# Leasing

pwc

# Lease accounting scope & impacts

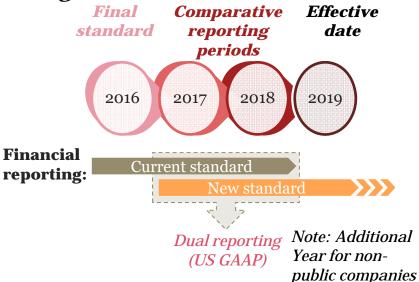
## Scope

- All industries, all entities
- Arrangements that meet the definition of a lease
- Embedded leases within other arrangements

# Leases of: What's out?

- Inventory or construction in progress
- Intangible assets
- Biological assets
- Exploration rights
- Natural resources
- Software
- Incl. internal use
- See ASU 2015-05

## **Timing**



#### **Balance sheet**

- Virtually all leases coming on balance sheet
- Asset & obligation (similar to today's capital leases)

#### P&L

- Dual recognition model for US GAAP
- Interest & amortization vs. single lease expense

#### **Disclosures**

• Enhanced qualitative & quantitative disclosures required

#### **Transition**

- Modified retrospective approach required
- Specified reliefs available (some must be elected as a package)

# Summary of a lessee's financial statement impact

	ASC 840	ASC 842
Definition of a lease	Control or output	Control
Lease classification	Bright lines	Bright lines removed
Balance Sheet	Operating leases are off- balance sheet for lessees	Lessee's record virtually all leases
Income statement	Dual model	
Inception versus commencement	Measurement at inception	Measurement at commencement
Reassessment	On modification	Event based
Lease versus non-lease components	Similar in concept but some changes	
Statement of cash flows	Similar to today	
Transition	N/A	One model with specific expedients

# PwC's Leasing Discussion: Appendix

# Why change current accounting?

## Perceived issues: Current standard

- Off-balance sheet "loophole" for operating leases
- "Bright line" tests to determine recognition
- Fails to meet financial statement users' needs

\*\*No major concerns with lessor acctg\*\*

# **Objectives:** New standard

- On-balance sheet recognition of lease assets & liabilities
- Enhanced disclosure of key information
- Increase transparency & comparability across organizations

# Recognition

#### Lessee

Finance





#### Balance sheet

**Right-of-use asset** Lease liability

#### **Income statement** Cash flow statement

Front loaded Interest = Operating Amortization expense Interest expense

Variable = Operating Principal = Financing

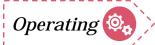
Cash flow statement

**Operating** Lease expense

#### Lessor

Sales/ direct financing





#### Balance sheet

Lease receivable

Unguaranteed residual • Interest income on

**Deferred** profit (DFL)

## Income statement

Front loaded

receivable and residual

Profit (immediate or deferred)

Underlying asset remains

Lease income

Operating

Operating

## What are the main changes?

The new standard at a glance (lessor's perspective)

The accounting applied by a lessor will largely be unchanged from that applied under previous GAAP. However, some changes to the lessor accounting guidance have been made...

Conformance with certain glossary terms in lessee guidance

Initial direct costs include only costs that would not have been incurred had the lease not been obtained

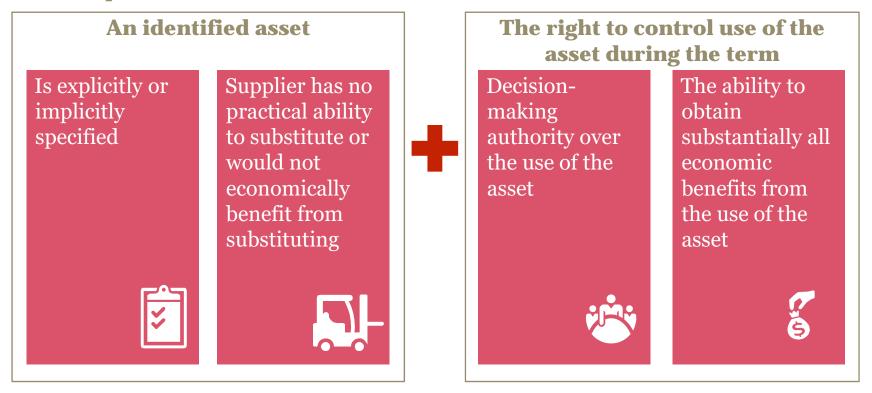
Alignment of lessor accounting model with the revenue recognition principle in Topic 606, in particular for sale-leasebacks

No differentiation of leases of real estate and leases of other assets

Up front profit will be deferred if control is not transferred to the lessee

# Identifying a lease

## Lease is present in a contract if the contract includes both:



## What's an "identified asset"?



Generally, it's an asset that must be used to fulfil the terms of the contract

Explicitly specified

- Contract explicitly identifies the asset
- Typically considered "identified asset"

Implicitly identified

- Asset may also be implied by contract
- E.g., the only asset that can be used to fulfill contract

Substitution rights?

- Consider impact on "identified asset" determination
- Such rights must be *substantive*

# What about substitution rights?



If supplier has the *substantive* right to substitute the asset during the contract, it's not an "identified asset"

## **Substantive substitution rights**

Supplier must have **both**:

## **Practical ability to substitute**

Customer cannot prevent substitution

Alternative assets readily available to substitute

# **Economic benefit from substituting**

Benefits exceed costs

Consider location of assets

# What's the "right to control"?



A customer has the *right to control* the use of an identified asset if it has the right to **both**:

(a) Obtain substantially all the *economic benefits* from use of the asset

(b) **Direct the use** of the asset

# What's the "right to control"?



## (b) *Direct the use* of the asset

- (i) Customer has the right to operate the asset (within scope of its right to use)
- (ii) Customer designed the asset (or specific aspects) in a way that predetermines either:

- Consider decision-making rights most relevant to changing how/for what purpose asset is used
- Examples include right to change:
  - The type of output produced
  - When / where output is produced
  - Whether output is produced & quantity of output
- How / for what purpose the asset will be used; or
- How the asset will be operated

# What's the "right to control"?



## (b) *Direct the use* of the asset

# Other items to consider:

Customer's ability to specify the output in a contract without any other decision-making rights is <u>not</u> a lease

A supplier's protective rights do <u>not</u>, in isolation, prevent customer from having right to direct the use of the asset

Decision-making rights around maintaining, insuring, &/or operating the asset do <u>not</u> grant right to change how/for what purpose used

# What about separation & allocation?

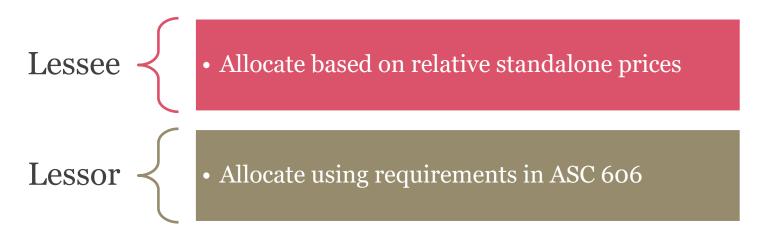
# After determining a contract contains a lease, entities must separate lease & non-lease components as follows:

- 1. Identify all separate lease components within the contract
  - 2. Allocate consideration to each separate lease component & the non-lease components\*\*\*
    - 3. Account for each separate lease component separately from the non-lease components

\*\*\*Practical expedient (lessees only):

- Lessees can choose <u>not</u> to separate non-lease components from lease components (policy election by asset class)
- Instead account for each separate lease component & associated non-lease component as single lease component

# Allocating consideration to components

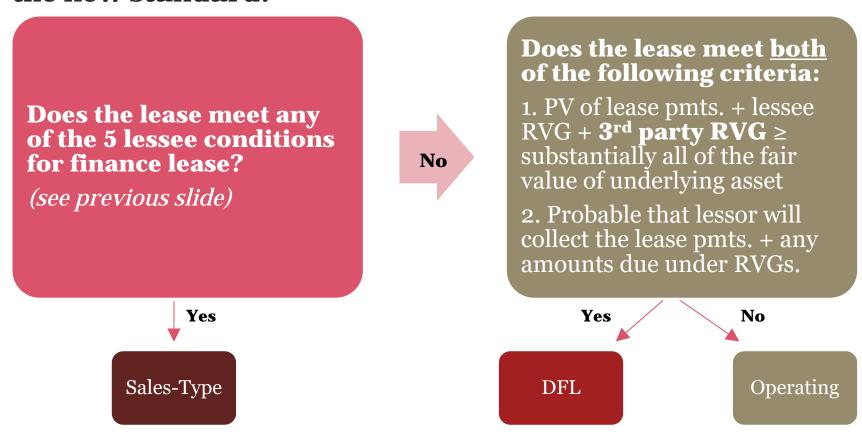


Components include <u>only</u> items/activities that transfer a good or service to the lessee

- Consequently, reimbursement or payment of lessor's costs (e.g., taxes, insurance) are <u>not</u> separate components:
  - No separate allocation made to such elements
  - Instead, include as part of the lease component

## Lessor classification

Key changes in lease classification model for lessors under the new standard:



## Lessor considerations

## For lessors, contract consideration includes:

- Fixed lease payments, less any incentives paid to lessee
- Variable payments that depend on an index or rate
- Other variable consideration (measured in accordance with ASC 606) that **solely relates** to efforts or outcomes from transferring **non-lease** goods/services to lessee

# **Lessors allocate consideration using Topic 606**

- Any variable payments included as consideration are allocated entirely to the non-lease component to which they specifically relate
  - Provided doing so is consistent with allocation objective in Topic 606
- If terms of a variable payment relate to a lease component, even partially, such payments are recognized only upon the resolution of the contingency

## What are initial direct costs?

# Incremental costs that an entity would not have incurred if the lease had not been obtained (executed)

IDC <u>excludes</u> costs that would have been incurred even if the lessee/lessor failed to execute the lease

## **IDC**

Broker's commissions payable only upon successful execution

Payments made to existing tenant to terminate its lease

## **Not IDC**

Legal costs to draft/negotiate lease

General overheads (depreciation)

Advertising, soliciting potential lessees, etc.

Fixed employee salaries

## Sale and leaseback transactions

## The transaction is a sale

- Seller lessee
  - Recognize the sale when the buyer-lessor obtains control
  - Derecognize the carrying amount of the underlying asset
  - account for the lease in accordance with Subtopic 842-20.
- Buyer lessor
  - Recognize the purchase
  - classify the lease in accordance with 842-30

## The transaction is not a sale

- Seller lessee: No sale. Proceeds are recorded as a liability.
- Buyer lessor: There is no purchase. Proceeds paid will be reflected as a receivable

## Account for 'off-market' terms

• If the terms of a transaction are off-market, adjustment is required (e.g., recognition of a rent prepayment or a borrowing from the buyer)

# What lessee disclosures are required?

# Qualitative

- General description of leases (& subleases)
- Existence of extension, termination, & purchase options, RVGs, variable lease pmts
- Significant judgments & assumptions
- E.g., determining whether contract is or contains a lease, separation/allocation, discount rate, etc.
- Leases that have not commenced but create significant rights / obligations
- Accounting policy elections
  - E.g., short-term leases, separating lease components, etc.

# Quantitative

- Finance lease cost (segregated b/t interest & amortiz.)
- Operating lease expense
- Short-term & variable lease cost
- Sublease income
- Gains / losses from SLBs
- Cash pmts & supplemental noncash info
- WA remaining lease term & disc rate

# What lessor disclosures are required?

## **Qualitative**

- General description of leases
- Existence of extension, termination, & purchase options, variable lease pmts
- Significant judgments & assumptions
  - E.g., determining whether contract is or contains a lease, separation/allocation, etc.
- Leases that have not commenced but create significant rights / obligations
- Risk management strategy associated with the RV of its leased asset

## Quantitative

- Profit or loss/interest income related to sales-type/DFL
- Lease income related to operating leases
- Lease income related to variable lease payments not included in measurement of lease receivables
- Components of its net investment in lease
  - E.g., carrying value of lease receivable, unguaranteed residual assets, deferred selling profit, etc.

## What about transition?

## Let's start with the good news—Practical expedients

# No need to reassess:

\*\*These reliefs must be elected as a package

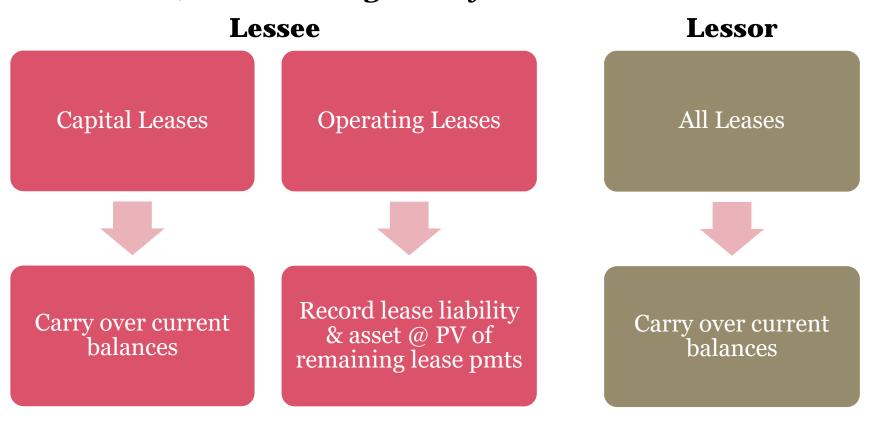
- Whether expired or existing contracts contain a lease
- Classification of expired or existing leases
- Amount of IDCs for existing leases

Can also elect to use **hindsight** when determining the following *(with or without electing the package reliefs above)*:

- Determining the lease term
- Exercise / non-exercise of extension, termination, & purchase options
- Assessing impairment of RoU assets

## What about transition?

If practical expedient is elected (no reassessment of original classification), transition is generally as follows:



## Lessee transition—details

**Modified retrospective approach:** Recognize cumulative effect to existing contracts in opening retained earnings on effective date

	Existing Operating Leases:	
under ASC 842	Operating	<ul> <li>Recognize lease liability &amp; RoU asset at later of (1) commencement date and (2) earliest comparative period</li> <li>Measure lease liability using remaining lease pmts &amp; probable RVG</li> <li>Measure RoU asset = liability, adjusted for (1) prepaid or accrued lease pmts, (2) unamortized IDC &amp; lease incentives, (3) impairment &amp; (4) any exit or disposal liability recognized (ASC 420)</li> <li>Write-off any unamortized IDC that is no longer IDC under ASC 842 as adjustment to equity</li> </ul>
Classification	Finance	<ul> <li>Recognize lease liability &amp; RoU asset at later of (1) commencement date and (2) earliest comparative period</li> <li>Measure lease liability using remaining lease pmts &amp; probable RVG</li> <li>Measure RoU asset as the <i>applicable proportion</i> of lease liability at commencement date, adjusted for (1) prepaid or accrued lease pmts &amp; (2) any exit or disposal liability recognized (ASC 420)</li> <li>Write-off any unamortized IDC that is no longer IDC under ASC 842 as adjustment to equity</li> </ul>

# Lessee transition—details

	Existing Capital Leases:		
842	Operating	• Derecognize the CV of asset/liability at later of (1) the commencement dat & (2) earliest comparative period—any difference treated as prepaid or accrued rent	
		Record lease liability using remaining lease payments	
er ASC		• Measure RoU asset = liability, adjusted for (1) prepaid / accrued lease pmts & (2) any unamortized IDC	
adjustment to equity		Write-off any unamortized IDC that is no longer IDC under ASC 842 as adjustment to equity	
Finance • Recognize lease liability & RoU asset = CV of exist later of (1) commencement date & (2) earliest contact the second of the second o		• Recognize lease liability & RoU asset = CV of existing asset / liability at later of (1) commencement date & (2) earliest comparative period	
Classification		• Include any unamortized IDCs that meet the ASC 842 IDC definition of IDC under ASC 842; write-off any unamortized IDC that is no longer IDC under ASC 842 as adjustment to equity	
		Subsequently measure lease liability & RoU asset in accordance with ASC 842	

# Lessor transition—details

	Existing Capital Leases:		
under ASC 842	Operating	<ul> <li>Continue to recognize the CV of underlying asset &amp; any lease asset/liability at later of (1) commencement date and (2) initial application date</li> <li>Previously recognized securitized receivable as secured borrowing</li> <li>Write-off any unamortized IDC that is no longer IDC under ASC 842 as adjustment to equity</li> </ul>	
Classification u	Sales-type / DFL	<ul> <li>Derecognize the CV of asset/liability at later of (1) the commencement date &amp; (2) earliest comparative period</li> <li>Recognize a net investment in the lease at later of (1) the commencement date &amp; (2) earliest comparative period, as if the lease had been accounted for as DFL of Sales-type since lease commencement</li> <li>Record any difference as adjustment to equity</li> </ul>	

# Lessor transition—details

	Existing Direct Financing/Sales-Type Leases:		
under ASC 842	Operating	<ul> <li>Recognize the asset at what the carrying amount would have been had the lease been classified as an operating lease under ASC 420</li> <li>Derecognize the CV of the net investment in the lease</li> <li>Record any difference as adjustment to equity</li> </ul>	
Classification	Sales-type / DFL	<ul> <li>Continue to recognize a net investment in the lease at later of (1) the commencement date &amp; (2) earliest comparative period</li> <li>Beginning on the effective date, account for the lease in accordance with ASC 842</li> </ul>	

# Overview – IFRS 16 vs. ASC 842

Issue	IFRS 16	US-GAAP
Definition of a lease	Right to use an asset, that is:  • identified asset, and • right to control the use	Same as IFRS 16
Exemptions		
Short-term lease (lessee)	Yes (Lease term ≤ 12 months; no purchase option)	Yes
Low-value assets (lessee)	Yes (Value ≤ USD5,000)	No

Issue	IFRS 16	US-GAAP
Lessee accounting		
Balance sheet	Right-of-use asset and lease liability for almost every lease	
Income statement	Single approach  Right-of-use asset: depreciation  Lease liability: effective interest rate method  Variable lease payments not included in lease liability (that is, not depending on index/rate)	Dual approach  Depending on the characteristics of the lease:  Similar to IFRS 16 or  Recognising a single lease expense typically on a straight-line basis over the lease term
Lessor accounting	Previous guidance is substantially carried forward	
Subleases	Classification of sublease refers to right-of-use asset	Classification of sublease refers to underlying asset
Sale and leaseback	Gain or loss on sale is limited to the amount that relates to the rights transferred	Gain or loss on sale is accounted for consistently with guidance that would apply to any other sale of assets
Reassessment of variable lease payments	Required for variable lease payments that depend on index/rate (when there is a change in cash flows)	In general no reassessment (however, remeasurement is required if the lease is reassessed for another reason)

# Questions

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