Leases – Considerations After Adoption

ROU Asset Impairment

- Right of use asset is subject to the impairment guidance in ASC 360 *Property, Plant, and Equipment*
- Three steps to impairment:
  - Step 1: Indicators of impairment – consider whether impairment indicators are present
  - Step 2: Test for recoverability – compare the sum of estimated undiscounted cash flows attributable to the asset to the carrying amount of the asset
  - Step 3: Measurement of an impairment – determine the fair value of the asset and recognize an impairment loss
- If an impairment loss is recognized, the ROU asset will subsequently be amortized on a straight-line basis based on the revised carrying amount

Lease Modification – Separate Contract

- A modification is accounted for as a separate contract if both of the following conditions are present:
  - The modification grants the lessee an additional right of use
  - The lease payments increase commensurate with the standalone price for the additional right of use

- If both conditions are met, the lease modification results in two separate contracts

Lease Modification – Not a Separate Contract

- Classification of the lease shall be reassessed as of the effective date of the modification
- Initial direct costs, lease incentives, and other payments are accounted for in the same way as for a new lease

Lease Modification – Not a Separate Contract

- Remaining consideration in the contract should be reallocated and lease liability should be remeasured using a discount rate at the effective date of the modification if a modification does any of the following:
  - A) Grants the lessee an additional right of use not included in the original contract
  - B) Extends or reduces the term of the lease
  - C) Fully or partially terminates an existing lease
  - D) Changes the consideration in the contract

Lease Modification – Not a Separate Contract

- From the previous slide, if (A), (B), or (D) occurs, the lessee shall recognize the amount of the remeasurement of the lease liability as an adjustment to the ROU asset
- From the previous slide, if (C) occurs, the lessee shall decrease the ROU asset on a basis proportionate to the termination of the existing lease. Any difference between the reduction in the lease liability and the ROU asset is recognized as a gain or loss

Lease Modification – Term Change

Example 1 – Term Change

- Original Lease:
  - 10 year lease for 10,000 square feet
  - Lease payments $100,000 per year
  - Discount rate 6%
- Modification
  - 5 years later, the lease is extended for another 5 years (15 years total)
  - Lease payments $110,000 per year for remaining 10 years
  - Discount rate 7%

Lease Modification – Term Change

Example 1 – Term Change

- <u>Not</u> a separate contract
- Remeasure the liability based on remaining payments at new discount rate
- **Adjustment to remeasure the lease liability will be offset to the ROU asset**
- No gain or loss

Lease Modification – Decrease in Scope

Example 2 – Decrease in Scope

- Original Lease:
  - 10 year lease for 10,000 square feet
  - Lease payments $100,000 per year with 5% annual increases
  - Discount rate 6%
- Modification
  - 5 years later, the lease is modified to reduce leased space from 10,000 sq ft to 5,000 sq ft
  - Lease payments decreased to $68,000 with 5% annual increases
  - Discount rate 7%

Lease Modification – Decrease in Scope

Example 2 – Decrease in Scope

- Not a separate contract
- Remeasure the liability based on remaining payments at new discount rate
- **Recognize a gain or loss** using one of the following approaches:
  - Liability Approach
  - ROU Asset Approach

Lease Modification – Decrease in Scope

Example 2 – Liability Approach

Step 2: Reduce the ROU Asset by 48%

	Pre-Modification Balance	Post-Modification Balance	Reduce by 48%
ROU Asset	$514,436	$266,548	$(247,888)
Lease Liability	$(590,767)	$(306,098)	$284,669

Step 1: Remeasure Lease Liability. Represents a reduction of 48%

Step 3: Recognize a Gain of 36,781

FASB Accounting Standards Updates

ASU 2016-13 Financial Instruments – Credit Losses

- Applies to all financial instruments carried at amortized cost
  - Loans held for investment
  - Held-to-maturity debt securities
  - Trade receivables
  - Reinsurance recoverables
  - Receivables that relate to repurchase agreements
  - Securities lending arrangements
- Effective for private companies in fiscal years beginning after December 15, 2022 (calendar year 2023)

ASU 2016-13 Financial Instruments – Credit Losses

- The biggest change from current guidance is the way to estimate credit losses
- Expectation is that uncollectible amounts will now be reflected sooner in the financial statements

Old GAAP	New GAAP
Incurred loss method	**Currently expected credit losses model**
Credit losses are recognized when it becomes probable that a credit loss occurred	Immediately recognize an allowance for credit losses based on historical experience and <u>future expectations</u>

ASU 2023-01 Leases (Topic 842)

Common Control Arrangements

Issue #1

- Terms and Conditions to be Considered

Issue #2

- Accounting for Leasehold Improvements

ASU 2023-01 Leases (Topic 842)

Common Control Arrangements – ***Issue #1***

- Topic 840 required that related party leases be classified based on the economic substance when those terms and conditions were affected by the related party nature
- Topic 842 requires that entities determine whether a related party arrangement between entities under common control is a lease
- Must classify and account for the lease on the same basis as an arrangement with an unrelated party (on the basis of legally enforceable terms and conditions)
- Stakeholders of private companies indicated that determining enforceable terms could necessitate obtaining a formal legal opinion

ASU 2023-01 Leases (Topic 842)

*Common Control Arrangements – **Issue #1***

- ASU 2023-01 provides a practical expedient for private and NFP entities to use the written terms and conditions of a common control arrangement to determine:
  - Whether a lease exists and, if so,
  - The classification of and accounting for that lease
- If no written terms and conditions, an entity is prohibited from applying the practical expedient and must evaluate enforceable terms and conditions

ASU 2023-01 Leases (Topic 842)

Common Control Arrangements – ***Issue #1***

- Practical expedient may be applied on an arrangement-by-arrangement basis
- Expected to reduce the costs associated with implementing and applying Topic 842 and diversity in practice
- Not available to public business entities

ASU 2023-01 Leases (Topic 842)

*Common Control Arrangements – **Issue #2***

- Leasehold improvements (LHI) generally must have an amortization period consistent with the shorter of the remaining lease term and useful life of the improvements
- Stakeholders noted that amortizing LHI for related party leases over a period shorter than the expected useful life of the LHI may result in reporting that does not represent the economics of the LHI

ASU 2023-01 Leases (Topic 842)

*Common Control Arrangements – **Issue #2***

- This Update requires that LHI associated with common control leases be:
  - Amortized by the lessee over the useful life of the LHI to the common control group as long as the lessee controls the use of the underlying asset through a lease. If the lessor obtained the right to control the use of the underlying asset through a lease with a nonrelated entity, the amortization period may not exceed the amortization period of the common control group
  - Accounted for as a transfer between entities under common control through an adjustment to equity if the lessee no longer controls the use of the underlying asset
  - Apply to all entities

ASU 2023-01 Leases (Topic 842)

Common Control Arrangements

- Effective for fiscal years beginning after December 15, 2023 (calendar year 2024)
- Early adoption is permitted for annual financial statements that have not yet been made available for issuance
- Follow transition requirements if adopting concurrently with Topic 842 Otherwise, may adopt prospectively or retrospectively

ASU 2023-02 Investments – Equity Method and Joint Ventures

Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method

- ASU 2014-01 introduced an option to apply the proportional amortization method to account for investments made primarily for the purpose of receiving income tax credits or other income tax benefits
- Limited to investments in low-income-housing tax credit structures
- This Update permits reporting entities to elect to account for their tax equity investments, regardless of the tax credit program, using the proportional amortization method if certain conditions are met

ASU 2023-02 Investments – Equity Method and Joint Ventures

Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method

- Effective for public business entities for fiscal years beginning after December 15, 2023 (calendar year 2024)
- Effective for all other entities for fiscal years beginning after December 15, 2024 (calendar year 2025)
- Early adoption is permitted

ASU 2023-02 Business Combinations – Equity Method and Joint Ventures

Recognition and Initial Measurement

- No specific authoritative guidance on how a joint venture (JV), upon formation, should recognize and initially measure assets contributed and liabilities assumed
- This amendment affects the accounting for contributions received upon formation by entities that meet the definition of a JV
- Existing JV have the option to apply the guidance retrospectively

ASU 2023-02 Business Combinations – Equity Method and Joint Ventures

Recognition and Initial Measurement

- A JV is the formation of a new entity without an accounting acquirer.
- A JV measures its identifiable net assets and goodwill, if any, at the formation date (date the entity meets the definition of a JV)
- Initial measurement of a JV’s total net assets is equal to the fair value of 100% of the JV’s equity
- A JV must provide relevant disclosures regarding the nature and financial effect of the JV formation

ASU 2023-02 Business Combinations – Equity Method and Joint Ventures

Recognition and Initial Measurement

- Effective for all JV formations with a formation date on or after January 1, 2025
- A JV formed before January 1, 2025 may elect to apply the amendments retrospectively

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