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WHITE PAPER

THE NEW LEASE ACCOUNTING STANDARD – ASC 842

CONTENTS

EXECUTIVE SUMMARY

ASC 842 Leases fundamentally changes lease accounting for lessees. Operating leases which used to be treated "off-balance" are now required to be recognized on-balance, resulting in the recognition of a right-of-use asset and a lease liability. Thus, accounting for leases may lead to a significant increase of total assets and liabilities in the statement of financial position and affect key financial ratios. With the introduction of the new topic, companies are facing major procedural challenges which entail the need for systematic preparation and monitoring of all leases.

This white paper gives a concise overview of the new guidance and its major impacts on lessees.

You will learn:

- More about the objective of ASC 842.
- More about the new requirements introduced by ASC 842.
- How the new accounting standard will affect lessees.
- How you can use LucaNet to manage the implementation of the new requirements.

1 INTRODUCTION

ASC 842 has been a hot topic since its publication in 2016. Public business entities (PBEs) were already required to apply the new topic for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For private companies and private not-for-profit entities, the effective date for the standard has been deferred: they now must apply ASC 842 for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. ASC 842 may still be adopted early.

ASC 842 requires lessees to recognize a right-of-use asset and a lease liability in the financial statements for all leases, regardless of their classification as an operating lease or a finance lease (previously "capital lease"). This may lead to material changes in the balance sheet and affect key performance indicators of many companies – particularly those that have large numbers of leased assets classified as operating leases. Companies across all industries will have to report a significant increase in assets and liabilities on the balance sheet as a result of the new standard.

The development of ASC 842 originally started as a joint project of the FASB and IASB in 2006 to develop consistent requirements for lease accounting. The background was the fact that the majority of leases were previously classified as operating leases and thus not recognized on the balance sheet. Future lease payments from operating leases were only disclosed in the notes. Considering the high amount of off-balance sheet financing transactions, the FASB addressed this issue with the new lease accounting model: a right-of-use asset and lease liability must be recognized on the balance sheet for all leases, regardless of their classification. The FASB's objective is a more accurate representation of the lessee's rights and obligations from leases as well as fewer opportunities to structure lease transactions in order to achieve a particular outcome on the balance sheet. Transparency and comparability of lessee's financial statements should be improved as well due to the similar accounting requirements for operating and finance leases in ASC 842.

2 THE FUNDAMENTAL CHANGES

Lease Classification

The following flowchart presents the lease classification for lessees:

Lease Classification Criteria for Lessees

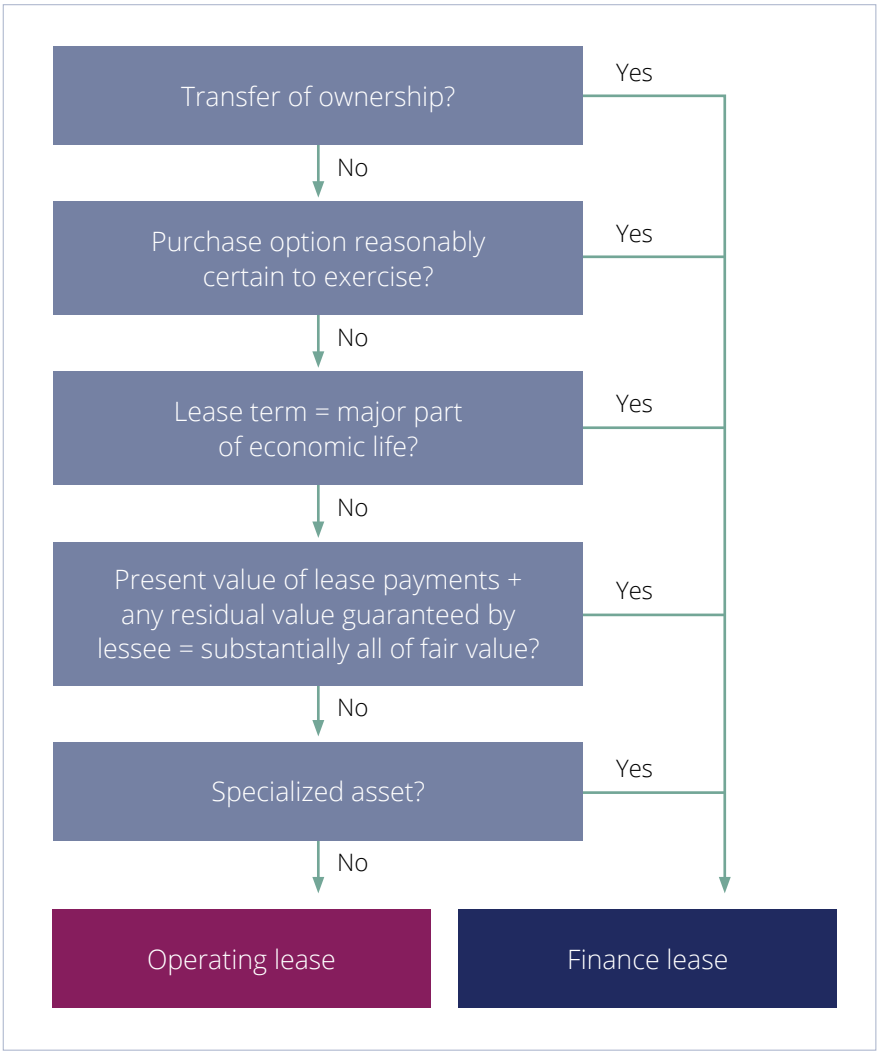

Figure 1: Lease classification for lessees (ASC 842-10-25-2)

Compared to the criteria under ASC 840, specialized assets with no alternative use to the lessor are an additional indicator for a finance lease under ASC 842.

Lessors still differentiate between operating leases, sales-type leases, and direct financing leases, similar to the previous classification criteria under ASC 840. The classification as a leveraged lease has been removed.

For determining the lease classification for lessors, the guidance for lessees applies. If none of the criteria for a sales-type lease is met, the lease is classified as either an operating lease or a direct financing lease.

Lease Classification Criteria for Lessors

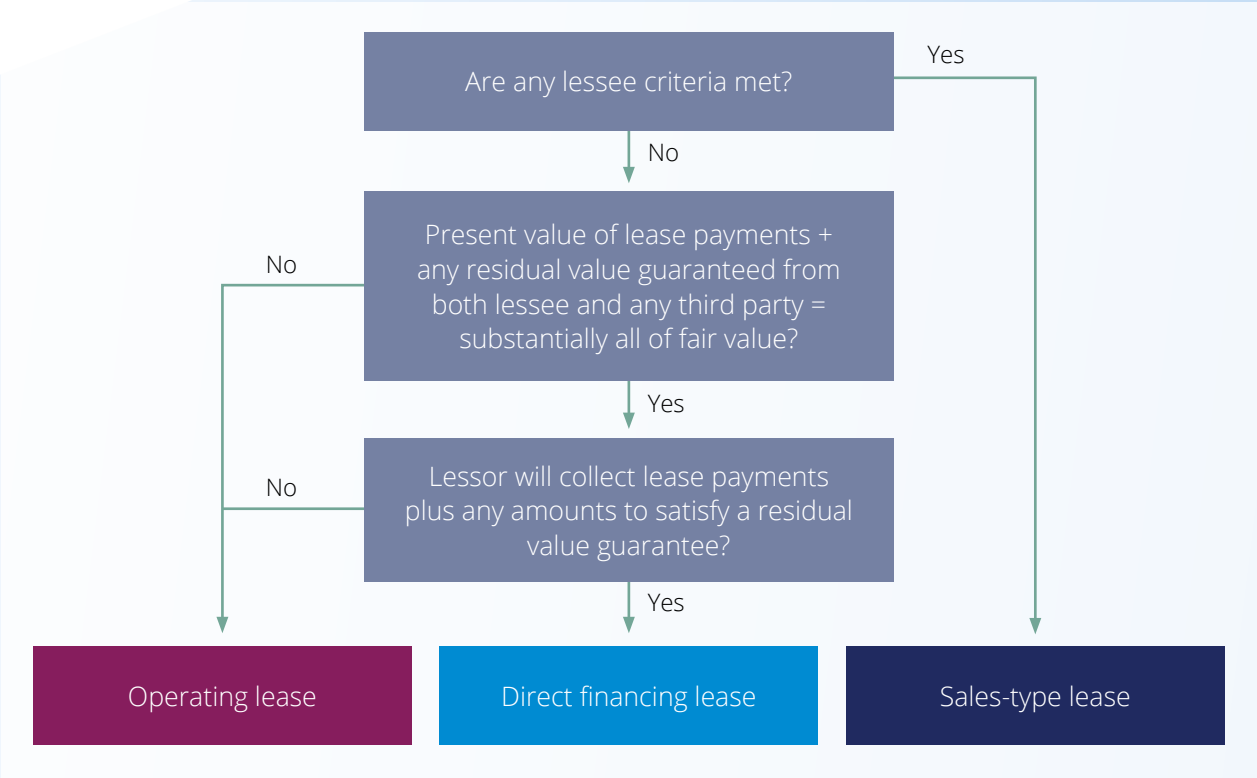

Figure 2: Lease classification for lessors (ASC 842-10-25-3)

Under previous guidance, the difference between a sales-type lease and a direct financing lease was the presence of upfront profit which classified the lease as sales-type. In ASC 842, the key distinction is based on control. This depends on whether the lease payments criterion is met in part due to a third-party residual value guarantee. If this is the case and lease payments are collectable, the lease is classified as direct financing lease.

Practical Expedient

ASC 842 contains a practical expedient for short-term leases. Lessees may choose to treat short-term leases in the same way as an operating lease according to ASC 840. In this case, lease expense is recognized on a straight-line basis in profit or loss over the lease term. Short-term leases have a lease term of no more than twelve months and do not include a purchase option.

Definition of a Lease

The FASB also revised the definition of a lease in ASC 842. The new definition focuses on control of an identified asset and may result in certain service contracts meeting the definition of a lease and thus being in scope of the new guidance for lease accounting. The following diagram provides a brief overview of the criteria which have to be considered to identify a lease according to ASC 842.

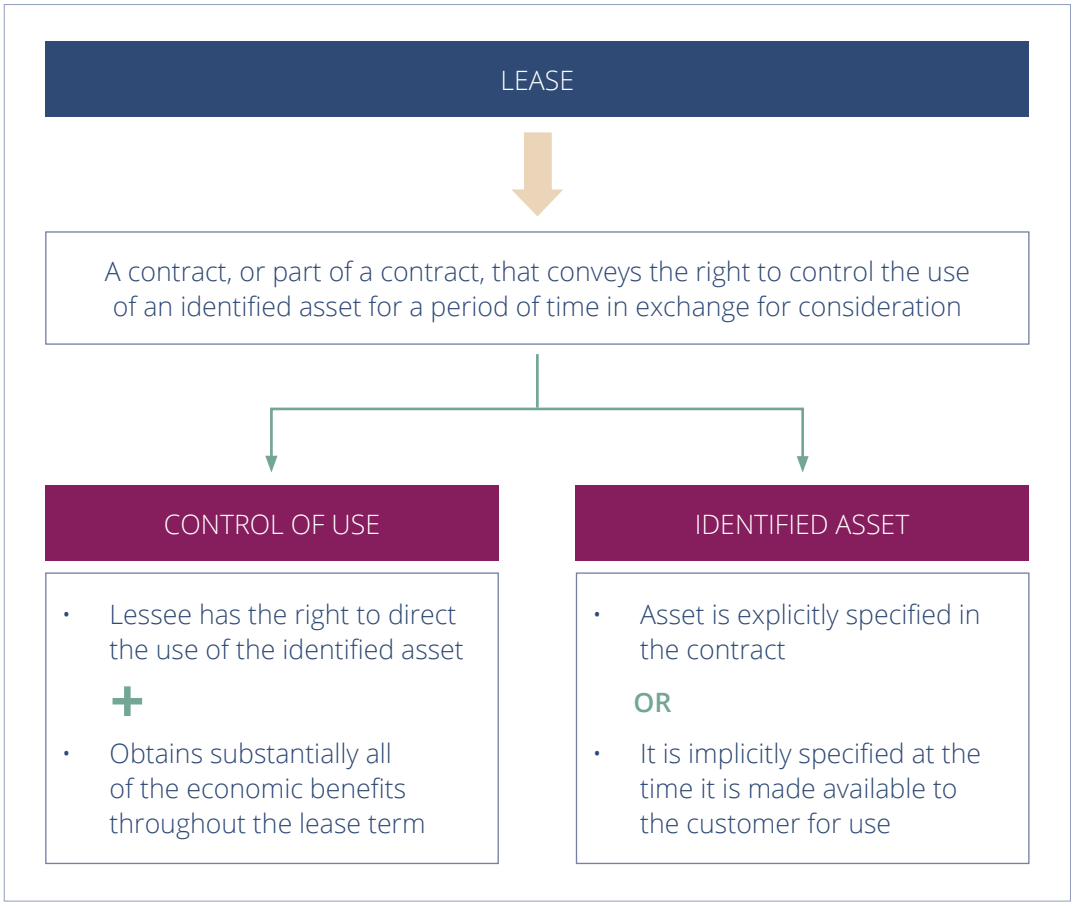

Figure 3: ASC 842 Definition of a lease (ASC 842-10-15-2 through -15-9)

Lessee Accounting

The main differences between operating and finance leases are the subsequent measurement of the right-of-use asset and the presentation of expenses in the income statement. Subsequent measurement for the lease liability is identical for operating and finance leases.

For finance leases, lessees are required to recognize amortization of the right-of-use asset separately from interest on the lease liability in the income statement. The right-of-use asset is generally amortized on a straight-line basis over the lease term.

For an operating lease, though, the lessee is required to recognize a single-periodic lease expense which represents the allocation of the lease payments and initial direct costs on a straight-line basis over the lease term. Interest expense and amortization are not presented separately in the income statement. Amortization of the right-of-use asset equals the difference between the single lease expense and the interest expense on the lease liability.

The Lease Liability

a) Initial measurement

The lease liability is initially measured at the present value of the future lease payments. The lease payments consist of:

- Fixed and in substance fixed payments,
- variable lease payments that depend on an index or a rate,
- the exercise price of an option to purchase the underlying asset,
- payments for penalties for terminating the lease term, and
- amounts expected to be payable under residual value guarantees.

When determining the discount rate for the lease for calculation of the present value of the lease payments, the lessee should use the rate implicit in the lease whenever that rate is readily determinable. However, in practice this rate often cannot be determined reliably; therefore, the lessee is required to use the incremental borrowing rate in the lease. For lessees that are non-PBEs it is permitted to use a risk-free discount rate for the lease.

b) Subsequent measurement

The subsequent measurement of the lease liability is based on the effective interest method for both operating and finance leases. The carrying amount of the lease liability is increased by interest calculated using the discount rate and reduced by lease payments made during the period.

The lessee is required to remeasure the lease liability using a revised discount rate if there is a change in the lease term, or a change in the assessment of a purchase option. A remeasurement of the lease liability is also required in cases where the amount expected to be paid under a residual value guarantee changes – this case, however, does not require a revision of the discount rate.

ASC 842 requires remeasurements of the lease liability to be recognized as an adjustment to the right-of-use asset. If the carrying amount of the right-of-use asset is reduced to zero due to the remeasurement, the lessee is required to recognize any remaining amount of the remeasurement in profit or loss.

c) Presentation

For finance leases, interest expense is presented separately from the amortization of the right-of-use asset, while it is presented as part of the single periodic lease expense for operating leases. Liabilities from finance leases must be presented separately from liabilities from operating leases on the balance sheet.

The Right-Of-Use Asset

a) Initial measurement

The right-of-use asset is initially recognized at the amount of the lease liability. Initial direct costs and prepaid lease expenses increase the carrying amount of the right-of-use asset, while incentive payments already received from the lessor reduce the carrying amount.

b) Subsequent measurement

For finance leases, the lessee is required to amortize the right-of-use asset on a straight-line basis, unless another systematic basis is more representative. If the lease liability is remeasured, the amortization of the right-of-use asset has to be adjusted on the date of remeasurement.

If ownership of the underlying asset transfers to the lessee by the end of the lease term or if the lessee is reasonably certain to exercise a purchase option, the right-of-use asset has to be amortized over the useful life of the underlying asset. This also applies in cases where the useful life is shorter than the lease term.

For operating leases, the right-of-use asset is subsequently measured at the amount of the lease liability, adjusted by prepaid or accrued lease payments, the remaining balance of any lease incentives received, as well as any unamortized initial direct costs, and impairment of the right-of-use asset. This measurement can be achieved by determining amortization as difference between the single periodic lease expense and the interest expense.
In case of triggering events, the lessee is required to carry out an impairment test and recognize a resulting impairment loss in accordance with ASC 360 Subtopic Impairment or Disposal of Long-Lived Assets. After the impairment, the right-of-use asset is measured at the carrying amount less accumulated amortization and impairment losses. Reversals of impairment losses are prohibited.

c) Presentation

For finance leases, amortization is presented separately from interest expense, while it is presented as part of the single periodic lease expense for operating leases. Right-of-use assets from finance leases must be presented separately from right-of-use assets from operating leases on the balance sheet.

Separation of Lease Components from Non-Lease Components

ASC 842 contains guidance for the separation of lease components and non-lease components (e.g. service components) that are included in a lease as well as guidelines concerning the allocation of the consideration of the contract to these components.
As a practical expedient, lessees may choose not to separate non-lease components from lease components and account for such components as a single lease component. In case the lessee decides to separate lease components from non-lease components, the lessee is required to allocate the consideration in the contract based on the relative standalone price of the components.

Lessee Reassessments

ASC 842 includes additional requirements for the reassessment of the lease term. If a triggering event occurs that is under the lessee's control or an option is exercised or not exercised (e.g. an option to extend the lease term or an option to terminate the lease), the lease term has to be reassessed by the lessee. This results in a reassessment of the lease classification and a remeasurement of the lease liability and right-of-use asset. On the remeasurement date, discount rate and variable lease payments based on a rate or index have to be reassessed as well. The lessee is required to monitor these triggering events on an ongoing basis. Under the previous guidance, reassessment was only required if a lease was modified or an option was exercised.

Sale and Leaseback Transactions

The new accounting requirements also apply to sale and leaseback transactions. However, a sale and leaseback transaction is only treated as a sale if:

- It meets the definition of a sale according to ASC 606,
- the leaseback is not a finance lease, and
- in case of a repurchase option, the repurchase price is at the asset's fair value at the time of exercise and alternative assets are readily available in the marketplace.

3 OUR SOLUTION FOR ASC 842

The LucaNet app Accounting for Leases makes it easy to implement the new regulations and comply with ASC 842.
Our solution:

- Provides you with a clear overview of all leases and their effects on the balance sheet and income statement.
- Offers maximum convenience for remeasurements and lease modifications by automatically carrying out all necessary new calculations.
- Generates the required quantitative disclosures automatically.
- Includes foreign currency translation of all ASC 842 related items in accordance with ASC 830.
- Allows easy integration of leases in the cash flow statement and the fixed asset schedule.
- Enables you to prepare forecasts and budgets that clearly present the impact of the new guidance.
- Comes with a detailed documentation that includes sample calculations in Excel for auditors and users.

Want to know more? Ask our experts how the LucaNet app Accounting for Leases can assist you in implementing ASC 842. Simply send an email to **asc842@lucanet.com**.

4 SUMMARY

The new guidance for lease accounting requires the recognition of a right-of-use asset and lease liability for both operating and finance leases. This leads to major impacts on industries with a high exposure to leases. As a result, key financial ratios, like the debt-to-equity ratio, may be significantly impacted. Operating and finance leases differ with respect to subsequent measurement of the right-of-use asset and presentation of lease expense in the income statement.

The LucaNet app offers proactive support for lease accounting. The app does not only assist you in the technical implementation of the new accounting rules, but also supports you with all process-related challenges.

We will be happy to provide you with further information about the LucaNet app Accounting for Leases. Please contact us at **asc842@lucanet.com.**

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For financial experts, by financial experts. Always fostering the most intelligent solutions. After all: consolidation, planning, reporting, and data management know no limits – so why should we? We're constantly challenging ourselves, questioning the tried-and-true. And this is why we do more than just create powerful applications: we create user experiences, helping you to fully grasp and navigate the intricacies of your company's finances and pave the way for a strong future.

Berlin is our home, but you'll find us wherever reliable financial data is needed. With a growing national and international presence and a strong network of partners, every day we're that much closer to you. And we've come a long way with our approach to rethinking finance: more than 2,700 companies in over 50 countries trust in LucaNet, including names such as FTI Touristik, edding, Leica, Roland Berger and Vaude. Find out what they already know – and let us make finance easier for you, too. erger and Vaude. Find out what they already know – and let us make finance easier for you, too.

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