

Gray, Gray & Gray, LLP Leases (Topic 842)

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Agenda

- Background
- Lessee & Lessor Accounting
- Measurement
- Financial Statements & Disclosure
- Transition
- Software
- Next steps
- Questions & Discussion

Background

FASB ASC 842 - Scope

- Applicable to any entity that enters into a lease and applies to all leases and subleases of PP&E;
- Not applicable to leases of:
 - Intangible assets
 - Explore for or use of non-regenerative resources such as minerals, oil and natural gas
 - Biological assets, such as timber
 - Inventory
 - Assets under construction

Definition of a Lease

- The new standard defines a lease as a contract, or part of a contract, that conveys the right to control the use of identified PP&E (the underlying asset) for a period of time in exchange for considerations;
- Under the new ASU, a contract would not involve the use of an identified asset – and thus would not be a lease – if the supplier has the substantive right to substitute the asset to fulfill the contract

Effective Dates

- Public business entities – Fiscal years beginning after December 15, 2018;
- Certain not-for-profit entities – Fiscal years beginning after December 15, 2019;
- Effective for fiscal years beginning after December 15, 2021 for privately-held companies

Lessee & Lessor Accounting

Lessee Accounting

- Lessee would account for most capital leases as finance leases and most existing operating leases as operating leases
- Both financing leases and operating leases would create an asset (right-of-use – “ROU”); and a liability, initially measured at the present value of the lease payments, to be reflected on the balance sheet
- A company may make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities for leases whose term is less than 12 months

Lessee Accounting (continued)

- Leases will be classified in accordance with the principle in existing lease requirements (that is, determining whether a lease is effectively an installment purchase by the lessee).
- The income statement treatment of financing and operating leases is different
 - For financing leases, lessees will recognize amortization of the ROU asset separately from interest on the lease liability
 - For operating leases, lessees will recognize a single total lease expense

Lessee – Simple Operating Lease Under 840 (OLD METHOD)

- 5-year retail store lease entered at end of 2019
- Lessee takes (or has the right to take) possession of or controls the physical use of the retail location on 12/31/2019
- Rent payment equals \$1,000 the first year and increases \$100 each year thereafter. Total payments over 5 years is \$6,000
- Assume this is an operating lease

Year	(Expense) St. Line Rent	(Cash) Lease Payments	(Asset/Liability) Deferred Lease Liability	
			Current Year	Cumulative
2019	-	-		-
2020	1,200	1,000	200	200
2021	1,200	1,100	100	300
2022	1,200	1,200	-	300
2023	1,200	1,300	(100)	200
2024	1,200	1,400	(200)	-
	6,000	6,000	-	

Lessee – Simple Operating Lease Under 842 (NEW METHOD)

- 5-year retail store lease entered at end of 2019
- Rent payment equals \$1,000 the first year and increases \$100 each year thereafter. Total payments over 5 years is \$6,000
- Incremental Borrowing Rate is 6% on December 31, 2019
- No initial direct costs recognized

Year	Rent Expense (a)	Lease Liability				Right of Use Asset		
		Beg	Int. (6%) (b)	Payment	End	Beg	Amort. =(a)-(b)	Ending
2019	-	-	-	-	(5,006)	-	-	5,006
2020	1,200	(5,006)	(300)	1,000	(4,306)	5,006	(900)	4,106
2021	1,200	(4,306)	(258)	1,100	(3,465)	4,106	(942)	3,165
2022	1,200	(3,465)	(208)	1,200	(2,472)	3,165	(992)	2,172
2023	1,200	(2,472)	(148)	1,300	(1,321)	2,172	(1,052)	1,121
2024	1,200	(1,321)	(79)	1,400	-	1,121	(1,121)	-
5	6,000			6,000				

Lessor Accounting

Topic 842 did not make extensive changes to lessor accounting. However, despite the overall similarities between the lessor accounting guidance in Topic 842 as compared with Topic 840, the Board made certain changes:

- Changes in lease classification between sales-type and direct financing
- Recognition of selling profit
- Narrowed definition of initial direct costs

Lease and Non-Lease Components

- Lessees must allocate components of a contract on a relative standalone price basis;
- Lessees are permitted to make an accounting policy election by class of underlying asset: They may separate the lease and non-lease components or account for the lease and non-lease components together as a single component

Non-Lease Components

- Distinct elements of a contract that are not related to securing the use of the leased asset
- Arrangements that include both lease and non-lease components are common in real estate transactions
 - For example, if the landlord/lessor of a property provides common area maintenance (CAM) of leased office space, such as cleaning and landscape services, the CAM involves delivery of a separate service and is not considered a cost of securing the office building. As such, it is considered a non-lease component

Short-Term Lease Exception

A short-term lease is a lease that on the commencement date has a maximum term of 12 months. The 12 months includes any renewal options that the lessee is reasonably certain to exercise. Leases that contain a renewal option that the lessee is reasonably certain to exercise after the 12 months do not qualify as a short-term lease. An entity must consider all relevant factors to determine whether the lessee is reasonably certain to exercise any options. A lessee may elect an accounting policy to exempt short-term leases from the general recognition and measurement requirements in Subtopic 842-20. The lessee can make the accounting policy election by class of underlying asset.

When applying the short-term lease exception to a class of leases, a lessee does not recognize a right-of-use asset or a lease liability. Instead, the lessee must recognize the lease payments on a straight-line basis and the variable lease payments when incurred.

Lease Modifications

- Both a lessee and a lessor should account for a lease modification as a separate lease (e.g. separate from the original contract) when (a) the modification grants the lessee an additional right of use not included in the original lease and (b) the additional right of use is priced commensurate with its standalone price
- Lease modifications that only extend the lease term never qualify as a new lease because they do not grant the lessee an additional right of use but only change the right of use the lessee already controls

Measurement

Measurement – Lease Term and Extension Options

- In determining the lease term, an entity should consider all relevant factors that create an economic incentive to exercise an option to extend, or not to terminate, a lease
- Such an option should be included in the lease term only if it is reasonably certain that the lessee will exercise the option having considered all relevant economic factors, or if exercise of the option is controlled by the lessor

Measurement – Discount Rate

Generally, a lessee must use the rate implicit in the lease when it is able to readily determine the rate. When the lessee is not able to readily determine the rate implicit in the lease, it must use its incremental borrowing rate. A nonpublic entity can elect an accounting policy to use a risk-free discount rate instead of its incremental borrowing rate. This election is made by underlying asset class or group. A nonpublic entity that makes this election must disclose its election, including the asset classes.

Measurement – Incremental Borrowing Rate

The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.

Measurement – Risk-Free Discount Rate

The risk-free rate is the rate investors expect to earn from an investment that carries zero risk over a period of time, such as a government treasury bill. The risk-free rate should be determined using a period comparable with the lease term.

https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value_month=202208

Select type of Interest Rate Data												
Daily Treasury Par Yield Curve Rates												
Select Time Period												
Current Month												
Apply												
Date	1 Mo	2 Mo	3 Mo	6 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
08/01/2022	2.22	2.33	2.56	2.96	2.98	2.90	2.82	2.66	2.64	2.60	3.12	2.92

Financial Statements & Disclosures

Balance Sheet Classification

- Lessees should disclose as separate line items on the balance sheet assets that result from financing leases, assets that result from operating leases, liabilities that result from financing leases, and liabilities that result from operating leases
- Alternatively, lessees may disclose those amounts in the notes to the financial statements, also indicating which line items in the balance sheet contain those amounts

Sample Balance Sheet



ASSETS	2022	2021
CURRENT ASSETS		
Cash and cash equivalents	\$ 2,515,948	\$ 841,865
Accounts receivable, net of allowance for bad debts of \$70,000 in 2022 and 2021	5,670,434	9,323,440
Inventories, net	8,476,792	6,442,049
Prepaid expenses and other current assets	180,186	165,718
TOTAL CURRENT ASSETS	16,843,360	16,773,072
PROPERTY AND EQUIPMENT, NET	380,782	420,662
OTHER ASSETS		
Security deposits	3,241	3,241
Right-of-use assets	1,653,764	-
TOTAL OTHER ASSETS	1,657,005	3,241
TOTAL ASSETS	\$ 18,881,147	\$ 17,196,975

CURRENT LIABILITIES		
Line of credit	\$ 600,000	\$ 3,200,000
Current portion of long-term debt	300,000	300,000
Current portion of financing leases	68,800	78,500
Current portion of lease liabilities	320,227	-
Accounts payable and accrued expenses	8,217,524	6,318,117
TOTAL CURRENT LIABILITIES	9,506,551	9,896,617
LONG-TERM LIABILITIES		
Long-term debt, net of current portion	350,000	650,000
Financing leases, net of current portion	105,600	184,100
Lease liabilities, net of current portion	1,316,305	-
TOTAL LONG-TERM LIABILITIES	1,771,905	834,100
TOTAL LIABILITIES	11,278,456	10,730,717
MEMBERS' EQUITY	7,602,691	6,466,258
TOTAL LIABILITIES AND MEMBERS' EQUITY	\$ 18,881,147	\$ 17,196,975

Statement of Cash Flows Presentation ^g3

- Lessees should classify cash payments related to leases as follows:
 - Cash payments for the principal portion of the lease liability arising from financing leases within financing activities;
 - Cash payments for the interest portion of the lease liability arising from the finance leases within operating activities;
 - Cash payments arising from operating leases within operating activities; and
 - Variable lease payments and short-term payments not included in the lease liability within operating activities

	2022	2021
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 2,576,133	\$ 5,507,760
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	78,991	51,592
Amortization of right of use assets	186,113	244,870
(Increase) decrease in assets:		
Accounts receivable	3,653,006	1,211,036
Inventory	(2,034,743)	235,963
Security deposits	-	35,071
Prepaid expenses and other current assets	(180,186)	16,652
Increase (decrease) in liabilities:		
Accounts payable and accrued expenses	1,899,407	(1,340,173)
Payments on lease liabilities	(205,220)	(263,909)
NET CASH PROVIDED BY OPERATING ACTIVITIES	5,973,501	5,698,862
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(68,552)	(116,618)
NET CASH (USED) BY INVESTING ACTIVITIES	(68,552)	(116,618)
CASH FLOWS FROM FINANCING ACTIVITIES		
Line of credit, net	(300,000)	(3,000,000)
Payments of finance leases	(88,200)	
Payment of long-term debt	(300,000)	(275,000)
Members' distributions	(3,542,666)	(1,465,379)
NET CASH (USED) BY FINANCING ACTIVITIES	(4,230,866)	(4,740,379)
INCREASE IN CASH AND CASH EQUIVALENTS	1,674,083	841,865
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	841,865	
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 2,515,948	\$ 841,865

Statement of Cash Flows Supplemental Information

Lease assets obtained in exchange for lease obligations:		
Operating leases		\$ 170,000
Finance leases		\$ 25,000

Disclosures

- Lessees are required to disclose both qualitative and quantitative information about leases, including, among other things:
 - The nature and terms of the leases;
 - Information about leases that have not yet commenced but that create significant rights and obligations for the lessee;
 - Significant assumptions and judgements made in applying the leases standard;
 - The main terms and conditions of any sale-leaseback transaction; and;
 - Accounting policy elections for the short-term lease exemption and risk-free rate, as applicable.
 - Variable leasing costs

Sample Disclosures – Accounting Policies

NOTE 2 – ACCOUNTING POLICIES

Recent Accounting Pronouncement: In February 2016, the FASB issued new guidance related to the accounting for leases. The new standard, ASC 842, “Leases”, replaces all current GAAP guidance on this topic. The new standard, among other things, requires a lessee to classify a lease as either an operating or financing lease, and to recognize a lease liability and a right-of-use asset for these leases on the balance sheet. The Company adopted the standard effective January 1, 2022 using the modified retrospective approach, which uses the effective dates as the initial date of application on transition with no retrospective adjustments to prior periods. The adoption of ASC 842 resulted in the initial recognition of right-of-use assets and corresponding lease liabilities of approximately \$1,770,000 on the Company’s balance sheet effective January 1, 2022.

Operating Leases: The Company has elected to use a risk-free rate as the discount rate for its leases. This election was made for all leases of the Company.

The Company has elected the short-term lease recognition exemption for all applicable classes of underlying assets. Leases with an initial term of 12 months or less, that do not include an option to purchase the underlying asset that we are reasonably certain to exercise, are not recorded on the balance sheet.

The Company has lease agreements with lease and non-lease components, which are generally accounted for separately with amounts allocated to the lease and non-lease components based on stand-alone prices. For office space leases the Company accounts for the lease and non-lease components as a single lease.

Sample Disclosure –Leases

NOTE 10—LEASING ACTIVITIES

The Company has operating and financing leases of buildings for corporate offices and data centers and for certain equipment. Our leases have remaining lease terms of 1 year to 15 years, some of which include options to extend the leases for up to 5 years, and some of which include options to terminate the leases within 1 year.

The following summarizes the weighted average remaining lease term and discount rate as of December 31, 2022:

Weighted Average Remaining Lease Term

Operating leases	7 years
Finance leases	12 years

Weighted Average Discount Rate

Operating leases	2.61%
Finance leases	5.1%

The following represents the finance lease right-of-use assets included in property and equipment at December 31, 2022:

Equipment	\$100,000
Accumulated depreciation	<u>(60,000)</u>
Net book value	\$40,000

Sample Disclosure –Leases (continued)

NOTE 10—LEASING ACTIVITIES (CONTINUED)

The maturities of lease liabilities as of December 31, 2022 were as follows:

Year Ending December 31:	Operating	Finance
2023	\$220,227	25,003
2024	249,433	27,925
2025	294,254	30,023
2026	335,679	34,009
2027	363,938	39,442
Thereafter	326,002	44,547
Total lease payments	1,789,533	200,949
Less: interest	(153,001)	(26,549)
Present value of lease liabilities	<u>\$1,636,532</u>	<u>\$174,400</u>

Sample Disclosure –Leases (continued)

NOTE 10—LEASING ACTIVITIES (CONTINUED)

The following summarizes the line items in the income statements which include the components of lease expense for the year ended December 31, 2022:

Operating lease:

Operating lease expense included in SG&A	<u>\$253,518</u>
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Finance lease:

Finance lease costs:

Amortization of lease assets included in depreciation and amortization expense	\$ 22,363
Interest on lease liabilities included in interest expense	<u>7,857</u>
Total finance lease costs	<u>\$ 30,220</u>

Transition

Transition

- Both lessees and lessors must apply a modified retrospective transition approach
- Required for all leases existing at or commencing after the beginning of the earliest period presented in the financial statements
- No transition accounting is required for leases that expired prior to the date of initial application of the standard
- Practical expedients can be applied upon transition

Software

LeaseJava: Example Lease

The Client provided us with the following lease terms below:

Lease commencement date: 5/1/2020

Lease term: 60 months

Payments

Year 1	\$	15,000
Year 2	\$	17,000
Year 3	\$	19,000
Year 4	\$	21,000
Year 5	\$	23,000


Transition date: 1/1/2022

Deferred rent liability at transition date: (\$64,000)

Discount rate: 1.10%

LeaseJava | Add New Lease

customer.leasejava.com/gray,%20gray%20&%20gray,%20llp/leases/edit?lease_id=6323841786eba71ade8413e3&client_id=62d6bb2a2ed3954c8ea7223e

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Zack Wensley ▾

GRAY, GRAY & GRAY TRAINING COMPANY - EDIT LEASE

05/01/2020 TO 04/30/2025

1 General


2 Lease Details

3 Payments

4 Transition Data

5 Classification

6 Allocations



Asset type *

Building ▾

Lease name *

150 Royall Street

Asset description

Serial / VIN / Asset ID

Sq. Footage

Address Line 1

Address Line 2

City

State *

MA ▾

Zipcode

Select currency

USD ▾

LeaseJava Generated Reports

Journal Entries

Date	Rent Deposit	Rent Payment Suspense Account	Rou Asset	Lease liability	Rent expense	Modification	Impairment	Transition	Non lease
1/31/2022		(\$17,000.00)	\$726,483.24	(\$792,483.24)	\$19,000.00			\$64,000.00	
2/28/2022		(\$17,000.00)	(\$18,348.86)	\$16,348.86	\$19,000.00				
3/31/2022		(\$17,000.00)	(\$18,294.30)	\$16,294.30	\$19,000.00				
4/30/2022		(\$17,000.00)	(\$18,331.71)	\$16,331.71	\$19,000.00				
5/31/2022		(\$19,000.00)	(\$18,326.40)	\$18,326.40	\$19,000.00				
6/30/2022		(\$19,000.00)	(\$18,364.60)	\$18,364.60	\$19,000.00				
7/31/2022		(\$19,000.00)	(\$18,360.49)	\$18,360.49	\$19,000.00				
8/31/2022		(\$19,000.00)	(\$18,377.54)	\$18,377.54	\$19,000.00				
9/30/2022		(\$19,000.00)	(\$18,414.14)	\$18,414.14	\$19,000.00				
10/31/2022		(\$19,000.00)	(\$18,411.72)	\$18,411.72	\$19,000.00				
11/30/2022		(\$19,000.00)	(\$18,447.24)	\$18,447.24	\$19,000.00				
12/31/2022		(\$19,000.00)	(\$18,445.96)	\$18,445.96	\$19,000.00				

Next Steps

Next Steps

- Gather your leases
- Choose a software – GG&G is using LeaseJava
- Enter lease data into software – GG&G can help
- Post journal entries to GL
- Generate disclosure information

Questions & Discussion