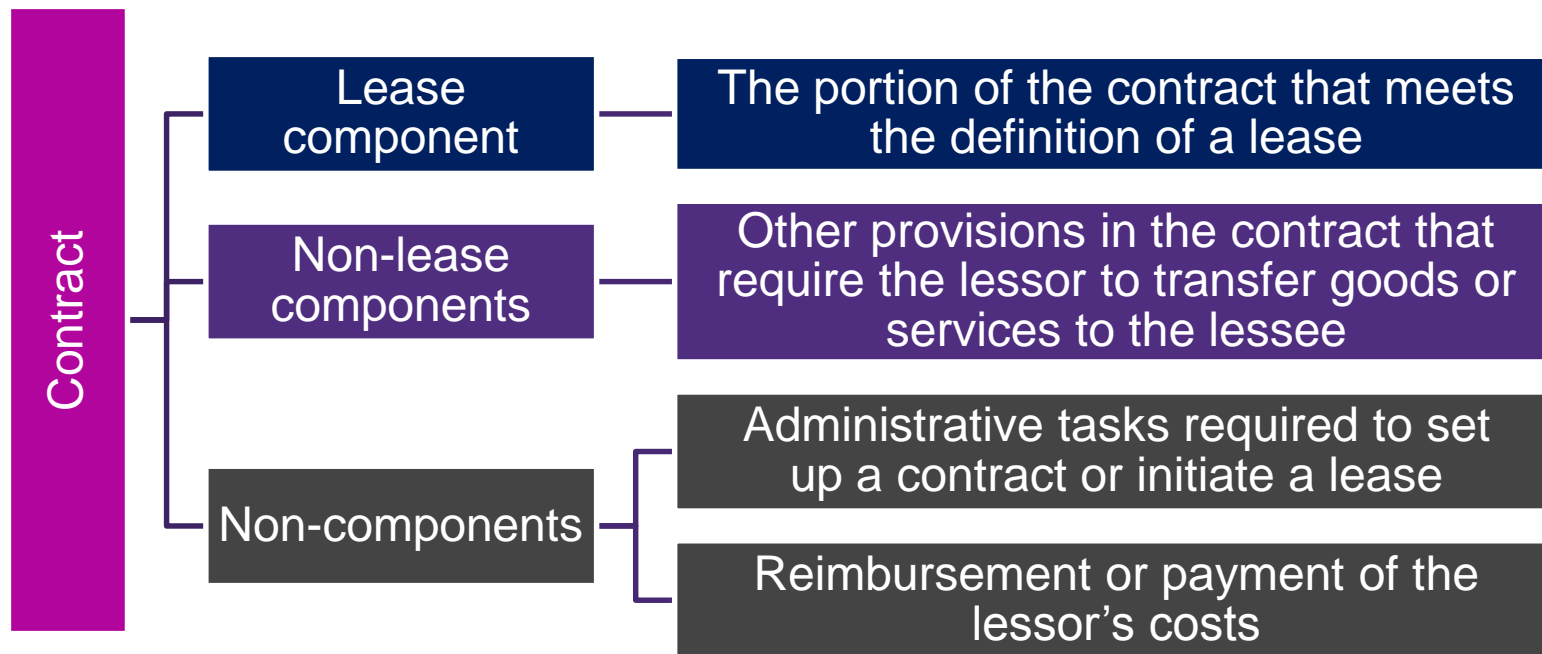
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# Components



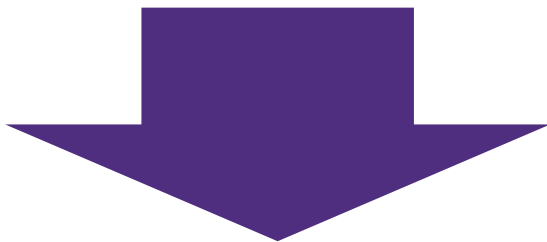


# Components of a contract



# Lessee practical expedient

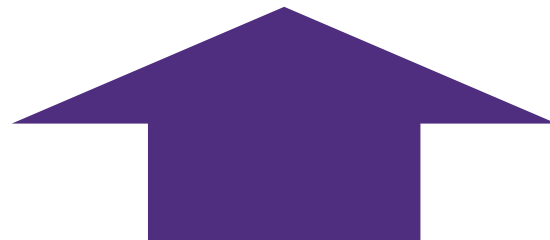
Accounting policy election to combine a lease component with its associated nonlease component(s) into a single lease component by class of underlying asset



... but the initial measurement of liability and asset will increase



Less effort to bifurcate lease and nonlease components ...



# Proposed lessor practical expedient

Practical expedient to combine non-lease components with the related lease component when:

- Timing and pattern of transfer is the same
- The lease component would be classified as an operating lease

Account for the combined component under ASC 606, rather than ASC 842, if the non-lease component is predominant. Main differences are:

- Timing of recognition for variable payments
- Disclosure requirements

# Allocation of consideration

## Lessee (ASC 842)

### Stand-alone price

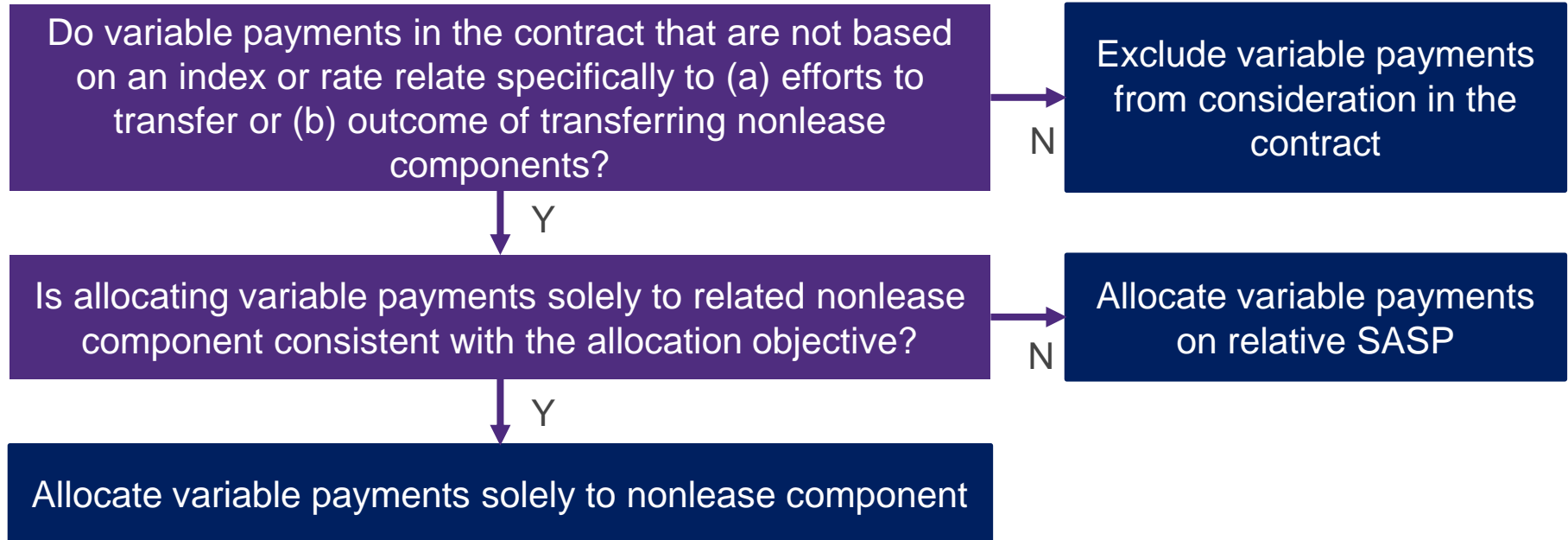
- Observable (from any supplier)
- Estimate
  - Maximize observable inputs
  - Residual

## Lessor (ASC 606)

### Stand-alone *selling* price (SASP)

- Observable (from lessor)
- Estimate
  - Adjusted market assessment
  - Expected cost plus margin
  - Residual

# Variable payments and SASP



# Lessee allocation of variable payments

Asset	<i>Retail space</i>
Term	<i>5 years</i>
Fixed payments	<i>\$100,000 per year</i>
Variable payments	<i>5% of annual sales</i>
Nonlease component	<i>Common area maintenance</i>
Combination expedient elected (lessee)?	<i>No</i>
Allocation	<i>80% lease, 20% non lease</i>
Classification	<i>Operating</i>

# Lessee allocation of variable payments

Year	Fixed payment	Sales-based payment	Actual CAM	Lease expense	CAM expense
1	\$100,000	\$75,000	\$26,000	\$160,800	\$40,200
	<i>Total = \$201,000</i>			* 80%	* 20%

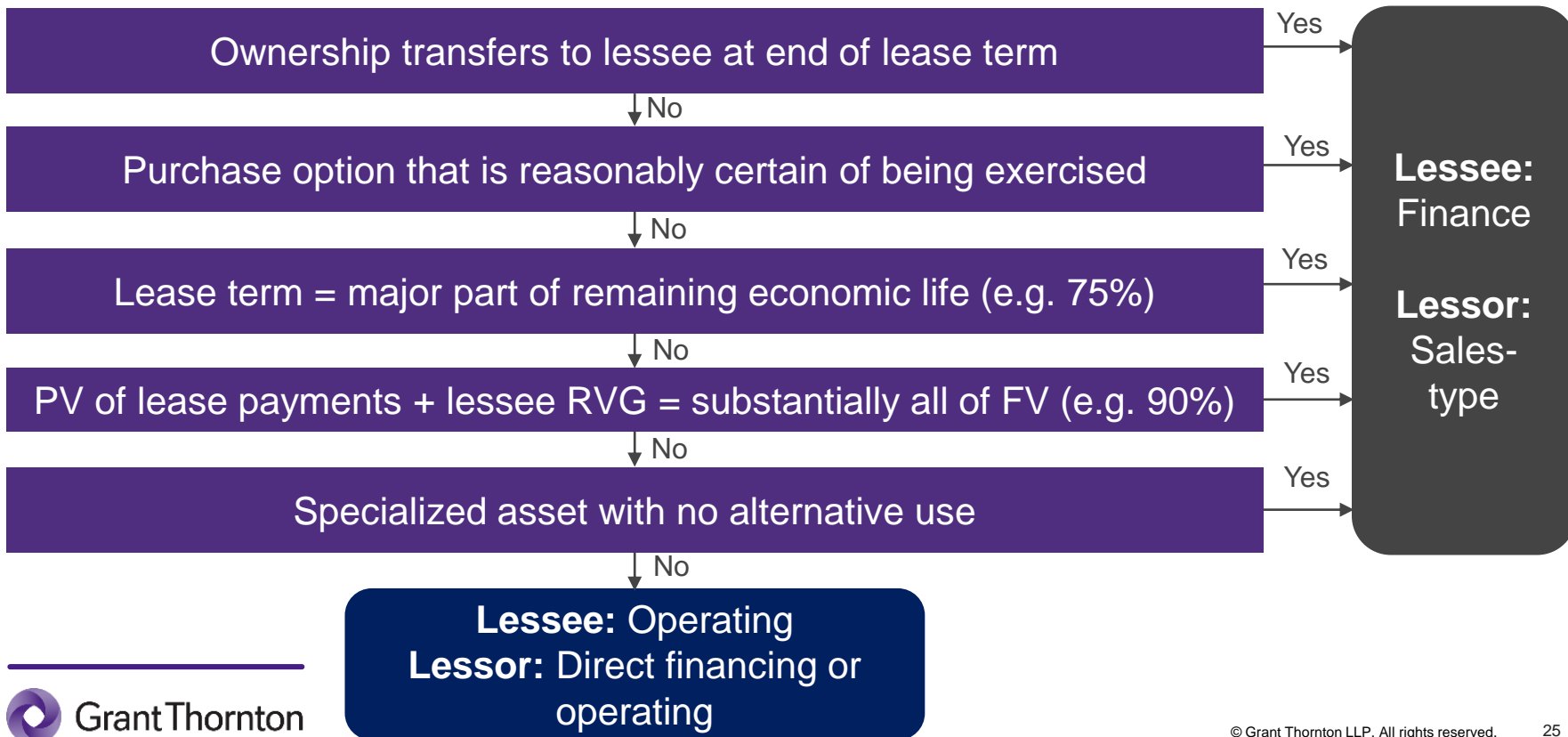
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# Classification

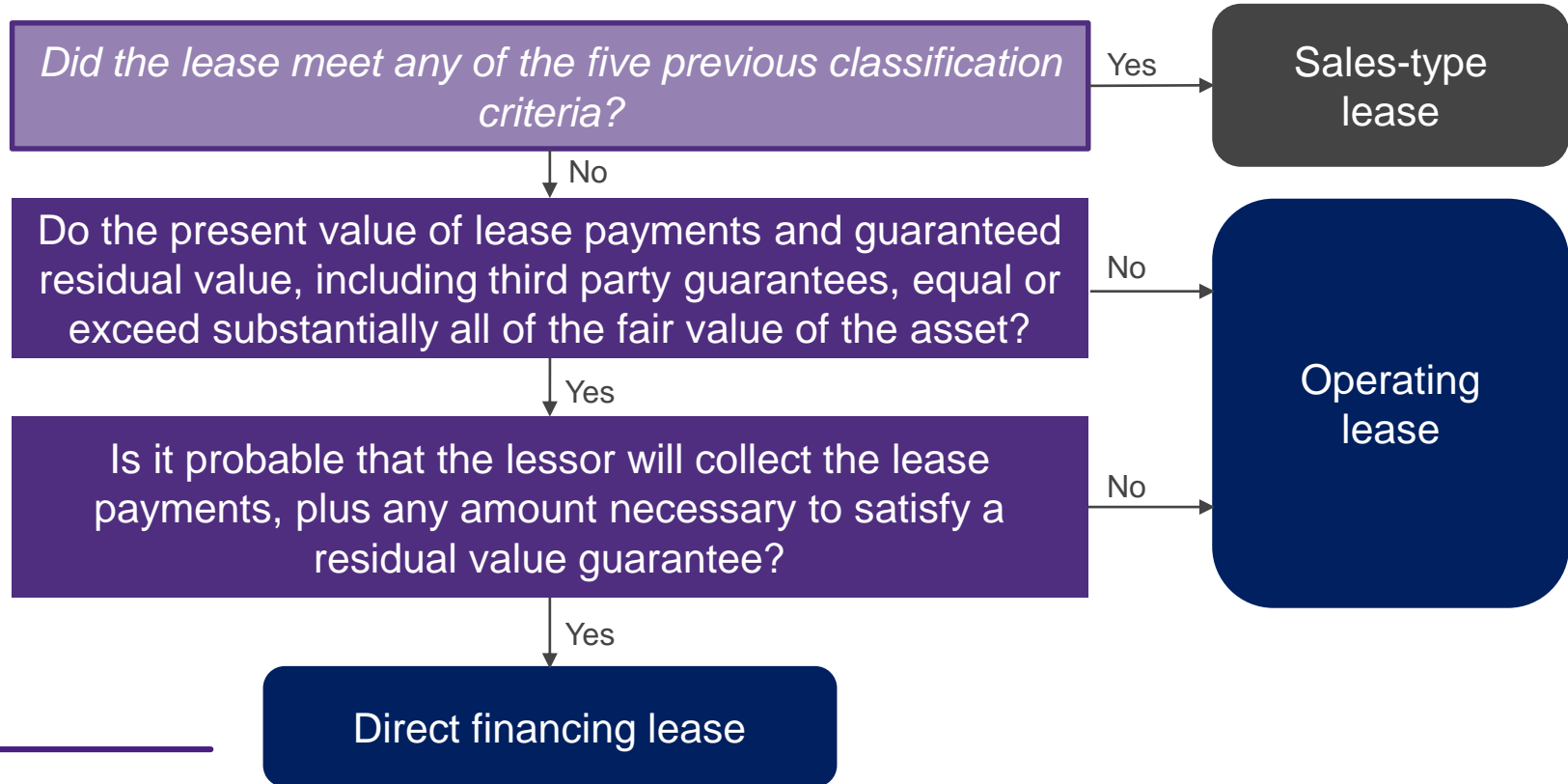




# Lease classification



# Additional lessor classification criteria



# Lease payments

## Include in lease payments

- + Fixed payments and in substance fixed payments, reduced by lease incentives paid to the lessee
- + Variable lease payments dependent on a rate or index
- + Options for which exercise is reasonably certain
- + Termination penalties if termination is reasonably certain
- + Fees paid by the lessee to owners of a special-purpose entity for structuring the transaction
- + Amount lessee is probable to owe under a residual value guarantee (lessee only)

## Exclude from lease payments

- Variable lease payments not dependent on an index or a rate
- Guarantee of the lessor's debt
- Amounts allocated to nonlease components

# Payments dependent on an index/rate

**Example 1:** Payments are \$10,000 in year 1, and increase annually by one month LIBOR at the end of each year. The lease term is 5 years and one month LIBOR at commencement is 2%.

Lessee uses one month LIBOR at commencement to project payments over the lease term. Therefore Lessee calculates lease payments of \$52,040.

**Example 2:** Payments are \$10,000 in year 1, and increase annually by the percentage increase in CPI during the year. The lease term is 5 years.

Lessee assumes that CPI at commencement will be the CPI throughout the lease. Lessee calculates lease payments of \$50,000.

# Present value of lease payments

## Implicit rate

- Use when readily determinable
- Often not known to lessee

## Incremental borrowing rate

- Rate lessee would pay to borrow on collateralized basis (any type of collateral)
- Assume similar term/environment

## Risk-free rate

- Practical expedient for private companies
- Would likely result in a larger lease liability

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# Lessee accounting



# Lessee initial measurement

ROU asset

Lease liability

Lease liability ←  
+ Payments made at or before commencement  
- Lease incentives received at or before commencement  
+ Initial direct costs

Present value of lease payments **not yet paid**

# Lessee subsequent measurement

	Operating	Finance
<b>ROU asset</b>	Lease liability + prepaid rent - accrued rent - remaining incentive + unamortized initial direct costs - impairment	Previous carrying amount - accumulated amortization - impairment
<b>Lease liability</b>	PV of remaining lease payments	Previous carrying amount + interest expense - lease payments

Amortize on SL basis

- remaining incentive  
+ unamortized initial direct costs



# ROU asset adjustment – operating lease

As described in ASC 842

Lease liability  
 + prepaid rent  
 - accrued rent  
 - remaining incentive  
 + unamortized IDCs  
 - impairment  
 = **ROU asset balance**

Adjusted lease cost

Lease cost  
 - interest  
 = **Adj. to ROU asset**

Residual amount

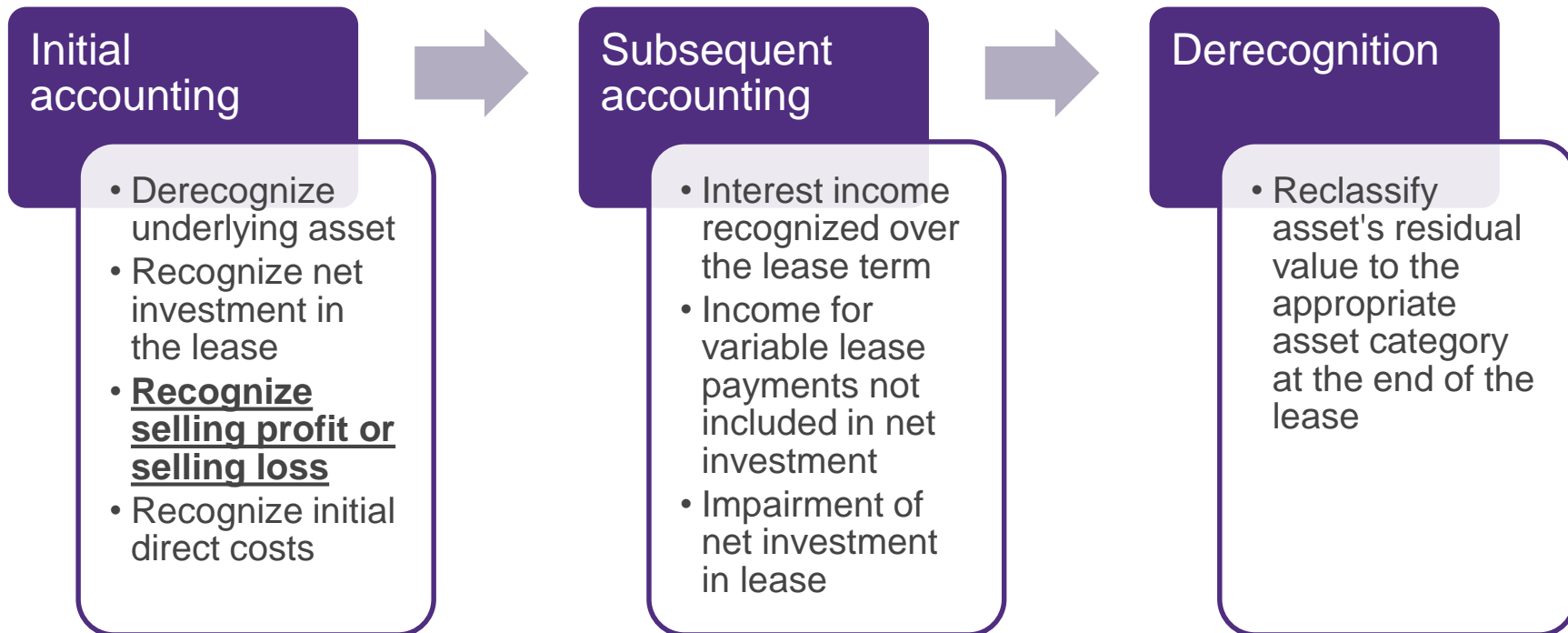
Dr. Lease liability	\$X	
Cr. Cash		\$X
Dr. Expense	\$X	
Cr. ROU asset		\$[ ]

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# Lessor accounting



# Sales-type leases



# Sales-type leases with significant variable payments

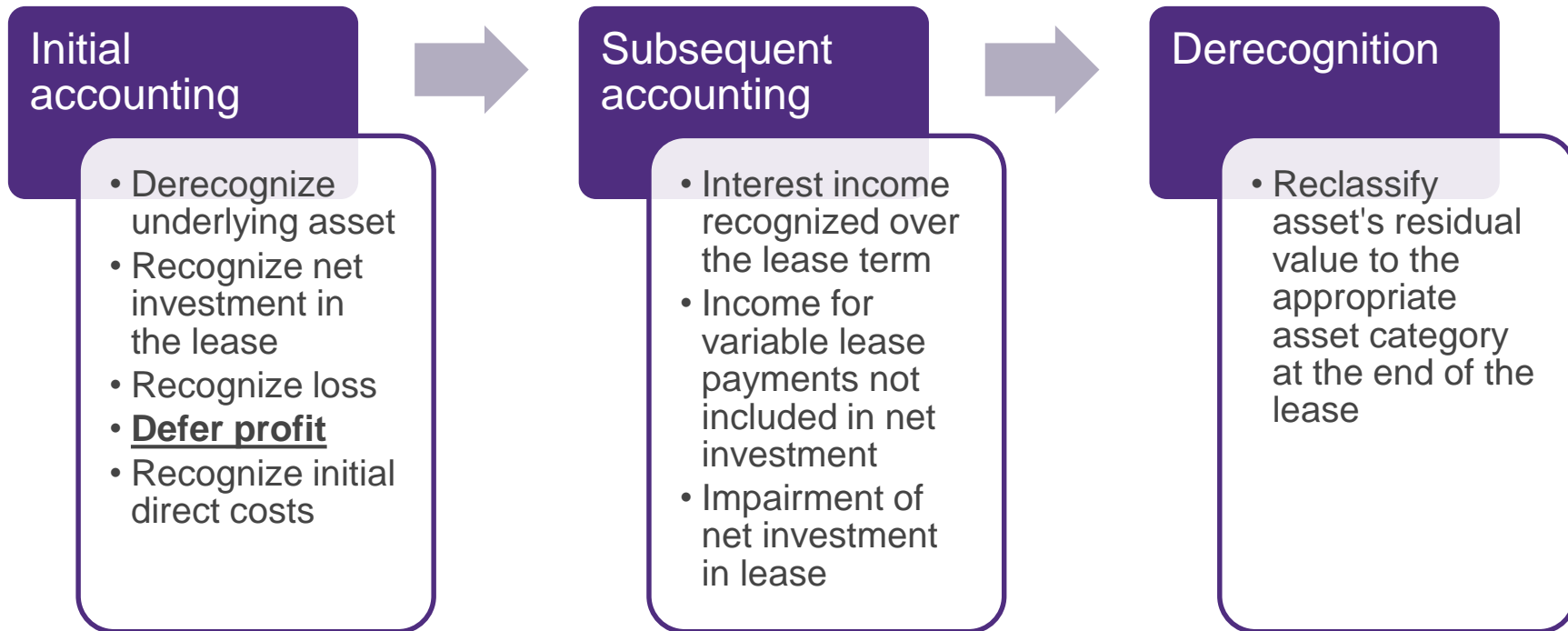
Application of Topic 842 could result in a negative rate implicit in the lease

Board clarified that lessors should **use a rate of 0%** if the calculated implicit rate is negative

**It is possible to have a day one loss in a sales-type lease**



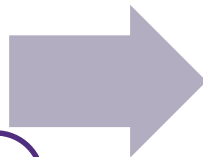
# Direct financing leases



# Operating leases (lessor)

## Initial accounting

- Underlying asset remains on balance sheet
- Defer initial direct costs



## Subsequent accounting

- Lease payments recognized on straight-line or other systematic or rational basis
- Variable lease payments recognized when changes in facts and circumstances occur

# Variable payments

ASC 842	ASC 606
Recognize in the period in which changes in facts and circumstances on which the variable payments are based occur	Recognize in the period that control is transferred

*Application of ASC 842 to variable payments allocated to non lease components should not accelerate recognition relative to ASC 606*

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# Effective date and transition





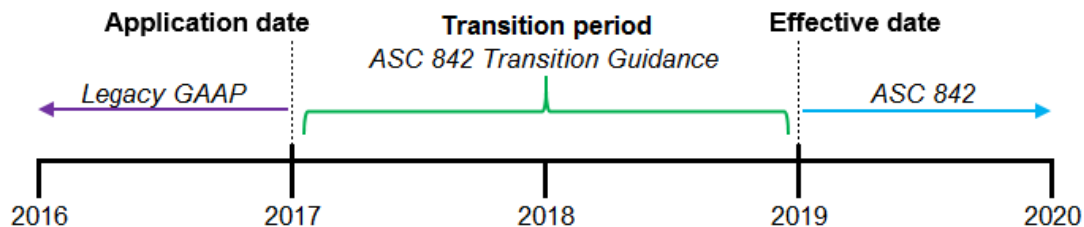
# Effective dates

Public business entities*	Other entities
Fiscal years beginning after December 15, 2018 and interim periods within those fiscal years	Fiscal years beginning after December 15, 2019 and interim periods within fiscal years beginning after December 15, 2020
January 1, 2019 for calendar year entities	January 1, 2020 for calendar year entities

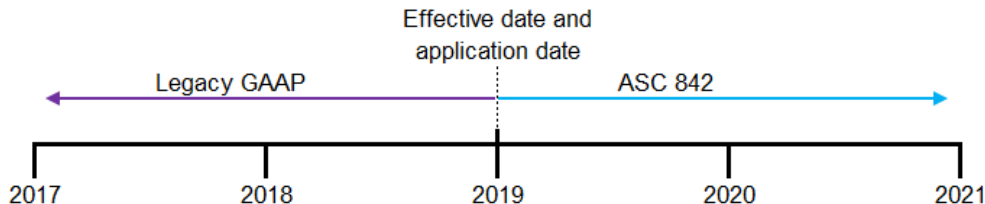
\* Entity that meets the definition of a public business entity solely because it includes, or is required to include, its financial statements or financial information in another entity's SEC filing can use the "other entities" effective date.

# Transition methods

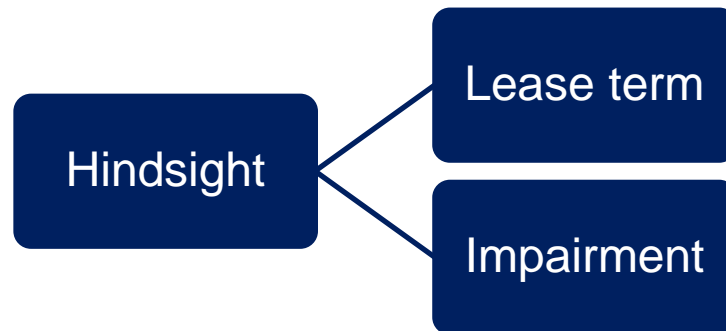
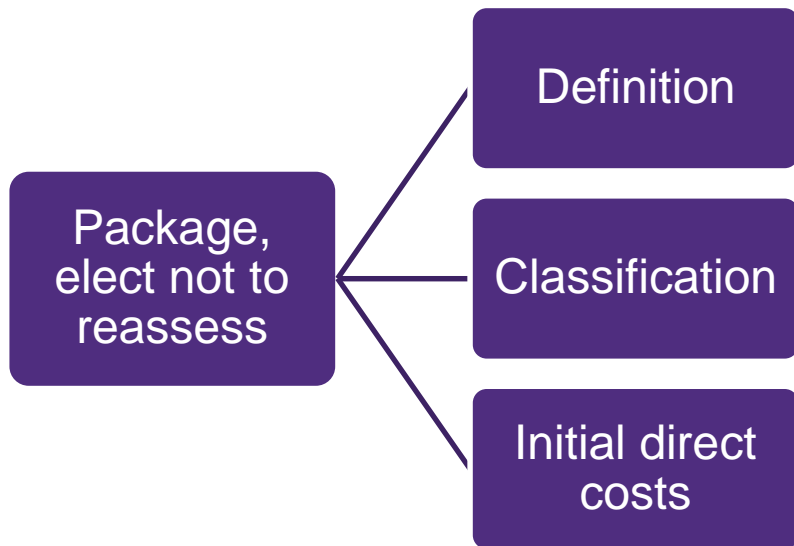
## *Modified retrospective – calendar year-end PBE*



## *Proposed alternative transition method – calendar year-end PBE*



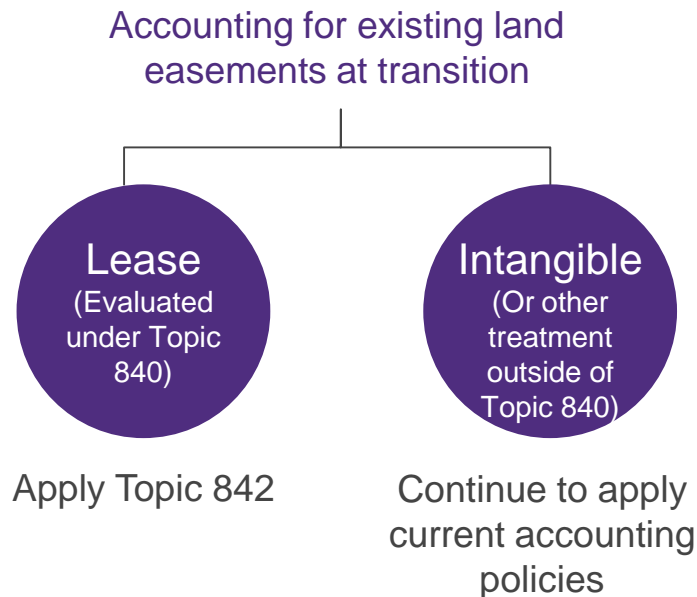
# Practical expedients



# Land easement expedient

## Transition provisions

- Land easements that existed before Topic 842's effective date and were not accounted for under Topic 840 will continue to be accounted for under the entity's current accounting policies
- Land easements currently accounted for under Topic 840 will apply Topic 842
- All new or modified land easements should first be evaluated under Topic 842



# Lessee transition – no change in classification

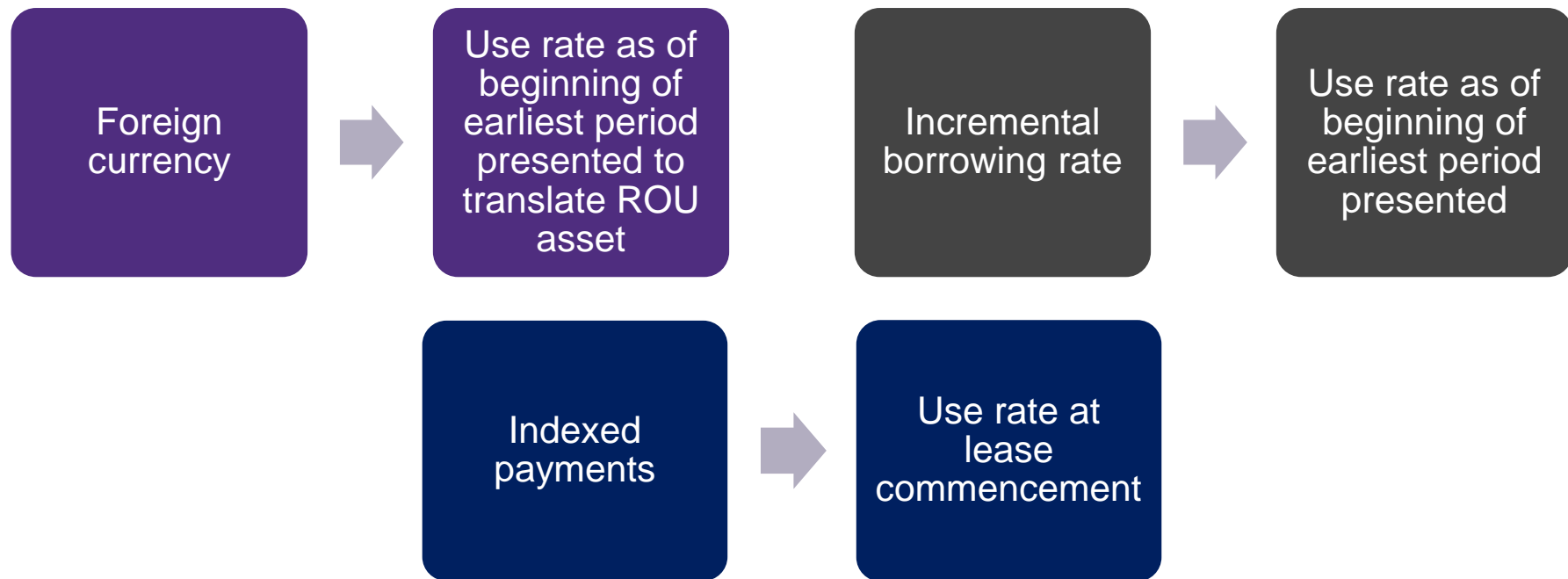
Type	Liability	ROU asset
Operating	PV of <u>remaining minimum rental payments</u> + PV of amount probable of being owed under residual value guarantee	Liability + or – <ul style="list-style-type: none"><li>• Prepaid / accrued lease payments</li><li>• Remaining balance of lease incentives</li><li>• Unamortized IDCs</li><li>• ASC 420 liability</li></ul>
Capital / finance	Bring forward the previous carrying amounts	

# Executory costs under ASC 840

ASC 840	ASC 842
Maintenance = "Executory costs"	Maintenance = Non-lease component
Diversity in practice on inclusion of executory costs in minimum rental payments	Continue to apply policy elected under ASC 840 when calculating the lease liability in transition

An entity may elect to combine lease and non-lease components in transition

# Rates used at transition



# Build to suit transition

	Guidance	Lessee not accounting owner	Lessee accounting owner
Construction completed before the effective date	ASC 840	Apply lessee transition guidance	Derecognize asset and liability, recognize difference in equity, apply lessee transition guidance
Construction in progress at effective date	ASC 842	Derecognize asset and liability, recognize difference in equity, apply lessee transition guidance	Continue to account for BTS assets under ASC 842



# Questions?



# Speakers



**Ryan Brady**

Partner

Accounting Principles

+1 312 602 8741

Ryan.Brady@us.gt.com



**Rahul Gupta**

Partner

Accounting Principles

+1 312 602 8084

Rahul.Gupta@us.gt.com



**Cullen Walsh**

Partner

Accounting Advisory Services

+1 212 624 5313

Cullen.Walsh@us.gt.com



**Carolyn Warger**

Manager

Accounting Principles

+1 617 848 4838

Carolyn.Warger@us.gt.com

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