LEASE STANDARD 842: GUIDANCE FOR GOVCONS (LESSEE ACCOUNTING ONLY)

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CohnReznick LLP

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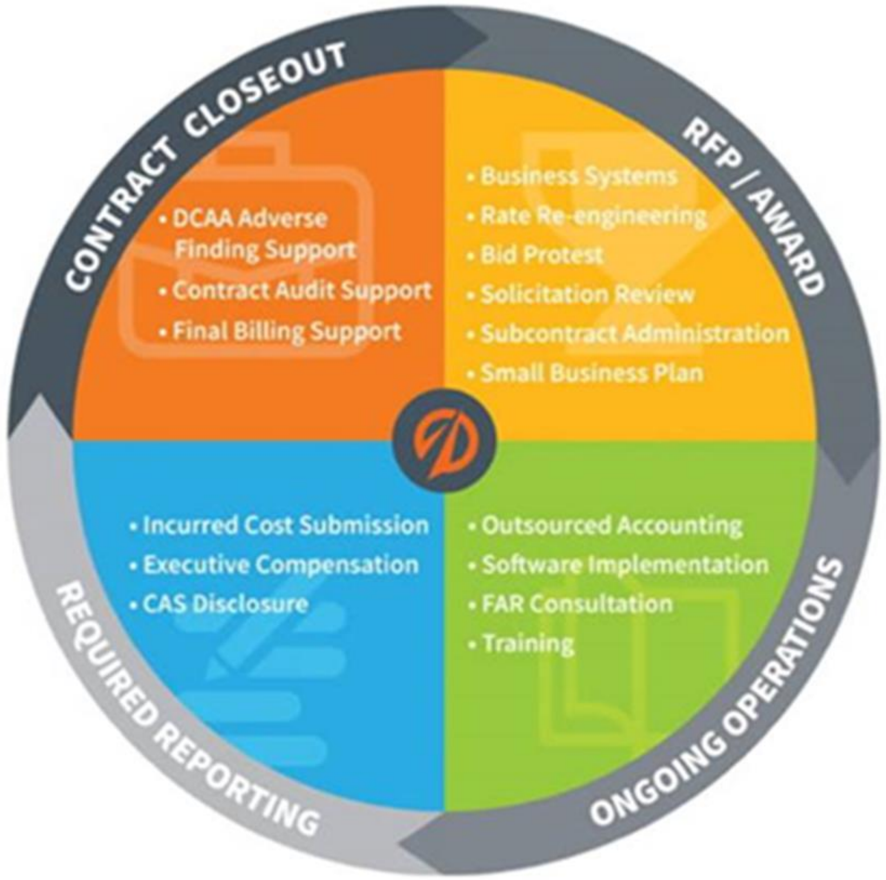

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AGENDA

- Effective Dates
- Summary of differences of ASC 840 vs 842
- Basics of lease accounting under Topic 842
- Example
- Transition & Practical Expedients
- Resources

EFFECTIVE DATES AND SCOPE

EFFECTIVE DATES

Reporting Period	Effective For Periods Beginning After		Early Adoption Permitted?
	Public Business Entities*	All Other Entities	
Annual	December 15, 2018	December 15, 2021	Yes
Interim		December 15, 2022	

- **Modified retrospective approach** required in transition (recognize and measure leases at the beginning of the earliest comparative period)

- Transition practical expedients available, that, if elected, could help simplify transition (will be discussed in greater detail later in this session)

SCOPE EXCEPTIONS

Topic 842 does not apply to the following:

- Leases for intangible assets (including internal use software licenses)
- Leases to explore for or use natural resources (extractive activities)
- Leases of biological assets, including timber
- Inventory
- CIP (Construction in Progress)

SUMMARY OF DIFFERENCES BETWEEN TOPIC 840 (EXISTING GAAP) & TOPIC 842 (THE NEW STANDARD)

SUMMARY OF KEY CHANGES

Current lease accounting guidance found in Topic 840 will be completely superseded by Topic 842

- Virtually all operating leases will be recognized on lessee balance sheets
  - Practical expedient is available for short term leases
- Removal of “bright lines” from lease classification criteria
  - No more 90% and 75% tests, but....
- Introduction of the “alternative use criterion” for lease classification
- New definition of a lease
- Fair value measurements for leases will be within the scope of Topic 820
- Initial direct costs (fewer allowed)
- Alignment with the new revenue recognition standard (Topic 606)

SUMMARY OF KEY CHANGES

Current lease accounting guidance found in Topic 840 will be completely superseded by Topic 842

- Modifications
- Lessee reassessment
- In-substance fixed payments
- Lessee involvement during the construction period (i.e., build-to-suit)
- Sale and leaseback transactions
- Quantitative information about leasing activities will be provided in disclosures
- Elimination of the leveraged lease classification (lessors)

BASICS OF LEASE ACCOUNTING UNDER THE TOPIC 842

CLASSIFYING LEASES

Lessees will classify leases as either
a) **financing*** or b) **operating**
**formerly capital leases under Topic 840*

1. Identify whether a contract is a or contains a lease
2. If a contract contains a lease, identify and separate the lease and non-lease components
3. Allocate contract consideration between lease and non-lease components
4. Determine the appropriate classification of any identified leases

DEFINITION OF A LEASE

What is the new definition of a lease?

- A **lease*** is a contract *<u>or part of a contract</u>*, **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.

- A period of time may also be described in terms of the amount of use of an identified asset (i.e. number of production units).

*See **ASC 842-10-15-3**

IDENTIFYING A LEASE

Identify whether a contract is or contains a lease

A lease conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

Right to control the use of the asset:

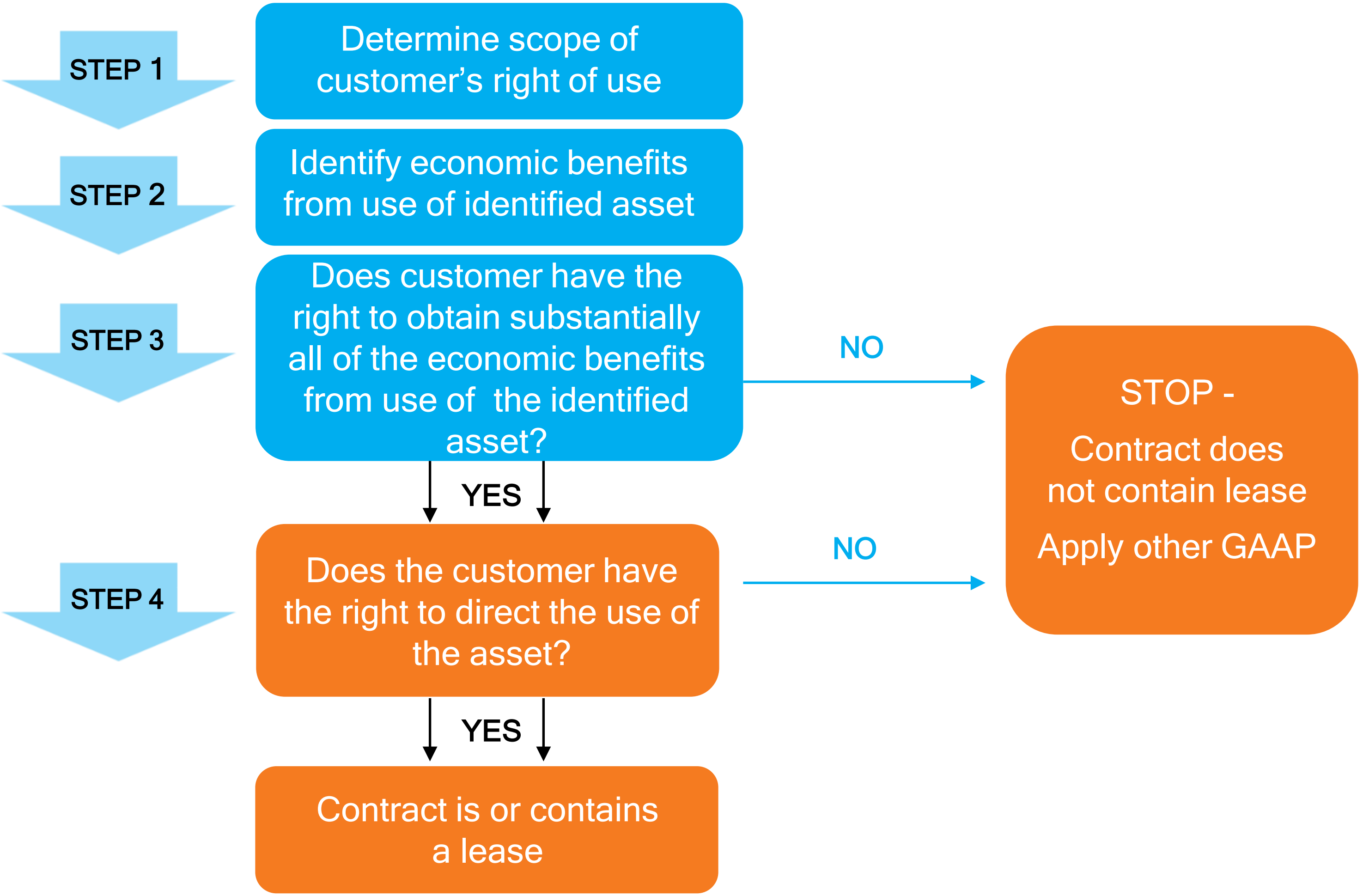
- Right to obtain substantially all of the economic benefits from use of the asset
- Right to direct the use of the asset

1. Identify whether a contract is a or contains a lease
2. Identify and separate the lease and non-lease components
3. Allocate contract consideration between lease and non-lease components
4. Determine the appropriate classification of any identified leases

Decision flowchart for identifying a lease is available at **ASC 842-10-55-1**.

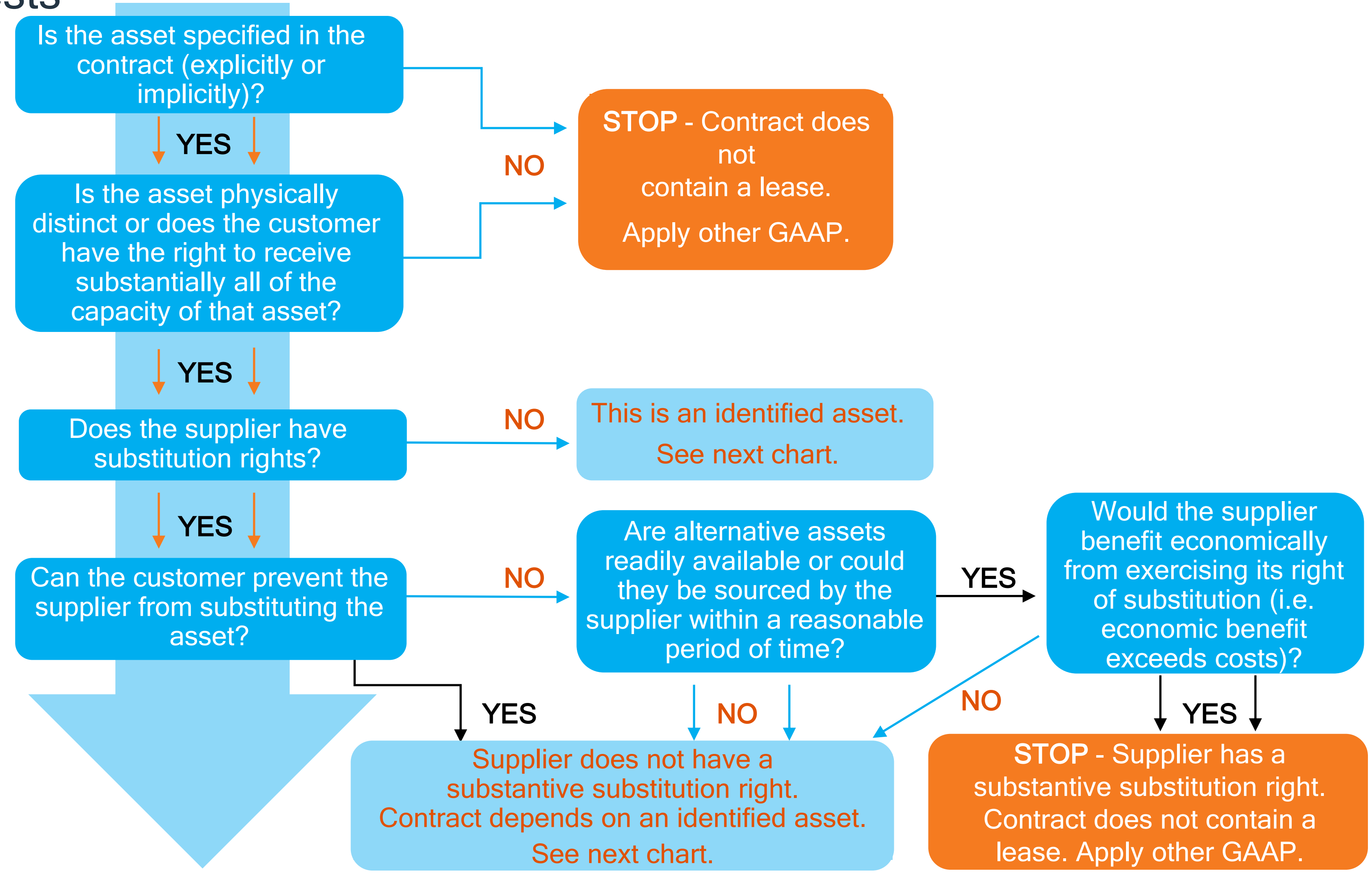
IDENTIFYING A LEASE - DECISION TREE

Control Test and Lease Determination



IDENTIFYING A LEASE - STEPS 1 & 2 DETAIL

Scope and Identification Tests



IDENTIFYING A LEASE - STEPS 3 & 4 DETAIL

Control Test: Once the asset has been identified, the reporting entity must evaluate whether it controls the use of that asset throughout the period of use. ASC 842-10-15-4 determines that control exists when the following two criteria are met:

- The right to obtain substantially all of the economic benefits from use of the identified asset
- The right to direct the use of the identified asset

Lease Determination [Conclusion]: If the arrangement meets all criteria noted above, then in accordance with ASC842, a lease is identified. Note: Lease term is defined as the period [or portion of the contract term] the customer has the right to control the use of an identified asset.

EMBEDDED LEASE EXAMPLES

Common examples of contractual agreements that may contain embedded lease agreements are as followed:

- Outsourced warehousing or outsourcing agreements: For example, a retail company contracts with Warehouse to lease 1,000 square feet of space to store its products for a three-year period. The contract specifies that the Company's inventory will be stored in an identified location in the warehouse and that location will be kept at a particular temperature. The Company will need to assess whether it controls the use of the identified asset (i.e., warehouse space) to determine if the arrangement contains a lease.
- Datacenter/hosting arrangements: Equipment (software or hardware assets) and services provided are typically bundled in one arrangement.
- Supply arrangements: Supply vendor terms often contain the use of equipment or products where the Company may have decision making power defined as control during the period of use. For example: water cooler, shredding, trash, cable, and other service arrangements.

GOVERNMENT CONTRACTING EXAMPLE

SCIF Rental

- Tenant and subtenant is required to record ROU asset
- Lease expense (allowable portion) can be direct or indirect
  - Direct – Government contract paid for SCIF (bid in contract)
  - Indirect – Overhead, G&A or Facility Service Center

IMPACT ON GOVERNMENT CONTRACTORS

- Finance Leases: The interest expense portion under finance leases will be unallowable and is consistent with prior accounting for capital leases.
  - FAR 31.205-11(h)

- Operating Leases: The lease expense recorded under operating leases associated with the ROU asset under finance leases are allowable.
  - FAR 31.205-36

- Other Impacts/Considerations:
  - DCAA audit guidance suggests that although the FAR has not been updated, the audit team should be aware of the change in terminology for GAAP reporting purposes. The GAAP change does not impact allowability under the FAR Cost Principles.

EXAMPLE OF EMBEDDED LEASE

Example (For Illustration Only)

Terms and Conditions of contracts between Customer and Supplier

- **Underlying assets specified in the contract:**
  - Bulldozer manufactured by Foreign Co. / Serial No. 12345
  - Truck manufactured by US Co. / VIN 678910
  - Crane manufactured by US Co. / Serial No.1112131415
- **Duration of the contract: 3 years with an optional 2-year renewal**
- **Restrictions**
  - Equipment may only be used in Connecticut or New York
  - Equipment may not be used for mining
- **Operation**
  - Supplier personnel to operate crane under Customer's direction
  - Customer personnel to operate the bulldozer and truck

Customer

Construction Company building a mixed use high rise

Needs equipment to use in the construction thereof

Supplier

Construction Equipment Dealer

Specializes in leasing, selling and financing construction equipment for construction companies

EXAMPLE OF EMBEDDED LEASE – CONT.

Example (For Illustration Only)

Does this contract contain any leases? YES

- Each asset is identified by manufacturer and Serial No. or VIN
- Supplier cannot substitute
- Customer has right to control the use as follows:
  - **Truck & Bulldozer**
    - Customer has exclusive use and therefore has right to obtain substantially all of the economic benefits over the contract term
    - Customer has the right to direct the use
  - **Crane**
    - Customer has exclusive use and therefore has the right to obtain substantially all of the economic benefits over the contract term
    - Although Supplier personnel will operate the crane, Customer will make relevant decisions about how and for what purpose the crane will be used and therefore has the right to direct the use of the crane
- The contractual restrictions are protective rights and do not restrict or inhibit Customer's ability to direct the use of the assets

IDENTIFYING LEASE COMPONENTS

Identify and separate the lease and non-lease components

Each right to control the use of an asset is a separate lease component if both:

a. The lessee can benefit from the right to use the asset; AND

b. The right to use the asset is neither highly dependent nor highly interrelated with another right in the contract to use such asset (i.e. each right does not significantly affect the other).

Identify whether a contract is a or contains a lease

Identify and separate the lease and non-lease components

Allocate contract consideration between lease and non-lease components

Determine the appropriate classification of any identified leases

For Lessees Only: Practical expedient is available for non-lease components

SEPARATING LEASE COMPONENTS

- Right to control the use of an underlying asset considered a lease if:
  - Lessee can benefit from the right to use on its own or with other readily available resources **regardless of whether those resources have been or will be obtained from the lessor or other suppliers**
  - Right to use not highly dependent nor interrelated with other rights in the contract (i.e. right of use does not significantly affect another)
- Notwithstanding, **the right to use land and right to use another asset each represent separate lease components** **unless** land lease component is insignificant
  - Land would be insignificant, for example, if separating it would have ***no*** affect on the lease classification of any other lease component in the contract

SEPARATING NON-LEASE COMPONENTS

- Non-lease components of a contract include items or activities that **transfer a *good or service*** to the lessee
- Items that do not transfer a good or service to a lessee:
  - Cost of administrative tasks to initiate a lease
  - Reimbursement or payment by lessee of lessor's costs (i.e., taxes)
- Non-lease components are accounted for separately from lease components and under other US GAAP

For Lessees Only: An accounting policy election is available to combine lease and non-lease components as a single lease component. ***The potential implications of this policy election should be carefully considered.***

SEPARATING NON-LEASE COMPONENTS – CONT.

- Key Takeaways:
  - Items that do not transfer a good or service are not separated from the lease components (i.e., they are part of the lease components)
  - Must determine whether items that do not transfer a good or service should be included in the measurement of lease payments
- Items that do not transfer a good or service would be included in the measurement of lease payments if:
  - Fixed and/or in substance fixed payments
  - Variable payments based on an index or rate
- Lease payments do not include:
  - Variable lease payments that are not based on an index or rate
  - Guarantee by lessee of lessor's debt
  - Amounts allocated to non-lease components

OTHER CONSIDERATIONS FOR GOVCON

Other Impacts/Considerations:

- Common Area Maintenance (CAM)
- Equipment Maintenance
- Impact to accounting policies & procedures
- Would adoption of ASU 842 be a significant accounting change for your organization?
  - If yes, remember to document and be prepared to outline the change on Schedule M in your ICE
    - Accounting costs
    - Changes to financial statements (Balance Sheet impact)

ALLOCATION OF CONTRACT CONSIDERATIONS

Allocate contract consideration between lease and non-lease components

Lessees: Allocate based on relative standalone prices of the separate lease and non-lease components

Lessors: Allocate based on the new revenue recognition guidance in Topic 606

IMPORTANT:
Lessees and lessors will use *different* allocation methods.

1. Identify whether a contract is a or contains a lease
2. Identify and separate the lease and non-lease components
3. **Allocate contract consideration between lease and non-lease components**
4. Determine the appropriate classification of any identified leases

DETERMINE CLASSIFICATION

Determine the appropriate classification of any identified leases

Application of the basic criteria is more principles based than under existing Topic 840. See next page for details.

1. Identify whether a contract is a or contains a lease
2. Identify and separate the lease and non-lease components
3. Allocate contract consideration between lease and non-lease components
4. Determine the appropriate classification of any identified leases

CRITERIA FOR FINANCE CLASS LEASES

<table>
<tr><th>The Basic Criteria</th><th>Additional Lessor Criteria</th></tr>
<tr><td>Transfer of ownership: The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.</td><td>1) The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in lease payments and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset, and</td></tr>
<tr><td>Purchase Option: The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.</td><td>2) It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.</td></tr>
<tr><td>Lease Term: Lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used to classify the lease.</td><td rowspan="3">When none of the basic criteria are met and the lease is not classified as a sales-type lease, the lessor must apply additional criteria described above in order to determine whether the lease should be classified as a direct financing lease or as an operating lease.

If both of the additional criteria for lessors are met, then the lease is classified as a direct financing lease. If not, then the lease is classified as an operating lease.</td></tr>
<tr><td>Lease Payments: The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.</td></tr>
<tr><td>Specialized Use: The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of lease term.</td></tr>
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FINANCIAL STATEMENT PROFILE

Amortization of the Right-of-Use (ROU) Asset

Lease Type[1]	Operating Lease	Finance Lease
Amortization Period	Lease Term	Shorter of Lease Term or Useful Life of the Underlying Asset
Amortization Method	Inversely proportionate to interest expense on the lease liability[1]	Ratably (e.g. Straight-Line)
Income Statement Presentation	Lease Expense (Amortization + Interest)	Amortization Expense (Separate from Interest)
Balance Sheet Presentation	ROU assets and lease liabilities for operating and finance leases presented in separate line items	

[1] Must subsequently adjust amortization when there is an ROU asset impairment or lease liability re-measurement. For an impairment of an ROU asset, the single rent cost on an operating lease will subsequently be calculated as the total of the amortization of remaining ROU asset on a straight-line basis plus interest.

GOVCON – FAR REFERENCES AND EFFECTS

Lease Type	Operating Lease	Finance Lease
FAR Reference	31.205-36	31.205-11(h)
Allowable?	Yes	Yes & No (Interest)
Income Statement Effect	Lease Expense	Lease & Interest Expense
Balance Sheet Presentation	SAME	

OVERVIEW OF CALCULATIONS

Initial Measurement:

- Lease Obligation = PV of lease payments not yet paid
  - PV uses IBR or RFR
- ROU Asset = Lease obligation + initial direct costs + prepaid lease payments – accrued/deferred rent due – lease incentives

Subsequent Adjustments:

- Lease Obligation = amortization using the effective interest method

ROU Asset:

- For Operating Leases = straight line rent expense
- For Finance Leases = front loaded similar to interest on lease obligation

DISCLOSURES

The standard includes extensive disclosure requirements intended to enable users of financial statements to understand the amount, timing and judgments related to a reporting entity's accounting for leases and the related cash flows.

A lessee should disclose all of the following:

A. Information about the nature of its leases, including
   1. A general description
   2. The basis and terms and conditions on which variable lease payments are determined
   3. The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its right-to-use assets and lease liabilities and those that are not
   4. The existence of terms and conditions of residual value guarantees provided by the lessee
   5. The restrictions of covenants imposed

DISCLOSURES – CONT.

B. Information about leases that have not yet commenced but creates significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset

C. Information about the significant assumptions and judgments made in applying the requirements of the standard, which may include:
   1. The determination of whether a contract includes a lease
   2. The allocation of consideration
   3. The determination of the discount rate

FINANCIAL STATEMENT IMPACT FOR LESSEES

	Balance Sheet	Income Statement	Statement of Cash Flows
Operating Lease (other than short-term lease election)			
Right-of-Use Asset	Recognized at the commencement date		All changes included in operating activities
Lease Liability	Recognized at the commencement date		All payments included in operating activities
Lease Cost		Single lease cost	
Short-term Operating Lease			
Right-of-Use Asset	Right-of-use asset and lease liability is not recognized		
Lease Liability	Right-of-use asset and lease liability is not recognized		
Lease Cost		Single lease cost recognized on a straight-line basis	All payments reflected in operating activities
Financing Lease			
Right-of-Use Asset	Recognized at the commencement date		Initial recognition of any unpaid amounts related to the right-of-use asset and the lease liability would be considered noncash activities.
Lease Liability	Recognized at the commencement date		Payment of the principal portion of the lease liability is included in financing activities.
Amortization Expense		Amortization expense of the right-of-use asset is presented consistent with depreciation expense of similar assets when compared to the leased asset.	Amortization expense would be an adjustment to income in operating activities.
Interest on Lease Liability		Interest expense on the lease liability is recognized consistent with other interest costs.	

GOVCON - INDIRECT RATE IMPACT

OPERATING lease

- Single lease cost recognized on a straight-line basis.
- Assuming no other changes and assumes lease expense is in G&A, G&A rate would be unchanged over the term of the lease. *(Pool and base remain the same since straight line)*

FINANCE lease

- Because the interest expense, also presented separately on the income statement, is declining each period, the total expense (interest + amortization) presented on the income statement is lower as the lease term progresses.
- Assuming no other changes and assumes amortization expense is in G&A, rate would not change over the term of the lease. *(Pool and base remain the same since straight line)*

EXAMPLES – LESSEE

OPERATING LEASE EXAMPLE

Effective Interest Method – Lessee Perspective

Key Terms of Contract

- Lease Term: 5-year lease term
- Discount Rate for the Lease: 6%
- Lease Payments Made Before Commencement: $5,000
- Lease incentive Received by Lessee: $2,500
- Initial direct Costs Paid by Lessee: $2,500
- Lease Payments: Annually at end of year (see table on next slide)

OPERATING LEASE EXAMPLE

Effective Interest Method - Lessee Perspective

Initial Measurement

- Lease liability: NPV of remaining lease payments (subsequent slide)
- Right of Use Asset:

Lease liability (initial measurement)	**59,978**
"Up-front" lease payment to lessor	5,000
Lease incentive received from lessor	(2,500)
Initial direct costs incurred	2,500
Right of use asset	**64,978**

OPERATING LEASE EXAMPLE

Effective Interest Method

- Straight-line expense is **Total Lease Cost** divided by lease term
  - $80,000 / 5 years = $16,000 of straight-line expense annually

- Total Lease Cost in this example was calculated as follows:

Lease Payments Over Lease Term		Lease Payment Made Prior to Commencement		Total Lease Cost
$75,000	+	$5,000	=	$80,000

OPERATING LEASE EXAMPLE

Effective Interest Method

Illustration of effective interest run-off of lease liability and amortization of right-of-use asset

This represents accrued interest, as there was no payment in year 1 after lease commencement.

Beginning balance times discount rate (6%)

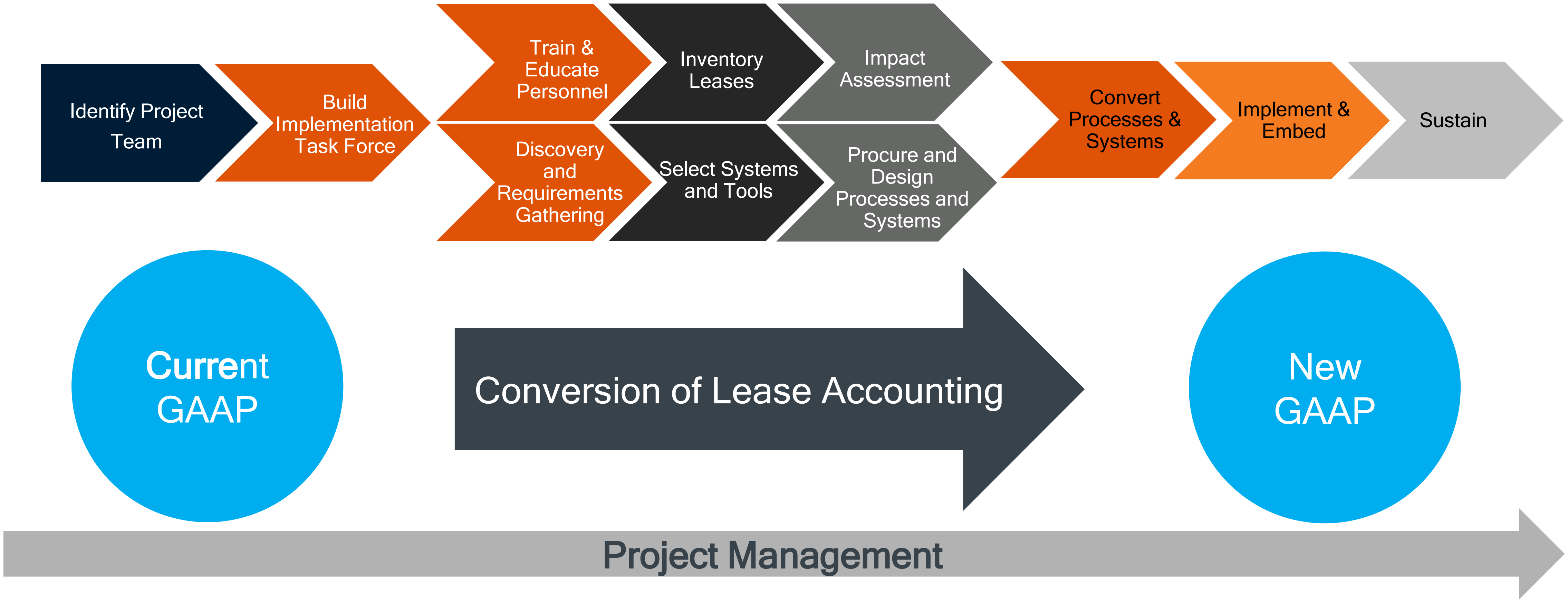
Year	Payment	Lease Liability Beg. Bal.	Lease Liability Principal	Lease Liability Interest	Lease Liability End. Bal.	Right of Use Asset Beg. Bal.	Right of Use Asset Amort.	Right of Use Asset End. Bal.
0					$ 59,978			$ 64,978
1	$ -	$ 59,978	$ (3,599)	$ 3,599	$ 63,577	$ 64,978	$ 12,401	$ 52,577
2	$ 10,000	$ 63,577	$ 6,185	$ 3,815	$ 57,391	$ 52,577	$ 12,185	$ 40,391
3	$ 15,000	$ 57,391	$ 11,557	$ 3,443	$ 45,835	$ 40,391	$ 12,557	$ 27,835
4	$ 25,000	$ 45,835	$ 22,250	$ 2,750	$ 23,585	$ 27,835	$ 13,250	$ 14,585
5	$ 25,000	$ 23,585	$ 23,585	$ 1,415	$ -	$ 14,585	$ 14,585	$ (0)
	$ 75,000							

Annual straight-line expense ($16,000) minus interest on lease liability.

TRANSITION & PRACTICAL EXPEDIENTS

TRANSITION

Implementation Timeline



SOME THINGS TO CONSIDER

- Covenant compliance
- Devising a transition strategy
- Accounting policy including whether practical expedients apply and are appropriate
- Data needs for measurement and disclosure
- Internal controls and systems/processes

DATA NEEDS & MEASUREMENTS

In order to determine the appropriate lease classification at the commencement date and perform measurements needed for recognition, certain data will need to be obtained.

Data Needs Common to Lessees	Additional Data Needed by Lessees
Economic life and special use of the leased asset	Discount rate – the lessor's rate implicit in the lease
Fair value of the underlying asset	Discount rate – the lessee's incremental borrowing rate
Lease payments	Discount rate – private business entity risk free rate
Lease term	
Initial direct costs	

SIGNIFICANT JUDGMENTS & DECISIONS

In order to avoid unintended consequences when adopting the new standard, a number of factors and judgments need to be evaluated.

Categories (excludes Transition Expedients discussed previously)

Lease Classification	"Reasonably Certain"	Accounting Policy Decisions	Discount Rates	Present Value Measurements
Purchase option	Contract terms		Measurements impacts:	
Lease term	Leasehold improvements		• Right of use asset • Lease liability • Interest expense	• Processes needed to prepare
Lease payments	Lease termination costs			• May have to be performed on lease by lease basis
	Underlying asset importance		• Risk free rate use by non-public entities pros and cons	

GOVCON REMINDER – POLICIES IMPACT

Document, Document, Document!

Updates to accounting policies and procedures and internal control documentation may be necessary once ASC 842 is implemented.

- Important for pre-award audits, accounting system reviews, etc.

RESOURCES

THE COHNREZNICK LEASE ACCOUNTING TOOLKIT

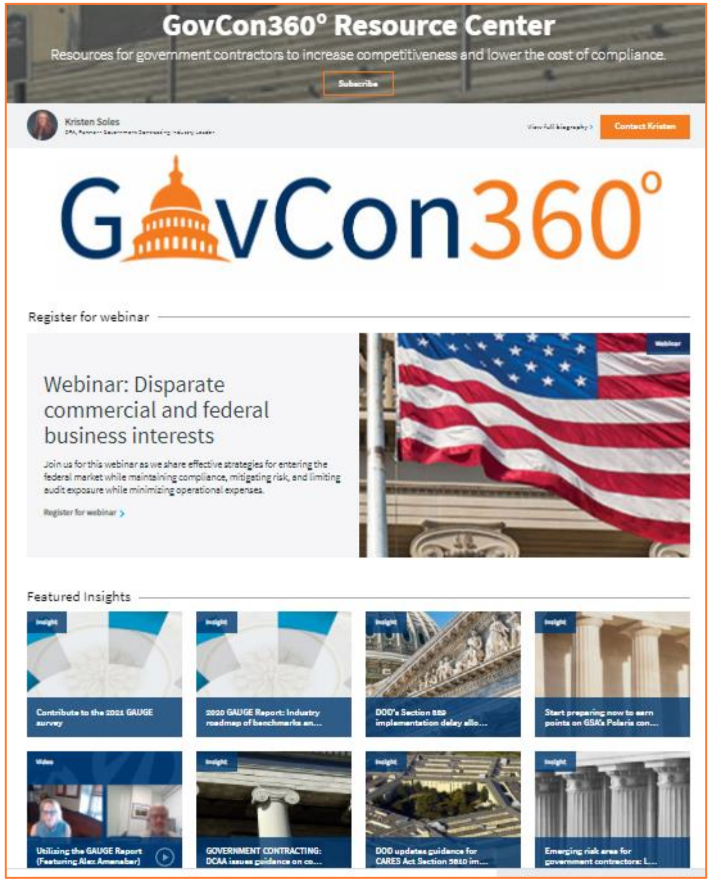
- Simple to use Excel-based calculation model
- Provides initial and subsequent calculation and entries
- Basic quantitative footnote disclosure calculations
- An alternative, economic solution to cloud-based software tools
- For more information and a demo, click below

CohnReznick Lease Accounting Toolkit

2022 GAUGE BENCHMARKING SURVEY & GOVCON360

For more government contracting insights, visit our GovCon360º Resource Center at

CohnReznick.com/GovCon360



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QUESTIONS? CONTACT US

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