



ASC-842 Rule: Impacting Financial Decision Making

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Speakers



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Agenda

- ASC 840 Overview
- Financial Reporting and Disclosures
- Bank Compliance Case Study



Objectives



- General understanding of ASC 842
- Understand the implementation changes on
 - Financial Reporting and Disclosures
 - Banking compliance



Lease Accounting



ASC 842 Leases

The current lease accounting model has been the same for over 30 years. In 2016, the Financial Accounting Standards Board issued new guidance for leases that will have a significant impact on the lease accounting model and will affect nearly all companies.

- ASC 842 – *Leases* was effective for public companies for years beginning after December 15, 2018 and thus has already been implemented across the public spectrum.
- This guidance was originally set to be effective for private companies for years beginning after December 15, 2019. However, this has since been deferred on two separate occasions for an additional year in each instance.
- As a result, ASC 842 – *Leases* is now required to be implemented by private companies for **fiscal years beginning after December 15, 2021** (calendar year 2022 for most entities).

ASC 842 Leases – Current Dates

Effective Dates



→ **Public Companies**

- Fiscal years beginning after December 15, 2018

→ **All other entities**

- Fiscal years beginning after December 15, 2021

ASC 842 Crash Course

- The “end game” is to get all leases with service lengths greater than 12 months onto the balance sheet.
- Leases 12 months or less in length are excluded from the guidance and are expensed pro-rata over the contract with no balance sheet impact.
- Operating/capital terminology replaced with operating/finance leases.
- Finance lease requirements remained relatively unchanged outside of the following:
 - Bargain purchase option reworded to purchase option reasonably certain to be exercised
 - New 5th category – specialized nature asset that only the lessee can use (i.e. no alternative use to the lessor without significant modification)

ASC 842 vs 840

ASC 842

- ✓ Lease classification determined at lease commencement
- ✓ Fixed payments and “in substance” fixed payments are identified as payments
- ✓ Executory costs (i.e. insurance, taxes, maintenance) considered
- ✓ Added a 5th criterion to determination of Finance/Capital Lease
- ✓ Asset is recorded at the amount calculated using a discount rate
- ✓ Only expected amounts owed at the end of the lease term should be included as lease payments

ASC 840

- ✓ Lease classification determined at execution
- ✓ Capital lease classification resulted in a liability
- ✓ Operating lease footnote disclosures only
- ✓ Executory costs (i.e. insurance, taxes, maintenance) excluded
- ✓ 4 Criterion tests for Capital vs Operating Lease
- ✓ Lease < Fair Value
- ✓ Residual value guarantees were included in the minimum lease payments

Financial Reporting and Disclosures



Consider setting up separate accounts:

- Fixed rent account (ASC 842)
- Short-term rent account
- Variable rent account

ASC 842 – Operating & Finance Lease Example

Fact Pattern

- 3 year lease from 1/1/2022 – 12/31/2024
- \$300,000 present value of future lease payments
- Payment stream – Year 1 \$100,000, Year 2 \$110,000, Year 3 \$125,000
- 5.51% interest rate implied in the lease
- No renewals periods
- No initial direct costs

Finance Lease Under ASC 842

Fact Pattern

Term: 1/1/2022 - 12/31/2024

\$300k PV of future payments at 1/1/2022

Payments:

Year 1 - \$100k

Year 2 - \$110k

Year 3 - \$125k

5.51% implied interest rate

LEASE COMMENCEMENT

	Debit	Credit
ROU Asset	\$ 300,000	
Lease Liability		\$ 300,000

YEAR ONE ENTRY

Interest Expense	\$ 16,535	
Amortization Expense	\$ 100,000	
Lease Liability	\$ 83,465	
ROU Asset		\$ 100,000
Cash		\$ 100,000

YEAR TWO ENTRY

Interest Expense	\$ 11,935	
Amortization Expense	\$ 100,000	
Lease Liability	\$ 98,065	
ROU Asset		\$ 100,000
Cash		\$ 110,000

YEAR THREE ENTRY

Interest Expense	\$ 6,530	
Amortization Expense	\$ 100,000	
Lease Liability	\$ 118,470	
ROU Asset		\$ 100,000
Cash		\$ 125,000

Operating Lease Under ASC 842

Fact Pattern

Term: 1/1/2022 - 12/31/2024
\$300k PV of future payments at 1/1/2022

Payments:

Year 1 - \$100k
Year 2 - \$110k
Year 3 - \$125k

5.51% implied interest rate

LEASE COMMENCEMENT

	Debit	Credit
ROU Asset	\$ 300,000	
Lease Liability		\$ 300,000

YEAR ONE ENTRY

Lease Expense	\$ 111,667	
Lease Liability	\$ 83,465	
ROU Asset		\$ 95,132
Cash		\$ 100,000

YEAR TWO ENTRY

Lease Expense	\$ 111,667	
Lease Liability	\$ 98,065	
ROU Asset		\$ 99,732
Cash		\$ 110,000

YEAR THREE ENTRY

Lease Expense	\$ 111,667	
Lease Liability	\$ 118,470	
ROU Asset		\$ 105,137
Cash		\$ 125,000

Comparison

FINANCE LEASE

	Year One	Year Two	Year Three	Total
Interest Expense	\$ 16,535	\$ 11,935	\$ 6,530	\$ 35,000
Amortization Expense	\$ 100,000	\$ 100,000	\$ 100,000	\$ 300,000
Total Expense	\$ 116,535	\$ 111,935	\$ 106,530	\$ 335,000
Operating Cash Flow	\$ 16,535	\$ 11,935	\$ 6,530	\$ 35,000
Financing Cash Flow	\$ 83,465	\$ 98,065	\$ 118,470	\$ 300,000
Total Cash Flows	\$ 100,000	\$ 110,000	\$ 125,000	\$ 335,000

OPERATING LEASE

	Year One	Year Two	Year Three	Total
Interest component	\$ 16,535	\$ 11,935	\$ 6,530	\$ 35,000
Amortization component	\$ 95,132	\$ 99,732	\$ 105,137	\$ 300,000
Total Rental Expense	\$ 111,667	\$ 111,667	\$ 111,667	\$ 335,000
Operating Cash Flow	\$ 100,000	\$ 110,000	\$ 125,000	\$ 335,000

Some Takeaways

- Recognition patterns for capital/finance leases are relatively unchanged from ASC 840 to ASC 842. The biggest changes for these leases is enhanced disclosures.
- The primary difference in recognition pattern between operating and finance leases is how the ROU asset is amortized.
 - ROU asset for financing leases is amortized over the shorter of their estimated useful lives or the terms of the respective leases, including periods covered by renewal options that the Company is reasonably assured of exercising.
 - ROU asset for operating leases is amortized based on total rental expense compared to the amount representing interest
- Additionally, operating leases result in greater operating cash outflows when compared to finance leases whose cash outflows are considered akin to debt.

Disclosure Examples – ASC 840

The disclosure examples on the following tabs were taken from Wendy's 10-K

Below is the old way

Rental expense for operating leases consists of the following components:

	Year Ended		
	2018	2017	2016
Rental expense:			
Minimum rentals	\$ 95,749	\$ 90,889	\$ 77,952
Contingent rentals	18,971	19,021	18,291
Total rental expense (a) (b)	\$ 114,720	\$ 109,910	\$ 96,243

Fiscal Year	Rental Payments	
	Capital Leases	Operating Leases
2019	\$ 47,087	\$ 95,877
2020	45,947	93,372
2021	47,604	92,987
2022	48,687	92,830
2023	50,193	92,807
Thereafter	699,697	1,058,037
Total minimum payments	\$ 939,215	\$ 1,525,910
Less interest	(483,579)	
Present value of minimum capital lease payments (a)	\$ 455,636	

Disclosure Examples – ASC 842

	December 29, 2019	December 30, 2018
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 300,195	\$ 431,405
Restricted cash	34,539	29,860
Accounts and notes receivable, net	117,461	109,805
Inventories	3,891	3,687
Prepaid expenses and other current assets	15,585	14,452
Advertising funds restricted assets	82,376	76,509
Total current assets	554,047	665,718
Properties	977,000	1,023,267
Finance lease assets	200,144	189,969
Operating lease assets	857,199	—
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt	\$ 22,750	\$ 23,250
Current portion of finance lease liabilities	11,005	8,405
Current portion of operating lease liabilities	43,775	—
Accounts payable	22,701	21,741
Accrued expenses and other current liabilities	165,272	150,636
Advertising funds restricted liabilities	84,195	80,153
Total current liabilities	349,698	284,185
Long-term debt	2,257,561	2,305,552
Long-term finance lease liabilities	480,847	447,231
Long-term operating lease liabilities	897,737	—

Disclosure Examples – ASC 842

	Common Stock	Additional Paid-In Capital	Retained Earnings: (Accumulated Deficit)	Common Stock Held in Treasury	Accumulated Other Comprehensive Loss	Total
Balance at December 30, 2018	47,042	2,884,696	146,277	(2,367,893)	(61,673)	648,449
Net income	—	—	136,940	—	—	136,940
Other comprehensive income, net	—	—	—	—	7,845	7,845
Cash dividends	—	—	(96,364)	—	—	(96,364)
Repurchases of common stock, including accelerated share repurchase	—	(15,000)	—	(202,771)	—	(217,771)
Share-based compensation	—	18,676	—	—	—	18,676
Common stock issued upon exercises of stock options	—	(808)	—	28,944	—	28,136
Common stock issued upon vesting of restricted shares	—	(13,677)	—	5,050	—	(8,627)
Cumulative effect of change in accounting principle	—	—	(1,105)	—	—	(1,105)
Other	—	114	(23)	89	—	180
Balance at December 29, 2019	\$ 47,042	\$ 2,874,001	\$ 185,725	\$ (2,536,581)	\$ (53,828)	\$ 516,359

Year Ended

	December 29, 2019	December 30, 2018	December 31, 2017
Cash flows from operating activities:			
Net income	\$ 136,940	\$ 460,115	\$ 194,029
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	131,693	128,879	125,687
Share-based compensation	18,676	17,918	20,928
Impairment of long-lived assets	6,999	4,697	4,097
Deferred income tax	837	(6,568)	(119,330)
Non-cash rental expense (income), net	28,202	(17,043)	(11,822)
Change in operating lease liabilities	(41,911)	—	—

Disclosure Examples – ASC 842

Company as Lessee

The components of lease cost for 2020 and 2019 are as follows:

	Year Ended	
	2020	2019
Finance lease cost:		
Amortization of finance lease assets	\$ 13,395	\$ 11,241
Interest on finance lease liabilities	40,682	37,012
	<u>54,077</u>	<u>48,253</u>
Operating lease cost	91,475	90,537
Variable lease cost (a)	59,076	58,978
Short-term lease cost	4,641	4,717
Total operating lease cost (b)	<u>155,192</u>	<u>154,232</u>
Total lease cost	<u>\$ 209,269</u>	<u>\$ 202,485</u>

The following table includes supplemental cash flow and non-cash information related to leases:

	Year End	
	2020	2019
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from finance leases	\$ 39,349	\$ 39,887
Operating cash flows from operating leases	85,689	91,824
Financing cash flows from finance leases	8,383	6,835
Right-of-use assets obtained in exchange for lease obligations:		
Finance lease liabilities	34,918	50,061
Operating lease liabilities	18,327	15,411

Disclosure Examples – ASC 842

The following table includes supplemental information related to leases:

	Year End	
	January 3, 2021	December 29, 2019
Weighted-average remaining lease term (years):		
Finance leases	16.2	17.1
Operating leases	14.6	15.4
Weighted average discount rate:		
Finance leases	9.54 %	9.87 %
Operating leases	5.06 %	5.09 %
Supplemental balance sheet information:		
Finance lease assets, gross	\$ 261,308	\$ 242,889
Accumulated amortization	(55,155)	(42,745)
Finance lease assets	206,153	200,144
Operating lease assets	821,480	857,199

The following table illustrates the Company's future minimum rental payments for non-cancelable leases as of January 3, 2021:

Fiscal Year	Finance Leases		Operating Leases	
	Company-Operated	Franchise and Other	Company-Operated	Franchise and Other
2021 (a)	\$ 4,779	\$ 47,503	\$ 19,195	\$ 70,730
2022	4,963	49,000	19,010	70,633
2023	4,927	50,632	19,037	70,460
2024	5,045	51,007	19,111	70,328
2025	5,140	51,423	19,065	69,977
Thereafter	59,126	628,162	167,441	699,756
Total minimum payments	\$ 83,980	\$ 877,727	\$ 262,859	\$ 1,051,884
Less interest	(30,716)	(412,810)	(77,388)	(326,684)
Present value of minimum lease payments (b) (c)	\$ 53,264	\$ 464,917	\$ 185,471	\$ 725,200

Disclosure Examples – ASC 842

Leases

In February 2016, the FASB issued new guidance on leases, which outlines principles for the recognition, measurement, presentation and disclosure of leases applicable to both lessors and lessees. The new guidance requires lessees to recognize on the balance sheet the assets and liabilities for the rights and obligations created by finance and operating leases. The Company adopted the new guidance during the first quarter of 2019 using the effective date as the date of initial application; therefore, the comparative periods have not been adjusted and continue to be reported under the previous lease guidance.

The new standard provides a number of optional practical expedients in transition. The Company elected the package of practical expedients, which permits us not to reassess under the new standard our prior conclusions about lease identification, lease classification and initial direct costs. For those leases that fall under the definition of a short-term lease, the Company elected the short-term lease recognition exemption. Under this practical expedient, for those leases that qualify, we did not recognize ROU assets or liabilities, which included not recognizing ROU assets or lease liabilities for existing short-term leases of those assets in transition. The Company also elected the practical expedient for lessees to account for lease components and nonlease components as a single lease component for all underlying classes of assets. In addition, the Company elected the practical expedient for lessors to account for lease components and nonlease components as a single lease component in instances where the lease component is predominant, the timing and pattern of transfer for the lease component and nonlease component are the same and the lease component, if accounted for separately, would be classified as an operating lease. The Company did not elect the use-of-hindsight practical expedient.

The standard had a material impact on our consolidated balance sheets and related disclosures. Upon adoption at the beginning of 2019, we recognized operating lease liabilities of \$1,011,000 based on the present value of the remaining minimum rental payments, with corresponding ROU assets of \$934,000. The measurement of the operating lease ROU assets included, among other items, favorable lease amounts of \$23,000 and unfavorable lease amounts of \$30,000, which were previously included in “Other intangible assets” and “Other liabilities,” respectively, as well as the excess of rent expense recognized on a straight-line basis over the minimum rents paid of \$67,000, which was previously included in “Other liabilities.” In addition, the standard requires lessors to recognize lessees’ payments to the Company for executory costs on a gross basis as revenue with a corresponding expense, which resulted in an increase of approximately \$38,000 to our 2019 franchise rental income and expense. The Company also recognized a decrease to retained earnings of \$1,105 as a result of impairing newly recognized ROU assets upon transition to the new guidance. The adoption of the guidance did not have a material impact on our consolidated statement of cash flows.

In connection with the adoption of the standard, the Company has reclassified finance lease ROU assets to “Finance lease assets,” which were previously recorded to “Properties.” The Company also reclassified the current and long-term finance lease liabilities to “Current portion of finance lease liabilities” and “Long-term finance lease liabilities,” respectively, which were previously recorded to “Current portion of long-term debt” and “Long-term debt,” respectively. The prior period amounts in the consolidated balance sheet and in the related notes to the financial statements reflect the reclassifications of these assets and liabilities to conform to the current year presentation.

Implementation Practical Expedients

- Practical expedients package (must be adopted on an “all or nothing” approach)
 - No reassessment of lease classification.
 - No reevaluation of existing/expired contracts for embedded leases
 - No reassessment of previously recorded initial direct costs.
- Hindsight expedient (lease terms, options, etc.)
- Combination of lease and non-lease components
 - Would just require the PV of fixed consideration to be calculated (i.e. fixed lease payments excluding executory costs such as CAM, insurance, etc.). Can be elected based on asset class.
- Private company discount rates
 - The risk-free interest rate can be utilized if there is no discount rate implicit in a lease contract.
 - Will result in larger lease liabilities on the balance sheet.
- Land easement expedient – historical treatment applies.

Banking Compliance Case Study



- Discuss impact on debt covenants with your banker
- EBITDA / EBITDAR

Lease Tracking Solution

- Options
 - Leveraging software
 - Excel spreadsheet
- Considerations
 - Number of leases to be tracked
 - Complexity of payment terms
 - Frequency of changes to lease agreements
- Software capabilities
 - Automate lease payment process
 - Direct interface with GL system
 - Central depository
 - Lease abstract creation
 - Critical date monitoring (e.g., renewal dates)
 - Real estate market analysis
- Software configuration
 - Testing
 - Training

LeaseCrunch Powered by GBQ


- The new lease standard has introduced a tremendous amount of work for your business. GBQ has partnered with LeaseCrunch®, a cloud-based lease accounting software for CPA firms, to help make the implementation process as seamless as possible.

**Benefits of using
LEASECRUNCH**



→ **EASY TO USE**

- LeaseCrunch® simplifies the complex lease standards with automated quantitative footnote disclosures, worry-free calculations, and step-by-step wizards.
- This easy implementation process, allows your business to be running in days.



→ **AFFORDABLE AND
SCALABLE**

- This software is cost-effective, whether for one lease or thousands.
- Manage your entire portfolio efficiently in one unified interface, with the option of prominently branding the solution to your business.

ASC 842 Leases – Lender Compliance

- As a reminder, many lending arrangements include financial covenants based on the risk portfolio/metrics at the lender. If failed, these could result in numerous financial statement considerations by your auditor including:
 - Debt classification (i.e. current vs. long-term)
 - Requirement of covenant waivers
 - Going concern considerations
- Given the significance of financial statement presentation changes previously discussed, key compliance ratios will most likely change, which include the following (this list is NOT all inclusive):
 - Current ratio
 - Debt Service Coverage
 - Funded debt to EBITDA
 - Debt to net worth ratio

ASC 842 Leases – Lender Compliance

- Appropriate communication should be taking place with your lender(s) to ensure compliance with any covenant requirements.
- We recommend that you work ahead with your lender(s) to determine appropriate updates to current covenant requirements, which could include adjustment to required thresholds or GAAP exceptions for ASC 842 within the covenant calculations.
- Additionally, businesses in certain industries already have rental expense added in to their calculations (EBITDAR, rent expense x a multiple, etc.). The changes might not be as significant in these instances, but should still be considered and appropriate conversations had.

Lender Compliance Example (Before and After)

- To illustrate the changes that the adoption of ASC 842 can have on your covenant compliance, we will walk through a before and after example showing the significance that this adoption can have in various scenarios.



Key Financial Metrics ASC 840 vs. ASC 842

ASSETS		ASC 840	ASC 842
Current Assets		\$ 8,000,000	\$ 8,000,000
Long-Term Assets			
Property and Equipment		5,000,000	5,000,000
ROU Asset		-	2,000,000
Total long-term assets		5,000,000	7,000,000
TOTAL ASSETS		\$ 13,000,000	\$ 15,000,000
LIABILITIES AND EQUITY		ASC 840	ASC 842
Current Liabilities			
Current liabilities		\$ 5,000,000	\$ 5,000,000
Current portion of long-term debt		1,000,000	1,000,000
Current portion of lease liability		-	200,000
Total current liabilities		6,000,000	6,200,000
Long-Term Liabilities			
Notes payable		5,000,000	5,000,000
Lease liability		-	1,800,000
Total long-term liabilities		5,000,000	6,800,000
Equity		2,000,000	2,000,000
TOTAL LIABILITIES AND EQUITY		\$ 13,000,000	\$ 15,000,000
Supplemental Information		ASC 840	ASC 842
Net Income		\$ 1,000,000	\$ 1,000,000
Interest		300,000	300,000
Income Taxes		100,000	100,000
Depreciation and Amortization		200,000	200,000
Rent expense (assume 100% operating leases)		180,000	180,000

Current Ratio & Debt to Net Worth – Before and After

- Current Ratio = Current assets / Current liabilities

	ASC 840	ASC 842
Current Assets	\$ 8,000,000	\$ 8,000,000
Current Liabilities	6,000,000	6,200,000
Current Ratio	<u>1.33</u>	<u>1.29</u>
Required In compliance?	1.30 Yes	1.30 No

- Debt to Net Worth Ratio = Total debt / Total equity / Net worth

	ASC 840	ASC 842
Debt	\$ 6,000,000	\$ 8,000,000
Net Worth	2,000,000	2,000,000
Debt to Net Worth Ratio	<u>3.00</u>	<u>4.00</u>
Required In compliance?	3.50 Yes	3.50 No

Funded Debt to EBITDA – Before and After

- Funded Debt to EBITDA = Total Debt / EBITDA
- EBITDA stands for earnings before interest, taxes, depreciation and amortization and is a metric used to evaluate free cash flow

	ASC 840	ASC 842
Net Income	\$ 1,000,000	\$ 1,000,000
Interest	300,000	300,000
Income Taxes	100,000	100,000
Depreciation and Amortization	200,000	200,000
EBITDA	1,600,000	1,600,000
Funded Debt	6,000,000	8,000,000
Funded Debt to EBITDA Ratio	3.75	5.00
Required	4.00	4.00
In compliance?	Yes	No

Funded Debt to EBITDAR – Lease Adjusted

- Funded Debt to EBITDAR = Total debt / EBITDAR
- EBITDAR is EBITDA plus rent expense and factors in the rental component to operations. Often times if this covenant is utilized, lease expense adjusted by a multiple will be added to funded (total) debt utilized in the calculation.

	ASC 840	ASC 842
EBITDA	\$ 1,600,000	\$ 1,600,000
Rent Expense	180,000	180,000
EBITDAR	1,780,000	1,780,000
Funded Debt	6,000,000	6,000,000
Plus 6x Rent	1,080,000	1,080,000
Total Funded Debt	7,080,000	7,080,000
Funded Debt to EBITDAR Ratio	3.98	3.98
Required	4.00	4.00
In compliance?	Yes	Yes

Debt Service Coverage – Before and After

- Debt Service Coverage = EBITDA / (Debt Principal + Interest)

	ASC 840	ASC 842
Net Income	\$ 1,000,000	\$ 1,000,000
Interest	300,000	300,000
Income Taxes	100,000	100,000
Depreciation and Amotization	200,000	200,000
EBITDA	1,600,000	1,600,000
Interest and Principal:		
Current portion of debt and lease liabilities	1,000,000	1,200,000
Interest	300,000	300,000
Total Interest and Principal	1,300,000	1,500,000
Debt Service Coverage Ratio	1.23	1.07
Required	1.10	1.10
In compliance?	Yes	No

Debt Service Coverage – Lease Adjusted

- Lease Adjusted Debt Service Coverage = EBITDAR / (Debt Principal + Interest + Rent Expense)

	ASC 840	ASC 842
Net Income	\$ 1,000,000	\$ 1,000,000
Interest	300,000	300,000
Income Taxes	100,000	100,000
Depreciation and Amotization	200,000	200,000
Rent Expense	180,000	180,000
EBITDAR	1,780,000	1,780,000
Interest, Principal and Rent:		
Current portion of debt	1,000,000	1,000,000
Interest	300,000	300,000
Rent expense	180,000	180,000
Total Interest, Principal and Rent	1,480,000	1,480,000
Debt Service Coverage Ratio	1.20	1.20
Required	1.10	1.10
In compliance?	Yes	Yes

Internal Control Process Updates

- The changes in financial reporting presentation will result in necessary updates to internal control process design to ensure the appropriate capture of pertinent data and data integrity.
- Below are a few process considerations/updates we are commonly seeing as it relates to the changes associated with ASC 842; however, this list is not all inclusive and will need to be tailored to your organization's complexity and lease situation.
 - Updates to financial reporting process
 - Additional management review controls
 - System user access rights (are third party software vendors being utilized?)
 - Additional collaboration with lease negotiation team and other applicable operational personnel
 - New leases, changes to renewal terms/obligations of existing portfolio, embedded leases, etc.

Questions



Contact Information



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