iLeasePro

Lease Accounting Changes
FASB ASC 842

Impact to the Hospitality Industry

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What are the ASC 842 changes?

The **ASC 842 Lease Accounting Standard** (Topic ASC 842) has recently become effective for all reporting periods after December 15, 2021 by the Financial Accounting Standards Board (FASB). This change was designed to provide greater balance sheet transparency of leasing activities for organizations that issue financial statements in accordance with generally accepted accounting principles (GAAP).

Leases, currently classified as operating leases, allow the lessee to avoid recognizing both the lease obligation as a liability and expensive investments as fixed assets on its financial statements. The standard changes will require that all leases, except certain narrowly defined short term leases, be recognized on lessee balance sheets as a Lease Liability with an offsetting Right to Use asset.

The definition of a lease is more complicated and many provisions in the lease will require expert evaluation to determine whether there are accounting implications that must be addressed.

With respect to expense recognition, the FASB requires the classification of leases into two types (finance and operating) with many equipment leases falling into finance and most real estate leases falling into operating. However, for many leases, judgment will have to be applied to ensure that the lease classification is appropriate. For finance leases, expense recognition would be accelerated while for operating leases, expense would be recognized basically on a straight-line basis as is the case under current GAAP.

As one can see, lease accounting will become extremely more complicated for lessees. And remember, the new lease accounting standard applies to all leases which fall under the definition of a lease in the new standard, both real estate and equipment leases.

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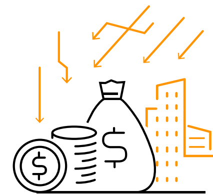
Net Effect of the Changes

The net effect of the new lease accounting standard will be a major increase in liabilities that must be recorded on the balance sheet of the lessees and a negative impact on debt to equity ratios. For many lessees that use debt-financing vehicles, which contain restrictive financial covenants, any increase in liabilities could present a particular challenge and may well require a waiver discussion with the lender. Certainly, lease versus purchase analyses will become more important and could result in a decrease in leasing activity. But it is difficult to envision any significant decrease in leasing for a number of reasons. Many companies are cash strapped and leasing presents a particularly advantageous form of financing for those organizations that want to minimize upfront cash outlays.

Additionally, leasing allows companies the flexibility to relocate more easily to another location or to change to a more advantageous equipment type after the termination of the lease. Ownership of real estate and equipment may well inhibit this flexibility.



Shorter-term leases will result in smaller liabilities that must be recorded. But there is a business trade off. Shorter-term leases mean more frequent lease renegotiation risk and the possibility of increased leasing costs.

Leasing strategies may need to change.

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Basic Provisions of ASC 842

The provisions of **ASC 842** require the financial statement preparer to determine these most important elements associated with a lease (not meant to be all inclusive):

- Does the contract in question meet the definition of a lease for accounting purposes?
- Does the contract contain any non-lease components?
- What is the lease term?
- What are the lease payments?
- How should a lease be classified?

A lease is defined as a "contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". Therefore, the lessee must be able to identify an asset or assets that can be used and also demonstrate that the contract allows the lessee to control the use of the identified asset for some period of time in exchange for consideration. In most cases, this will be a rather straightforward evaluation but there are situations involving, for example, where the lessee or the lessor have the right of substitution of an asset or where it is not clear which party has control of the asset that will require judgment to determine whether the definition of a lease is met.

ASC 842 requires that the lessee evaluate whether any non-lease components are contained in the contract and whether such non-lease components should be accounted for separately. An example of this situation is where a manufacturer lessor of equipment requires that the contract with the lessee include maintenance services of the equipment that are provided by the lessor.

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Determining the lease term and the lease payments associated with the lease term are significant because the FASB has retained the requirement that most lease contracts be recorded on the balance sheet of the lessee using a right-of-use model for recording the right-of-use asset ("the ROU asset") and the liability to make lease payments.

The calculation of the lease liability would be derived from the present value of the fixed lease payments beginning at the lease commencement date (the date at which the lessor makes the underlying asset available to the lessee) with the possible inclusion of certain lease incentives, certain lease option periods, residual value guarantees expected to be paid and certain purchase and lease termination options.

The initial carrying value of the ROU asset would be equal to the initial value of the lease liability plus any initial direct costs associated with negotiating and arranging the particular lease, any payments made to the lessor at or before the commencement date of the lease less any lease incentives received from the lessor.

The discount rate to be utilized in the present value calculation would be determined on a lease by lease basis and would be the rate used by the lessor for the particular transaction. Alternatively, since the lessee may well not know the rate used by the lessor, the lessee should use its own incremental borrowing rate at the lease commencement date.

The FASB has worked to reduce complexity by including:

- The lessee can make an accounting policy election to apply the current GAAP operating lease accounting model for those short-term leases that have a maximum possible lease term of 12 months or less, including option periods.
- The previous requirement to include variable lease payments has been revised to apply only to those payments that are based on an index or a rate or that are in-substance fixed payments.
- The requirement to include payments during an option period has been redefined to include only those payments where the lessee has a significant economic incentive to exercise the option.
- Lease and non-lease components (predominantly services provided by the lessor) would generally be accounted for separately.

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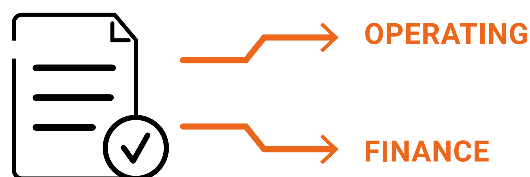
A major change involves lease classification based upon the nature of the asset being leased and how lease related expenses are recognized. Leases of assets that are not property (mainly equipment) would be classified as finance leases unless either the lease term is for an insignificant portion of the leased asset's economic life or the present value of the lease payments is insignificant versus the asset's fair value.

Leases of property would be classified as operating leases unless either the lease term is for the major portion of the leased asset's remaining life or the present value of the lease payments accounts for substantially all of the asset's fair value.

Recognition of lease related expense would differ significantly depending upon how the lease was classified. For a finance lease, the lease liability would be accreted using the interest method with lease payments being used to reduce the liability. The ROU asset would be amortized on a straight-line basis. This "interest method' pattern results in overall accelerated expense pattern in earlier periods and lower expense in the later periods of the lease term. Additionally, interest and amortization expense are presented separately in the financial statements for a finance lease.



For an operating lease, the lease liability is accreted in the same manner as a finance lease but the amortization of the ROU asset is adjusted so that the overall lease expense is recognized essentially on a straight- line basis. For operating leases, a single lease expense line item is presented in the financial statements, comprising both the interest and amortization components.

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Reassessment

After the date of commencement, the lessee may have to reassess the initial accounting for the lease transaction if either the lease term or the lease payment stream changes.

Circumstances that could trigger reassessment include:

- The index or rate utilized to measure the variable lease payments changes, for example, where CPI increases are included in the lease terms and the CPI index initially utilized changes or
- The lease contains option periods and the lessee original conclusion as the whether there is a significant economic incentive to exercise the option changes.

The reassessment may be required at each reporting period and result in the adjustment of the carrying amounts of the lease liability and the ROU asset. Additionally, if the reassessment does result in a change in the lease payment stream, the rate utilized to discount the payments may also have to be reassessed.

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Disclosures

ASC 842 includes a series of both qualitative and quantitative disclosures in order for the financial statement reader to understand more completely the nature of the lessee's lease portfolio.

Unless separately disclosed in the financial statements, the lessee would be required to disclose all financial statement amounts relating to the lease portfolio in the footnotes. Qualitative disclosures would include, among other matters, significant judgments made in applying the accounting guidance, information about the nature of the lease portfolio, including a description of the types of leases and certain information regarding options and variable lease payments. Quantitative disclosures would include a reconciliation of opening and closing balances of the aggregate lease liability separately for finance and operating leases (this disclosure would be optional for nonpublic companies) and a maturity analysis of the lease liability reflecting the undiscounted cash flows which would include a reconciliation to the ending carrying value of the lease liability.

ASC 842 Effective Date

The **ASC 842 Lease Accounting Standard** went into effect for private business entities for reporting period beginning after December 15, 2021, including interim financial statements.

But these dates represent the end of the process, not the beginning. Any existing lease in place on the adoption date will have to be identified, measured and presented on the balance sheet, reflecting the new rules.

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Example Financial Statement Analysis

An example of what one might consider a typical situation may the best way to demonstrate the effect on the financial statements of the provisions in ASC 842 versus current GAAP accounting requirements.

The lessee in our example is the operator of a 100 room hotel and leases the land and a newly constructed building on which the hotel is situated from one lessor and also leases various pieces of equipment from another lessor.

The land and building lease is triple net and there aren't any non-lease components (such as real estate related executor costs) which have to be considered separately. In addition, although the lease contains two underlying assets (land and building), we do not believe that they would have to be accounted for separately within the lease because they are dependent upon one another and highly interrelated. The lease term is 10 years and calls for monthly payments of $20,000 per month over the term of the lease. There are no options to extend, variable lease payments, purchase options or residual value guarantees contained in the lease agreement and no initial direct costs that have been incurred in executing the lease.

As indicated, the lessee also leases equipment from another lessor. These are separate leases and as such would have to be evaluated separately, however, for purposes of our example; we will aggregate the leases into one payment stream. The aggregated lease term is 60 months and the payment is $10,000 per month over the term of the lease. The lessee is responsible separately for all costs of the equipment and, therefore, there aren't any non-lease components that have to be accounted for separately. As with the lease of the land and building, there are no other payments, other than the fixed payments noted previously, that must be considered.

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The lessee has determined that the real estate lease is an operating lease since it is a property lease, the lease term is not for a major part of the remaining economic life of the real estate and the present value of the lease payments are insignificant when compared to the fair value of the underlying assets. The equipment leases are determined to be finance leases since the underlying assets are not property and the lease term is for a significant part of the total economic life of the underlying assets.

The present value of both payment streams must be calculated and, since the lessee is not privy to the interest rate that was utilized by the lessor in structuring the leases, the lessee will use its incremental borrowing rate for the present value calculation – assumed to be 5%.

	ASC 842 GAAP		Current GAAP	
Year	**Lease Liability**	**ROU Asset**	**Lease Liability**	**ROU Asset**
Year 0	$2,415,534	$2,415,534		
Year 1	2,160,448	2,170,752		
Year 2	1,897,733	1,913,446		
Year 3	1,627,000	1,642,976		
Year 4	1,347,837	1,358,668		
Year 5	1,059,814	1,059,814		
Year 6	868,459	868,459		
Year 7	667,314	667,314		
Year 8	455,878	455,878		
Year 9	233,624	233,624		
Year 10				

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The income statement impact of the changes versus current requirements is presented in the following table:

	ASC 842 GAAP				Current GAAP
Year	**Lease Expense**	**Interest Expense**	**Amortization Expense**	**Total**	**Lease Expense**
Year 0	$240,000	$105,981	24,322	370,303	360,000
Year 1	240,000	$105,981	19,427	365,408	360,000
Year 2	240,000	$105,981	14,282	360,263	360,000
Year 3	240,000	$105,981	8,873	354,854	360,000
Year 4	240,000	$105,981	3,188	349,169	360,000
Year 5	240,000	$105,981		240,000	360,000
Year 6	240,000			240,000	240,000
Year 7	240,000			240,000	240,000
Year 8	240,000			240,000	240,000
Year 9	240,000			240,000	240,000
Year 10	240,000			240,000	240,000

Note that under **ASC 842** as it relates to the balance sheet, the lessee would have both a significant liability and asset that must be recognized on its balance sheet as compared to Current GAAP. Both the liability and the asset balances decline as payments are made and amortization is charged to income. The ROU asset that must be recognized is not a tangible asset and will not enhance financial viability while the lease liability will clearly be included in the overall indebtedness of the entity. Since the entity's equity would not change, the asset to equity and the debt to equity ratios would change significantly, and the impact is particularly negative as to the debt to equity ratio.

With respect to the lessee's income statement, what under Current GAAP is relatively straight-forward accounting becomes considerably more complicated. The expense recognition for the finance equipment lease is accelerated into the early years of the lease term and the finance lease expense is now presented in two separate categories of interest and amortization expense. The expense presentation for the operating property lease remains consistent with Current GAAP, namely, straight-line recognition. The total column is presented here for illustrative purposes only to show how total expense will be impacted under ASC 842 but that amount will not be presented separately in the financial statements.

It is interesting to note that, for those entities that have significant finance leases, although total expense recognition may be accelerated in the early years of the lease term, Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") will be more favorable since interest and amortization are added back to derive the EBITDA calculation.

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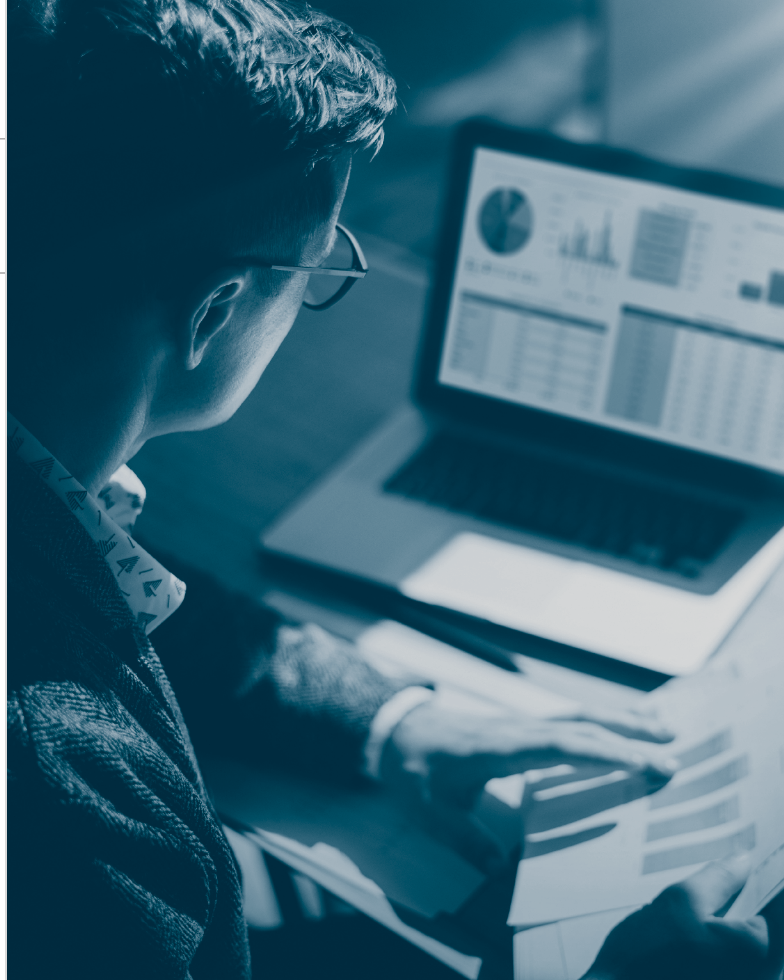
Next Steps



Preparation is key for effective implementation. Summarized below is just a partial list of next steps that lessees should be considering in preparation for the lease accounting changes.

The issues that must be considered are more numerous and complex than under the current accounting standards and require a complete understanding of all of the terms of the lease. In addition, the reassessment requirements are much more are rigorous. It is critical that the terms of each lease be documented clearly and consistently in a manner that allows for ready review. Lessees should strongly consider the need for a technology solution that captures all of the key provisions of the lease and stores them in an easily accessible format.

How will your leasing strategy change as a result of the new accounting standards? No one wants accounting to drive the economics of the organization, but they will undoubtedly be a consideration. Will lease versus buy decisions change? Will lease terms change? Longer lease terms will result in larger liability balances. The more complex the lease terms, the more time that is necessary to consider all of the accounting implications.

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Financial statement analytics will change dramatically, particularly debt to equity and debt service coverage ratios. Lessees should consider the implications on among other things, debt covenant compliance, employee compensation plans, contractual agreements and other key legal documents. And remember that although overall earnings may be lower, EBITDA may actually increase. How will this anomaly impact the key financial ratios?

Income tax policy is unlikely to change as a result of the accounting changes, therefore, book-tax differences will likely increase and result in a more complex tax computation.

Consult your technical and financial advisers well in advance. It is easy to underestimate the amount of work that is necessary in order to prepare to adopt the new standards.

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Contact us

iLease Management LLC is the developer of iLeasePro, a lease management and accounting solution which will help lessees meet the compliance requirements of the upcoming FASB Lease Accounting Standard changes.

www.iLeasePro.com

iLease Management LLC
100 Cummings Center, Suite 207
Beverly, MA 01915

John J Meedzan
Managing Partner
jmeedzan@ileasepro.com