



Future Shock Lease Accounting Changes: How will you be Impacted?

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Topics for Discussion

- Background
- Current Requirements
- The Future
- The Impact
- The Accounting - Lessees
- Example
- The Accounting - Lessors
- Transition
- Status and Effective Date
- Q&A/Open Discussion



Background

Why the change?

- Shed 'off-balance sheet' transactions – prevalent in accounting scandals over the last few years
 - SEC noted in 2005 the need for an overhaul of lease accounting literature
- Joint FASB and IASB proposal



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Background

- Existing lease model:
 - Similar transactions can be accounted for in different ways
 - Provide structuring opportunities – form over substance
 - Bright-line, not principles based
 - Conceptually flawed as leases meet the definition of assets and liabilities

Current Requirements

- Two types of leases:
 - Operating
 - Capital (or Finance)

- Operating lease
 - Rent payments are expensed on a straight line basis over the lease term; extension options are not considered
 - Lease transactions and commitments are disclosed in the footnotes to the financial statements
 - No asset or liability recognized





Current Requirements (cont.)

- Capital lease
 - Record asset and corresponding liability
 - Asset is depreciated over its estimated useful life
 - Liability is reduced based on the effective interest method

The Future

■ Proposed changes

- Eliminates operating leases
- Right of use concept
- Balance sheet will be grossed up – asset and obligation to be recognized
- Timing of expense recognition will be impacted
- Significant management estimation required, will cause volatility in earnings

The Impact

- Scope:
 - All leases of tangible assets; intangible assets are excluded
 - Short term leases – longest possible term ≤ 12 months
 - Existing leases not expected to be grandfathered
 - Will not apply to:
 - Immaterial items
 - Items considered to be a purchase and sale

The Accounting – Lessee

■ Initial Measurement

- Asset and liability measured at the PV of lease payments, plus direct costs [and prepaid rent]
Does not include executory costs.
 - Lease term
 - Lease payments
 - Include extensions – more likely than not to occur
 - Include contingent rentals – probability weighted outcomes
- Discount rate is the lessee's incremental borrowing rate or lessor's implicit rate, if known

The Accounting – Lessee (cont.)

- Lease Term – factors to consider
 - Contractual
 - Non-contractual
 - Significant leasehold improvements
 - Nature and location of asset
 - Is asset specialized?
 - Lessee specific
 - What are lessee's intentions?
 - Past practice

The Accounting – Lessee (cont.)

- Subsequent measurement
 - Asset
 - Amortized cost basis, typically straight line
 - Subject to impairment assessments
 - Obligation
 - Amortized cost using effective interest method
 - Cash payments recorded as interest and reduction of principal

The Accounting – Lessee (cont.)

- Subsequent measurement (cont.)
 - Changes in renewal terms
 - Reassess at each reporting date
 - Detailed examination not required, facts and circumstances based
 - Recognize change in asset and obligation



The Accounting – Lessee (cont.)

- Subsequent measurement (cont.)
 - Changes in contingent rentals and other cash flows
 - Reassess at each reporting date
 - Recognize current and prior period changes in income statement
 - Recognize other changes in asset and obligation

The Accounting – Lessee (cont.)

CHANGES IN CARRYING AMOUNT OF LEASE LIABILITY DUE TO:

Changes in Lease Term

Adjust Right of Use Asset

Changes in Contingent Rentals,
and Other Cash Flows

Changes Related to Future
Periods

Adjust Right of Use Asset

Changes Related to
Current or Prior Periods

Recognize in Income Statement

Example – Simple Lease

Lease Terms and Assumptions

Square feet		1,000
Annual initial rent/sq. ft [paid monthly]	\$	20
Initial annual rent	\$	20,000
Escalation - annual		2%
Incremental borrowing rate - assumed		7%

Balance Sheet	Inception	20x1	20x2	20x3	20x4	20x5	20x6	20x7	20x8	20x9	20x0
Right of use asset	\$ 155,400	\$ 139,860	\$ 124,320	\$ 108,780	\$ 93,240	\$ 77,700	\$ 62,160	\$ 46,620	\$ 31,080	\$ 15,540	\$ -
Lease obligation	\$ (155,400)	\$ (145,980)	\$ (135,470)	\$ (123,770)	\$ (110,800)	\$ (96,460)	\$ (80,620)	\$ (63,190)	\$ (44,040)	\$ (23,020)	\$ -

Income Statement		20x1	20x2	20x3	20x4	20x5	20x6	20x7	20x8	20x9	20x0	Total
Proposed Treatment												
Amortization of right of use	Straight line	\$ 15,540	\$ 15,540	\$ 15,540	\$ 15,540	\$ 15,540	\$ 15,540	\$ 15,540	\$ 15,540	\$ 15,540	\$ 15,540	\$ 155,400
Interest expense	Eff. interest	10,580	9,890	9,110	8,250	7,300	6,250	5,090	3,820	2,420	890	63,600
		<u>\$ 26,120</u>	<u>\$ 25,430</u>	<u>\$ 24,650</u>	<u>\$ 23,790</u>	<u>\$ 22,840</u>	<u>\$ 21,790</u>	<u>\$ 20,630</u>	<u>\$ 19,360</u>	<u>\$ 17,960</u>	<u>\$ 16,430</u>	<u>\$ 219,000</u>
Current Treatment												
Straight line rent expense		<u>\$ 21,900</u>	<u>\$ 21,900</u>	<u>\$ 21,900</u>	<u>\$ 21,900</u>	<u>\$ 21,900</u>	<u>\$ 21,900</u>	<u>\$ 21,900</u>	<u>\$ 21,900</u>	<u>\$ 21,900</u>	<u>\$ 21,900</u>	<u>\$ 219,000</u>
Difference - Current Period		4,220	3,530	2,750	1,890	940	(110)	(1,270)	(2,540)	(3,940)	(5,470)	
Difference - Cumulative		4,220	7,750	10,500	12,390	13,330	13,220	11,950	9,410	5,470	-	
Cash paid - Monthly		<u>\$ 20,000</u>	<u>\$ 20,400</u>	<u>\$ 20,810</u>	<u>\$ 21,220</u>	<u>\$ 21,650</u>	<u>\$ 22,080</u>	<u>\$ 22,520</u>	<u>\$ 22,970</u>	<u>\$ 23,430</u>	<u>\$ 23,920</u>	<u>\$ 219,000</u>

Financial Statement Presentation

- Assets should be presented separately from owned assets as Right of Use asset
 - Amortization and interest expense not rent expense
- Lease obligation presented separately from other liabilities as Lease Obligation
 - Lease payments allocated between interest expense and principal
- Detailed discussion of estimates

The Accounting – Lessor

- Performance obligation approach
 - Lessor retains significant risks and benefits
 - Asset remains on balance sheet
 - Separate receivable and performance obligation recognized

The Accounting – Lessor (cont.)

- Derecognition Approach
 - Lessor does not retain significant risks and benefits
 - Recognize lease receivable
 - Derecognize a portion of the leased asset considered to be transferred and recognize gain or loss

The Accounting – Lessor (cont.)

- Risks and Benefits Retained - factors to consider:
 - Significant contingent rentals based on use or performance of leased property
 - Option to extend or terminate the lease
 - Is the lease term short in relation to the useful life of the asset?

The Accounting - Subleases

- Subleases
 - Account for head-lease in accordance with right of use model
 - Account for sublease in accordance with lessor model [performance obligation or derecognition]



The Accounting – Subleases (cont.)

■ Subleases – Presentation

Cash		X
Property, plant and equipment		X
Right-of-use asset	X	
Lease receivable	X	
Lease obligation	(X)	
Net sublease asset		<u>X</u>
Total Assets		<u><u>X</u></u>
Trade and other payables		X
Lease obligation		X
Total Liabilities		<u><u>X</u></u>

Transition

- At transition date
 - Lease obligation and right of use asset to be recognized for all leases
 - Measured at the PV of remaining lease payments using rate at transition date
 - Restate prior periods

Status and Effective Date

- Exposure Draft issued
 - Comment period has commenced
- Final standard expected in Q2 of 2011
- Effective 2012



Q&A/Open Discussion

Some thoughts:

- Begin developing a strategy for initial adoption and ongoing assessments
- Proper documentation will be crucial
- Initiate discussions with banks re. covenants