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BDO KNOWS: LEASES

CONTENTS

INTRODUCTION 1
DISCLOSURE OBJECTIVE 2
PRESENTATION 3
DISCLOSURE 4
SALE AND LEASEBACK 8
LEVERAGED LEASES 8
OTHER DISCLOSURE CONSIDERATIONS 9
APPENDIX A DISCLOSURE EXAMPLE - LESSEE 10

FASB Topic 842: Presentation and Disclosure

INTRODUCTION

In February 2016, the Financial Accounting Standards Board ("FASB" or "the Board") issued its highly-anticipated leasing standard in ASU 2016-02 ("ASC 842" or "the new standard") for both lessees and lessors. Under its core principle, a lessee will recognize right-of-use ("ROU") assets and related lease liabilities on the balance sheet for all arrangements with terms longer than 12 months. The pattern of expense recognition in the income statement will depend on a lease's classification. See *BDO KNOWS: FASB Topic 842, Leases* for an overview of the standard.

During deliberations for the standard, many users indicated that the existing disclosure requirements did not provide sufficient information to understand an entity's leasing activities. As a result, the new standard also introduces an overall disclosure objective together with significantly enhanced presentation and disclosure requirements for leases.

DISCLOSURE OBJECTIVE

FASB Accounting Standards Codification (ASC) 842-20-50-1 and 842-30-50-1 provide that "the objective of the disclosure requirements is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases." The standard further indicates that "a lessee [lessor] shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. A lessee [lessor] shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or by aggregating items that have different characteristics."[1]

With that objective in mind, significant judgment will be required to determine the level of disclosures necessary for an entity. However, as a guiding principle, the basis for conclusions indicates "if leasing is a significant part of an entity's business activities, the disclosures would be more comprehensive than for an entity whose leasing activities are less significant…"[2] For example, although the new standard does not provide specific quantitative or qualitative disaggregation requirements such as those required under ASC 606, for entities for which leasing is a significant portion of their business, such disaggregation might be appropriate.

Entities must make appropriate disclosures for each annual reporting period for which a statement of comprehensive income (statement of activities) is presented and in each year-end statement of financial position. Entities are not required to repeat disclosures if the information is already presented in the financial statements as required by other accounting standards.

Although the majority of the disclosures required by ASC 842 only affect an entity's annual financial statements, the new standard requires that lessors provide a table disclosing lease income for each interim and annual reporting period.[3] Additionally, in the year of adoption, the Securities and Exchange Commission (SEC) requires public companies to include all required annual disclosures in any interim financial statements that are prepared until the next annual financial statements are filed – even if the disclosure requirements are only applicable for annual periods.

1 ASC 842-20-50-2 and ASC 842-30-50-2

2 ASU 2016-02 Background Information and Basis for Conclusions, paragraph BC 276

3 ASC 842-30-50-5

PRESENTATION

Lessee

A lessee is required to present ROU assets resulting from finance leases separately from ROU assets resulting from operating leases and separately from other assets, either on the face of the balance sheet or in the footnotes. Similarly, lease liabilities for finance leases are required to be presented separately from lease liabilities from operating leases and from other liabilities. In addition, ROU assets are presented as noncurrent in the lessee's balance sheet, consistent with how other amortizing assets such as PP&E are presented. However, the related lease liabilities are subject to current and long-term presentation requirements in a classified balance sheet, consistent with the way other financial liabilities are presented.

If the lessee chooses to report ROU assets and liabilities within other line items on the balance sheet rather than in separate captions, the lessee is prohibited from reporting finance lease ROU assets or finance lease liabilities in the same caption as operating lease ROU assets and operating lease liabilities. Additionally, disclosure of which line items in the statement of financial position include the ROU assets and lease liabilities would be required.

For finance leases, a lessee should present the interest expense on the lease liability and amortization of the ROU asset in a manner consistent with how the lessee reports other interest expense and depreciation or amortization expense in the income statement. For operating leases, the lessee must present both components together as lease expense within income from continuing operations, consistent with the presentation of other operating expenses. Lease expense should be classified within cost of sales; selling, general, and administrative expense; or another expense line item depending on the nature of the lease.

The new standard does not provide specific guidance on the presentation of variable lease payments (for either finance or operating leases). Paragraph BC271 in the basis of conclusions for ASU 2016-02 indicates that amounts recognized in the income statement should be presented within income from continuing operations. We believe that presentation as either lease expense or interest expense may be appropriate, depending on the nature of the lease. In making this determination, lessees should assess whether the payments are more akin to lease payments or interest.

The cash flow classification of payments related to finance leases should be consistent with the classification of payments associated with other financial liabilities. Payments of principal should be presented as financing activities, while payments of interest would typically result in operating cash flow presentation. Payments related to operating leases, leases to which the lessee has applied the practical expedient for short term leases, and any variable lease payments for either operating or finance leases should all be classified as operating cash outflows (unless the payment represents a cost of bringing another asset to the condition and location necessary for its intended use, in which case it should be classified within investing activities). Additionally, the establishment of ROU assets and lease liabilities at inception of a lease (or that change as a result of lease modifications or reassessment events) should be disclosed as noncash investing and financing activities.

Lessor

A lessor is required to present lease assets (i.e., net investment in leases) resulting from sales-type and direct financing leases separately from other assets in the balance sheet. Lease assets are financial assets that are subject to current and long-term presentation requirements in a classified balance sheet.

For operating leases, the assets underlying the leases and related depreciation are presented in accordance with other accounting guidance (e.g., ASC 360). Assets subject to lease under operating leases should be presented separately from owned assets that are held and used by the lessor as they are subject to different risks. Any rent receivable, deferred rent revenue (i.e., that results from requirement to recognize rents on a straight-line basis), or prepaid initial direct costs would be subject to current and long-term presentation requirements.

Income arising from leases should be presented separately in the income statement or in the footnotes. If presented in the footnotes, a lessor must also disclose which line items include lease income. Revenue and cost of goods sold related to profit or loss on leases recognized at the commencement date should be presented on a gross basis if the lessor uses leases as an alternative means of realizing value from goods that it would otherwise sell. If the lessor uses leasing as a means of providing finance, profit or loss should be presented on a net basis (i.e., as a single line item).

The new standard does not provide specific guidance on the presentation of variable lease payments received for direct financing or sales type leases. We believe that presentation as either lease income or interest income may be appropriate, depending on the nature of the lease. In making this determination, Lessors should assess whether the payments are more akin to lease payments or interest.

Lessors must classify all cash receipts from leases as operating activities in the statement of cash flows.

DISCLOSURE

As noted previously, the objective of the disclosure requirements in the new leasing standard is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. To help entities achieve this objective, the leasing standard prescribes quantitative and qualitative disclosures that are required for all entities.[4]

The following table summarizes the disclosure requirements of the leasing standard:

Summary of Required Disclosures[5]

	LESSEES – ANNUAL DISCLOSURES	LESSORS – ANNUAL DISCLOSURES	
Statement of Financial Position ASC 842-20-45-1 through 45-3	▶ Present, or disclose in the notes, separately from each other and from other assets and liabilities: • Finance lease right-of-use assets • Operating lease right-of use assets • Finance lease liabilities • Operating lease liabilities ▶ Classify right-of-use assets and lease liabilities as current or noncurrent consistent with the way similar nonfinancial assets and financial liabilities are classified ▶ Disclose which line items in the statement of financial position include the right-of-use assets and lease liabilities ▶ Lessee is prohibited from presenting: • Finance lease right-of-use assets in the same line item as operating lease right-of-use assets • Finance lease liabilities in the same line item as operating lease liabilities	**Sales-Type and Direct Financing Leases** ▶ Present lease assets separately from other assets in the statement of financial position ▶ Classify lease assets as current or noncurrent consistent with the way similar assets are classified **Operating Leases** ▶ Present the underlying assets subject to an operating lease in accordance with other accounting standards	Statement of Financial Position ASC 842-30-45-1 through 45-2 and 842-30-45-6
Statement of Comprehensive Income ASC 842-20-45-4	▶ For finance leases, present interest expense on the lease liability and amortization of the right-of-use asset in a manner consistent with how the entity presents other interest expense and depreciation and amortization of similar assets, respectively. ▶ For operating leases, lease expense should be included in income from continuing operations	▶ Present, or disclose in the notes, income arising from leases. ▶ Disclose which line items in the statement of comprehensive income include lease income ▶ Present profit or loss on the lease recognized at the commencement date in a manner that best reflects the lessor's business model, for example: • Present revenue and cost of goods sold relating to leasing activities in separate line items if lessor uses leases as an alternative means of realizing value from goods it would otherwise sell • Present profit or loss in a single line item if lessor uses lease for purposes of providing finance	Statement of Comprehensive Income

4 Unlike other recent standards, ASC 842 does not distinguish between public entities and all other entities. The disclosure principal and related requirements apply to all entities.

5 This summary of required disclosures may be useful in understanding the general disclosure requirements; however it should not be used in place of the leases standard.

Summary of Required Disclosures[5]

Statement of Cash Flows **ASC 842-20-45-5**	▶ Classify repayments of the principal portion of the lease liability arising from finance leases within financing activities ▶ Classify interest on the lease liability arising from finance leases in accordance with requirements relating to interest paid in ASC 230 on cash flows ▶ Classify payments arising from operating leases within operating activities, except to the extent that those payments represent costs to bring another asset to the condition and location necessary for its intended use, which should be classified within investing activities ▶ Classify variable lease payments and short-term lease payments not included in the lease liability within operating activities	▶ Classify cash receipts from leases within operating activities[6]	**Statement of Cash Flows** **ASC 842-30-45-5 and 842-30-45-7**
Qualitative Information **ASC 842-20-50-3(a) through 50-3(b) and 842-20-50-4**	▶ Information about the nature of its leases, including • A general description of the leases • The basis and terms and conditions on which variable lease payments are determined • 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-of-use assets and lease liabilities and those that are not. • The existence and terms and conditions of residual value guarantees provided by the lessee. • The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations • Identify the information relating to subleases included in the above disclosures. ▶ Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset. ▶ Disclose lease transactions between related parties	▶ Information about the nature of its leases, including • A general description of the leases • The basis and terms and conditions on which variable lease payments are determined • The existence and terms and conditions of options to extend or terminate the lease. • The existence and terms and conditions of options for a lessee to purchase the underlying asset. ▶ Disclose lease transactions between related parties ▶ Information about how lessor manages risk associated with the residual value of its leased assets • Risk management strategy for residual assets • Carrying amount of residual assets covered by residual value guarantees • Any other means by which the lessor reduces its residual asset risk, for example: – Buyback agreements – Variable lease payments for use in excess of specified limits	**Qualitative Information** **ASC 842-30-50-3(a), 842-30-50-4, and 842-30-50-7**

6 In March 2019, the FASB issued ASU 2019-01, Leases (842): Codification Improvements. The ASU allows lessors within the scope of ASC 942, Financial Services – Depository and Lending, to continue to report principal payments received under leases as investing activities.

Summary of Required Disclosures[5]

Significant Judgments
ASC 842-20-50-3(c)

- Information about significant assumptions and judgments made, including:
  - The determination of whether a contract contains a lease
  - The allocation of consideration in a contract between lease and nonlease components
  - The determination of the discount rate for the lease

Significant Judgments
ASC 842-30-50-3(b)

- Information about significant assumptions and judgments made, including:
  - The determination of whether a contract contains a lease
  - The allocation of consideration in a contract between lease and nonlease components (unless a lessor elects the practical expedient in paragraph 842-10-15-42A and all nonlease components in the contract qualify for that practical expedient)
  - The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term

Quantitative Disclosures
ASC 842-20-50-4 and 50-6

- For each period presented, disclose amounts related to a lessee's total lease cost (including both amounts recognized in income and capitalized) and the cash flows arising from lease transactions
  - Finance lease cost, segregated between:
    - Amortization of right-of use assets
    - Interest on lease liabilities
  - Operating lease cost
  - Short-term lease cost
    - Excluding expenses relating to leases with a lease term of one month or less
  - Variable lease cost
  - Sublease income, disclosed on a gross basis, separate from finance or operating lease expense
  - Net gain or loss recognized from sale and leaseback transactions
  - Amounts segregated between those for finance and operating leases for:
    - Cash paid for amounts included in the measurement of lease liabilities segregated between operating and financing cash flows
    - Supplemental noncash information lease liabilities arising from obtaining right-of-use assets
    - Weighted-average remaining lease term
    - Weighted-average discount rate (ASC 842-20-55-53 provides an example of these disclosures.)

Quantitative Disclosures
ASC 842-30-50-5 through 50-6 and 842-30-50-8 through 50-13

- For each period[7] presented, disclose in tabular format:
  - Sales-type leases and direct financing leases
    - Profit or loss recognized at the commencement date
    - Interest income (either in aggregate or separated by components of the net investment in the lease)
    - Lease income relating to variable lease payments not included in the measurement of the lease receivable
  - Operating leases
    - Lease income relating to lease payments, including variable lease payments
- Disclose the components of the lessor's aggregate net investment in sales-type and direct financing leases:
  - Carrying amount of lease receivables
  - Unguaranteed residual assets
  - Deferred selling profit on direct financing leases
- Sales-Type and Direct Financing Leases
  - Explain significant changes in the balance of unguaranteed residual assets and deferred selling profit on direct financing leases
  - Disclose maturity analysis (i.e., 5-year table) of undiscounted lease receivables
    - Provide reconciliation of undiscounted cash flows to the lease receivables recognized in the statement of financial position (or disclosed separately in the notes)

7 The disclosures regarding lease income as discussed in ASC 842-30-50-5 are required for each annual and interim (e.g., quarterly) reporting period

Summary of Required Disclosures[5]

Quantitative Disclosures (cont)	▶ Disclose maturity analysis of undiscounted lease liabilities (i.e., 5-year table) separately for finance leases and operating leases • Provide reconciliation of undiscounted cash flows to the finance lease liabilities and operating lease liabilities recognized in the statement of financial position	▶ Operating Leases • Disclose maturity analysis (i.e., 5-year table) of lease payments to be received • Provide disclosures required by ASC 360 on property, plant, and equipment separately for underlying assets under operating leases from owned assets	Quantitative Disclosures (cont)
Policy Elections and Practical Expedients ASC 842-20-50-8 through 50-9	▶ Disclose policy election for short-term leases, if elected • If the short-term lease expense does not reasonably reflect the lessee's short-term lease commitments, disclose that fact and the amount of short-term lease commitments. ▶ Disclose practical expedient for not separating lease components from non-lease components, if elected • Class or classes of underlying assets to which the election applies	▶ An entity that elects the practical expedient to not separate nonlease components from associated lease components (including an entity that accounts for the combined component entirely in ASC 606 on revenue from contracts with customers) shall disclose the following by class of underlying asset: • Accounting policy election and the class or classes of underlying assets for which it has elected to apply the practical expedient • The nature of – The lease components and nonlease components combined as a result of applying the practical expedient – The nonlease components, if any, that are accounted for separately from the combined component because they do not qualify for the practical expedient • The accounting standard the entity uses to account for the combined component (i.e., ASC 842 or ASC 606)	Policy Elections and Practical Expedients ASC 842-30-50-3A

SALE AND LEASEBACK

If a seller-lessee enters into a sale and leaseback transaction, it must provide the disclosures required for lessees. Similarly, a buyer-lessor must provide the disclosures for lessors. Additionally, a seller-lessee must disclose the main terms and conditions of the sale and leaseback transaction and must disclose any gains or losses arising from the transaction separately from gains or losses on disposal of other assets.

LEVERAGED LEASES

Although ASC 842 removed leveraged lease accounting, leases that met the definition of a leveraged lease under ASC 840 that commenced before the effective date of ASC 842 are grandfathered in. As such, entities that continue to have leveraged leases must continue to provide disclosures as required by ASC 842-50, which carries forward existing guidance from ASC 840.

OTHER DISCLOSURE CONSIDERATIONS

Transition

The leasing standard requires an entity to provide the general disclosures required by ASC 250 Accounting Changes and Error Corrections. Entities are also required to provide an explanation to users of financial statements about which practical expedients were used in transition.

SAB 74 Disclosures

In periods prior to adoption of the leasing standard, entities are required to make disclosures under the SEC's Staff Accounting Bulletin No. 74 (codified in SAB Topic 11.M), *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period* ("SAB 74"). SAB 74 requires that when a recently issued accounting standard has not yet been adopted, a registrant disclose the potential effects of the future adoption in its interim and annual SEC filings. SAB 74 disclosures should be both qualitative and quantitative. According to Center for Audit Quality Alert 2017-03, ***SAB Topic 11.M – A Focus on Disclosures for New Accounting Standards***, the SEC staff expects that SAB 74 disclosures will become more robust and quantitative as the new accounting standard's effective date approaches. As such, the following types of SAB 74 disclosures are expected in a registrant's financial statements in the periods before new accounting standards are effective:

- **A comparison of accounting policies.** Registrants should compare their current accounting policies to the expected accounting policies under the new accounting standard(s).
- **Status of implementation.** The status of the process should be disclosed, including significant implementation matters not yet addressed or if the process is lagging.
- **Consideration of the effect of new footnote disclosure requirements in addition to the effect on the balance sheet and income statement.** A new accounting standard may not be expected to materially affect the primary financial statements; however, it may require new significant disclosures that require significant judgments.
- **Disclosure of the quantitative impact of the new accounting standard if it can be reasonably estimated.**
- **Disclosure that the expected financial statement impact of the new accounting standard cannot be reasonably estimated.**
- **Qualitative disclosures.** When the expected financial statement impact is not yet known by a registrant, a qualitative description of the effect of the new accounting standard on the registrant's accounting policies should be disclosed.

Selected Financial Data – 5 Year Table

Some SEC registrants have questioned whether they must recast all periods reflected in the 5 year Summary of Selected Financial Data in accordance with the new leasing standard? In short, the answer is "no". Registrants are only required to adjust the periods in the financial data table that correspond to the periods adjusted in the registrant's financial statements. For example, an entity that elects to adopt the new standard as of the effective date (i.e., without restating prior comparative periods), will not adjust the four prior periods in the selected financial data table. Companies will be required to provide the disclosures required by Instruction 2 to S-K Item 301 regarding comparability of the data presented.

APPENDIX A

Disclosure Example - Lessee

BACKGROUND

For purposes of this example, we have assumed that Susie's Stitch-n-Sew ("Susie's") is a national retailer of fabrics and other craft materials which primarily leases its retail locations. We have not presented a statement of financial position, but have assumed that Susie's has presented the following captions:

- Operating lease ROU assets
- Fixed assets, net
- Current portion of operating lease liabilities
- Long-term operating lease liabilities
- Current portion of long-term debt
- Long-term debt

We have also not presented a statement of comprehensive income, but have assumed that Susie's has presented Cost of sales, SG&A expense, Depreciation and amortization expense, and Interest expense.

This example assumes that the guidance in ASC 842 has been in effect for all periods presented, and that all amounts are in millions.

NOTE X. LEASES

Susie's has historically entered into a number of lease arrangements under which we are the lessee. Specifically, of our 250 retail locations, 240 are subject to operating leases and 5 are subject to finance leases. In addition, we lease our corporate headquarters facility, as well as various warehouses and regional offices. We are also a party to an additional 12 leases in which we previously operated a retail location, but which are now subleased to third parties. In addition, we have elected the short-term lease practical expedient related to leases of various equipment used in our retail locations.

As of December 31, 20X9, we have entered into eight leases for additional retail locations and one lease for an additional warehouse which have not yet commenced. Although certain of the retail locations are currently under construction, we do not control the building during construction, and are thus not deemed to be the owner during construction.

All of our retail leases include multiple optional renewal periods. Upon opening a new retail location, we typically install brand-specific leasehold improvements with a useful life of eight years. To the extent that the initial lease term of the related lease is less than the useful life of the leasehold improvements, we conclude that it is reasonably certain that a renewal option will be exercised, and thus that renewal period is included in the lease term, and the related payments are reflected in the ROU asset and lease liability. Generally, we do not consider any additional renewal periods to be reasonably certain of being exercised, as comparable locations could generally be identified within the same trade areas for comparable lease rates.

All of our leases include fixed rental payments, but many of our leases also include variable rental payments. Specifically, a number of our leases in certain markets require rent payments that are calculated as a percentage of sales in that location. In addition, we also commonly enter into leases under which the lease payments increase at pre-determined dates based on the change in the consumer price index. While the majority of our leases are gross leases, we also have a number of leases in which we make separate payments to the lessor based on the lessor's property and casualty insurance costs and the property taxes assessed on the property, as well as a portion of the common area maintenance associated with the property. We have elected the practical expedient not to separate lease and nonlease components for all of our building leases.

During 20X9, 20x8 and 20x7, we recognized rent expense associated with our leases as follows:

	20x9	20x8	20x7
Operating lease cost:			
Fixed rent expense	$23.7	$22.6	$20.5
Variable rent expense	3.8	3.6	3.4
Finance lease cost:			
Amortization of ROU assets	2.5	2.4	2.2
Interest expense	2.0	2.1	2.0
Short-term lease cost	0.2	0.2	0.3
Sublease income	(1.3)	(1.1)	(1.2)
Net lease cost	$30.9	$29.8	$27.2
Lease cost – Cost of sales	$4.2	$4.0	$4.1
Lease cost – SG&A	22.2	21.3	18.9
Lease cost – Depreciation and amortization	2.5	2.4	2.2
Lease cost – Interest expense	2.0	2.1	2.0
Net lease cost	$30.9	$29.8	$27.2

Amounts recognized as right-of-use assets related to finance leases are included in Fixed assets, net in the accompanying statement of financial position, while related lease liabilities are included in Current portion of long-term debt and Long-term debt. As of December 31, 20x9 and 20x8, right-of-use assets and lease liabilities related to finance leases were as follows:

	20x9	20x8
Finance lease ROU assets	$17.6	$17.0
Finance lease liabilities:		
Current portion of long-term debt	2.2	2.2
Long-term debt	15.3	15.1

During the years ended December 31, 20x9, 20x8 and 20x7, we had the following cash and non-cash activities associated with our leases:

	20x9	20x8	20x7
Cash paid for amounts included in the measurement of lease liabilities:			
Operating cash flows from operating leases	$26.0	$25.7	$24.8
Operating cash flows from finance leases	2.0	2.1	2.0
Financing cash flows from finance leases	2.0	1.9	1.9
Non-cash investing and financing activities:			
Additions to ROU assets obtained from:			
Net lease cost	$30.9	$29.8	$27.2
New operating lease liabilities	$18.7	$20.3	$16.2
New finance lease liabilities	-	3.4	-

The future payments due under operating and finance leases as of December 31, 20x9 is as follows:

	Operating	Finance
Due in 20y0	$ 22.6	$ 2.2
20y1	23.9	3.8
20y2	24.7	3.6
20y3	22.4	3.2
20y4 and thereafter	35.2	6.1
	128.8	18.9
Less effects of discounting	(35.9)	(3.6)
Lease liabilities recognized	$ 92.9	$15.3

As of December 31, 20x9 and 20x8, the weighted-average remaining lease term for all operating leases is 3.4 years and 3.5 years, respectively, while the weighted-average remaining lease term for all finance leases is 4.9 years and 5.6 years, respectively.

Because we generally do not have access to the rate implicit in the lease, we utilize our incremental borrowing rate as the discount rate. The weighted average discount rate associated with operating leases as of December 31, 20x9 and 20x8 is 4.2% and 4.0%, respectively, while the weighted-average discount rate associated with finance leases is 3.9% and 3.8%, respectively.

Contact:

THOMAS FAINETEAU
National Assurance Partner
214-243-2924 / tfaineteau@bdo.com

JON LINVILLE
National Assurance Director
214-243-2940 / jlinville@bdo.com

JIN KOO
National Assurance Partner
214-243-2941 / jkoo@bdo.com

ANGELA NEWELL
National Assurance Partner
214-689-5669 / ajnewell@bdo.com