Miles CPA Review: FAR - 2019 Updates

Summary of updates:

- **FAR-4.4: Leases** [ASC 842] effective fiscal years beginning after Dec 15, 2018 (for issuers) and effective fiscal years beginning after Dec 15, 2019 (for non-issuers)

FAR-4.4: Leases

FASB issued ASC 842 to amend accounting & reporting for leases effective fiscal years beginning after Dec 15, 2018 (for issuers) and effective fiscal years beginning after Dec 15, 2019 (for non-issuers). Key changes:

- **Change in Lessee accounting for operating leases** -
  - **Recognize the assets and liabilities that arise from leases** (earlier: this was only required for finance leases, and was not required for operating leases)
    - Liability on B/S: Liability to make lease payments (Lease Liability)
    - Asset on B/S: Right-of-use asset representing its right to use the underlying asset for the lease term (Lease Asset)
  - **Recognize a single lease cost**, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis (note: this is unlike finance leases wherein interest expense and amortization expense are recognized each period)
  - Classify all cash payments within operating activities in the statement of cash flows
  - Note:
    - For any optional payments, include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is reasonably certain to exercise that purchase option
    - For any variable payments, include only payments based on an index/rate and measure using the initial index/rate at the commencement date.
      E.g., Lease requires $10,000 lease payment per year for 3 years that will increase each year based on CPI. The lease liability will be calculated based on $10,000 cash lease payment for each of the 3 years (irrespective of the expectation of changes in CPI). Thereafter, say in year 2, if CPI increases by 4%, actual lease payment will be $10,400 of which $10,000 will be treated as the fixed lease payment and $400 will be the variable lease payment
      E.g., If Lessee is required to make variable lease payments each year of the lease @2% of Lessee's sales generated from the leased building, this variable payment (which is linked to performance and not based on an index/rate) will not be included in the measurement of the lease liability
  - **Lessee exception for short-term leases (term of 1 year or less)** - Lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term

- **Definition of a lease** - At inception of a contract, an entity should determine whether the contract is or contains a lease, wherein a lease conveys the right to control the use of identified PP&E (an identified asset) for a period of time in exchange for consideration. Control over the use of the identified asset means that the customer/lessee has both (1) the right to obtain substantially all of the economic benefits from the use of the asset, and (2) the right to direct the use of the asset
  - Under earlier lessee accounting model, the critical determination was whether a lease was a capital lease or an operating lease because lease assets and lease liabilities were recognized only for capital leases. However, per ASC 842, critical determination is whether a contract is or contains a lease because lessees are required to recognize lease assets and lease liabilities for all leases— finance and operating—other than short-term leases (i.e., if the entity elects the short-term lease recognition and measurement exemption)

- **Terminology change** - In line with IFRS, lessees to use the term "**finance lease**" for non-operating leases (vs. "capital lease" earlier)

- **Lease & non-lease components** - Entities required to separate the lease components from the non-lease components (e.g., maintenance). Although this was a requirement in previous GAAP, ASC 842 provides more guidance on how to identify and separate
  - Consideration in the contract is allocated to the lease and non-lease components on a relative standalone price basis (for lessees) or in accordance with the Revenue Recognition standards (for lessors)
  - Consideration attributable to non-lease components is not a lease payment and, therefore, is not included in the measurement of lease assets or lease liabilities
  - Exception (practical expedient for lessees) – Lessees may make an accounting policy election by class of underlying asset not to separate lease components from non-lease components. If an entity makes this accounting policy election, it is required to account for the non-lease component together with the related lease components as a single lease component

- **Sale and Leaseback Transactions** - For a sale to occur in the context of a sale and leaseback transaction, the transfer of the asset must meet the requirements for a sale per the Revenue Recognition standards
  - If there is no sale for the seller-lessee, the buyer-lessor also does not account for a purchase. Any consideration paid for the asset is accounted for as a financing transaction by both the seller-lessee and the buyer-lessor.
    E.g., If the "leaseback" is a finance lease (from seller-lessee's perspective), transfer of the asset is NOT a "Sale" (i.e., treat as if no "Sales" has happened). Rationale is that the seller-lessee has not satisfied any performance obligation per Step 5 of the Revenue Recognition standards [since control of the asset is not transferred to the buyer-lessor]

- **Disclosures** - Qualitative disclosures along with specific quantitative disclosures
  - To enable F/S users to assess the amount, timing, and uncertainty of cash flows arising from leases

- **IFRS 16** – FASB and IASB worked on a joint project to update lease accounting (wherein FASB issued ASC 842 and IASB issued IFRS 16). Therefore, rules are similar. Minor differences below:
  - Lessee accounting model
    - IFRS 16 has a lessee recognition and measurement exemption for leases of assets with values of less than $5,000
  - Lessor accounting model
    - IFRS 16 does not distinguish between sales-type and direct financing leases; therefore, IFRS 16 permits recognition of selling profit on direct financing leases at lease commencement

Operating Leases [revise FAR 4.4 (II)]

➢ **Operating Leases: Accounting by Lessee**

- **At commencement date:**

  CAPITALIZE as **Lease (Right-to-use) Asset** on B/S and a corresponding **Lease Liability** [i.e., operating leases are no longer off-B/S]

  ✓ **Discount rate** - Lessee should use the rate implicit in the lease whenever that rate is readily determinable. If the rate implicit in the lease is not readily determinable, a lessee uses its incremental borrowing rate

  ⇒ A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term, as an accounting policy election for all leases

  ✓ **J/E:**

Lease (Right-to-use) Asset	**XXX**	
Lease Liability		**XXX**

- **After commencement date:**

  RECORD LEASE PAYMENT as a reduction of Lease Liability. J/E:

Pay off	Lease Liability ↓	XXX	
	Cash		XXX

  EXPENSE LEASE COST on a straight-line basis over the lease term. J/E:

	Lease Expense on I/S	XXX		
Interest added	Lease Liability ↑		XXX	
Amortize	Lease (Right-to-use) Asset (plug)			XXX

  ✓ Note: In a finance lease, lessee recognizes interest expense on I/S (as the lease liability is paid) and depreciates/amortizes the lease asset. However, in an operating lease, the lessee only recognizes a single lease cost which too is recognized on a straight-line basis (such that the lease expense over the lease term is the same $ every period)

- **Lessee exception for short-term leases (term of 1 year or less)** - Lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term

➢ **Operating Leases: Accounting by Lessor**

- Lessor continues to record the underlying asset on its B/S and recognizes the periodic lease income (similar accounting as earlier)

Example on Operating Lease (Lessee):

On 1/1/X1 Lessee Co. leases from Lessor Co. equipment for 3 years @$25,000 payable at the end of each year. The asset life is 10 years with incremental borrowing rate of 10%. The lease is an operating lease.

PV information:
PV of ordinary annuity for 3 years @10% is 2.48685

Solution - Part 1 of 2: At commencement date, recognize Lease Asset & Lease Liability

PV of lease payments (note this is ordinary annuity) = $25,000 ∗ 2.48685 = $62,171

J/E to recognize lease asset and lease liability:

	1/1/X1	
Lease (Right-to-use) Asset	62,171	
Lease Liability		62,171

Solution - Part 2 of 2: After commencement date, recognize Lease Expense on I/S, record Lease Payments (in cash), and amortize the Lease Asset & Lease Liability

Amortization schedule:

	J/E #1	J/E #2			B/S	
Period	Actual Lease Payment	Lease Expense on I/S	"Interest" @10% of Lease Liability CV	Plug for Lease Asset amortization	Lease Asset CV	Lease Liability CV
	Reduces Lease Liability	*Expense on I/S (straight-line)*	*Increases Lease Liability*	*Reduces Lease Asset*		
1 (1/1/X1)					$62,171	$62,171
1 (12/31/X1)	$25,000	$25,000	$6,217	18,783	$43,388	$43,388
2 (12/31/X2)	$25,000	$25,000	$4,339	20,661	$22,727	$22,727
3 (12/31/X3)	$25,000	$25,000	$2,273	22,727	$0	$0

J/E #1: Actual lease payment:

	12/31/X1		12/31/X2		12/31/X3	
Pay off Lease Liability ↓	25,000		25,000		25,000	
Cash		25,000		25,000		25,000

J/E #2: Lease expense:

	12/31/X1		12/31/X2		12/31/X3	
Lease Expense on I/S	25,000		25,000		25,000	
Interest added to Lease Liability ↑		6,217		4,339		2,273
Amortize Lease (Right-to-use) Asset (plug)		18,783		20,661		22,727

Example on Operating Lease (Lessee):

On 1/1/X1 Lessee Co. leases from Lessor Co. equipment for 3 years @$20,000 payable at the end of Year 1, $25,000 payable at the end of Year 2 and $30,000 payable at the end of Year 3. The asset life is 10 years with incremental borrowing rate of 10%. The lease is an operating lease.

PV information:
PV of $1 @10%: 0.90909 if n=1 year | 0.82645 if n=2 years | 0.75131 if n=3 years

Solution - Part 1 of 2: At commencement date, recognize Lease Asset & Lease Liability

PV of lease payments = ($20,000 x 0.90909) + ($25,000 x 0.82645) + ($30,000 x 0.75131) = $61,382

J/E to recognize lease asset and lease liability:

	1/1/X1	
Lease (Right-to-use) Asset	61,382	
Lease Liability		61,382

Solution - Part 2 of 2: After commencement date, recognize Lease Expense on I/S, record Lease Payments (in cash), and amortize the Lease Asset & Lease Liability

Amortization schedule:

	J/E #1	J/E #2			B/S	
Period	Actual Lease Payment	Lease Expense on I/S	"Interest" @10% of Lease Liability CV	Plug for Lease Asset amortization	Lease Asset CV	Lease Liability CV
	Reduces Lease Liability	*Expense on I/S (straight-line)*	*Increases Lease Liability*	*Reduces Lease Asset*		
1 (1/1/X1)					$61,382	$61,382
1 (12/31/X1)	$20,000	$25,000	$6,138	18,862	$42,520	$47,520
2 (12/31/X2)	$25,000	$25,000	$4,752	20,248	$27,272	$22,272
3 (12/31/X3)	$30,000	$25,000	$2,728	22,272	$0	$0

J/E #1: Actual lease payment:

		12/31/X1		12/31/X2		12/31/X3	
Pay off	Lease Liability ↓	20,000		25,000		30,000	
	Cash		20,000		25,000		30,000

J/E #2: Lease expense:

		12/31/X1		12/31/X2		12/31/X3	
	Lease Expense on I/S	25,000		25,000		25,000	
Interest added to	Lease Liability ↑		6,138		4,752		2,728
Amortize	Lease (Right-to-use) Asset (plug)		18,862		20,248		22,272

- **Lessee & Lessor F/S: Recap**

	B/S	I/S	C/F [per US GAAP]
LESSEE			
Operating	Lease right-to-use Asset Lease Liability	$\boxed{\text{Lease Expense}}$	Operating
Finance	Lease right-to-use Asset Lease Liability	Interest Expense Amortization Expense	Operating [Interest portion] Financing [Principal portion]
LESSOR			
Operating	PP&E (underlying asset)	$\boxed{\text{Lease Income}}$	Operating
Sales-type / Direct Financing	~~PP&E (underlying asset)~~ Lease Receivable	Interest Income Gain/Loss on Sale	Operating

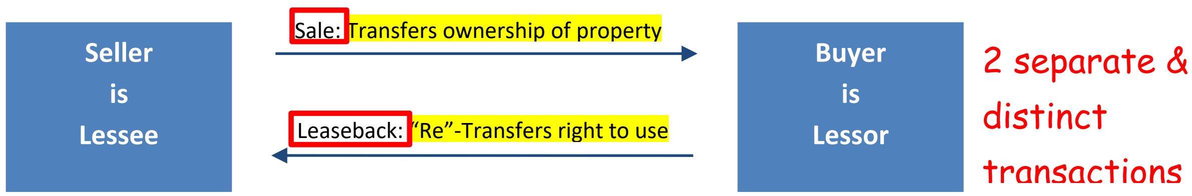
Lease classification [revise FAR 4.4 (III)]

- **LESSEE** - Must meet any **one criteria to treat the lease as a Finance Lease** (else, treat as Operating Lease): {"OWNER" – as if the lessor is selling the asset to the lessee and the lessee is the new OWNER}
  - O • Ownership transfer - The lease transfers ownership of the underlying asset to the lessee by the end of the lease term   Title transfer
  - W • Written purchase option - The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise
    - ✓ E.g., Lessee has a bargain purchase option to purchase the asset from the lessor at a price which is estimated to be 50% of the asset's then fair value   Bargain purchase option
  - N • No alternative use - The underlying asset is of a specialized nature such that it is expected to have no alternative use to the lessor at the end of the lease term
    - ✓ In other words, the asset is custom-made for the lessee's use (and no one else will have any use for it)
  - E • Equal or excess PV - The PV of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the FV of the underlying asset
    - ✓ Reasonable approach to assess this criteria: PV = **90% or more** than FV
    - ✓ In other words, lessee is heavily investing in the asset by committing to pay a lot of $
  - R • Remaining economic life - The lease term is for the major part of the remaining economic life of the underlying asset
    - ✓ Reasonable approach to assess this criteria: Lease term covers **75% or more** of the remaining economic life of the underlying asset
    - ✓ In other words, lessee will use the underlying asset for most of its life
    - ✓ However, if the commencement date falls at or near the end of the economic life of the underlying asset (say, in the last 25% of the total economic life of the underlying asset), do not use this criterion to classify the lease

- **LESSOR** - May account for as
  - **Sales-type Lease** - If any one of the "OWNER" criteria is met {"OWNER" – as if the lessor is selling the asset to the lessee and the lessee is the new OWNER}
  - If none of the OWNER criteria is met -
    - ✓ **Direct financing Lease** - recheck the "E" of "OWNER" criteria wherein:
      - ⇒ Any residual value guarantees from any other third party other than the lessee (but unrelated to the lessor) is included in the PV, and
      - ⇒ It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee
    - ✓ Operating Lease - any lease other than a sales-type lease or a direct financing lease

Sale Leaseback [replace FAR 4.4 (V)]

- **Property is sold by the owner and immediately leased back again** with the original owner/seller NOT giving up possession or use of the property on sale
  - Done mainly for cash management - Seller needs cash as well as continued possession/use of the property



- Determining whether the transfer of the asset is a "Sale" in the first place
  - **If the "leaseback" is an operating lease** (from seller-lessee's perspective), **transfer of the asset is a "Sale"**
    - ✓ Accounting by seller-lessee -
      - ⇒ Recognize the "Sale" of the transferred asset (per the Revenue Recognition standards). Therefore, the carrying amount of the underlying asset is now derecognized (since it's sold!)
      - ⇒ Account for the lease as an Operating lease
    - ✓ Accounting by buyer-lessor -
      - ⇒ Recognize the transferred asset (since the asset is purchased by the buyer-lessor!)
      - ⇒ Account for the lease as an Operating lease

  - **If the "leaseback" is a finance lease** (from seller-lessee's perspective), **transfer of the asset is NOT a "Sale"** (i.e., treat as if no "Sales" has happened)
    - ✓ Rationale: Seller-lessee has not satisfied any performance obligation per Step 5 of the Revenue Recognition standards [since control of the asset is not transferred to the buyer-lessor]
    - ✓ Accounting by seller-lessee -
      - ⇒ Do not derecognize the transferred asset (since no "sales" has happened per the Revenue Recognition standards!)
      - ⇒ Account for the amount received (from the buyer-lessor) as a financial liability
    - ✓ Accounting by buyer-lessor –
      - ⇒ Do not recognize the transferred asset (since no "sales" has happened!)
      - ⇒ Account for the amount paid (to the seller-lessee) as a receivable

Example on Sale-leaseback:

On 1/1/20X0, Shipping Corp. sold a ship with an estimated useful life of 20 years. Shipping Corp. simultaneously leased back the ship. Applicable data follows:

Sale price of ship at fair value	$925,000
Carrying value of ship	200,000
Monthly rental	10,000

$725,000 gain on sale

How should Shipping Corp. account for the sale on the lease commencement date assuming:

1. Lease-back period is 6 months after which the lease was not renewed (Operating Lease)
2. Lease-back period is 3 years (Operating Lease)
3. Lease-back period is 15 years (Finance Lease)

Solution - Part 1 of 3: Transfer of the asset is a Sale

Transfer of the ship is a sale. Therefore:

- Shipping Corp. recognizes gain on sale of $725,000 ($925,000 - $200,000)
- Shipping Corp. accounts for the lease as an operating lease recognizing a Lease right-to-use Asset and Lease Liability at lease commencement date (since the lease term is 1 year or less, may use the exemption available for short-term leases, and need not recognize the Lease Asset and Lease Liability)

Solution - Part 2 of 3: Transfer of the asset is a Sale

Transfer of the ship is a sale. Therefore:

- Shipping Corp. recognizes gain on sale of $725,000 ($925,000 - $200,000)
- Shipping Corp. accounts for the lease as an operating lease recognizing a Lease right-to-use Asset and Lease Liability at lease commencement date

Solution - Part 3 of 3: No Sale!

Since the leaseback is a finance lease, the transfer of the ship is NOT a "Sale". Therefore:

- Shipping Corp. does not recognize any sale, and continues to carry the ship at its carrying value of $200,000
- Shipping Corp. recognizes the $925,000 received as a financial liability on its B/S