

FORVIS

Leases for Dealerships – Time To Implement!

September 21, 2022

Meet Your Facilitators...

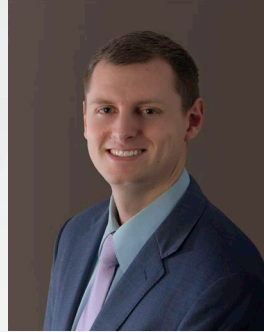


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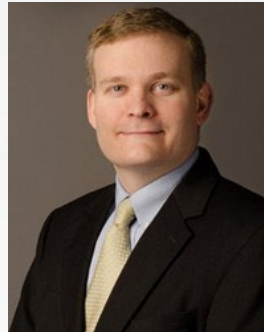


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Agenda

- A. Understand the basics of how the standard works
- B. Walk through the core concepts
- C. Discuss considerations for the dealership industry
- D. Review steps to prepare for the standard and the transition

Understanding the Basics

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What is the new lease standard (ASC 842)

To summarize...the vast majority of leases will now be recorded on the balance sheet



Key Questions in Accounting for Leases

Do I have a lease?

What is the term?

What is the discount rate?

Any non-lease components?

GUIDANCE

Lease defined as “*the right to control the use of an identified asset for a period of time in exchange for consideration.*”

- **Control:**

- Right to economic benefits
- Right to direct use of asset

- Determining “right to direct use” may require judgment

- If supplier has substantive substitution rights, customer does not have control; therefore no lease.

Do I Have a Lease?

ASC 840

A lease is an agreement conveying the right to use property, plant, or equipment (land and/or depreciable asset) usually for a stated period of time.

ASC 842

A lease is a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

Potential Embedded Leases

- Advertising / billboard
- IT contracts if they include hardware
- Service contracts that include the use of equipment
- Signs

Key Questions in Accounting for Leases

Do I have a lease?

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Any non-lease components?

GUIDANCE

- **Term: Noncancelable period for which lessee has right to use asset plus periods covered by—**
 - Option to extend if lessee is reasonably certain to exercise the option
 - Option to terminate if lessee is reasonably certain not to exercise option
 - Renewals or extensions of lease at option of lessor
- **Exception (if elected) to the general rule to recognize all leases on the balance sheet for leases with terms of 12 months or less.**

Lease Term Examples

- **Example 1:** 5-year noncancelable term + at commencement date, lessee reasonably certain to exercise 2-year renewal option = 7-year lease term
- **Example 2:** 5-year noncancelable term + at commencement date, lessee uncertain to exercise 2-year renewal option = 5-year lease term
- **Example 3:** Related party month-to-month lease cancelable by the lessee (dealership) with no lease term specified = TBD (but this is a contract under ASC 842)

**NOTE: if a related party lease was a building lease and concluded it was not a lease under 842 (i.e. due to lack of legally enforceable contract), any leasehold improvements would be expensed as incurred as amortization period of leasehold is shorter of useful life and lease term

Key Questions in Accounting for Leases

Do I have a lease?

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What is the discount rate?

Any non-lease components?

GUIDANCE

Rate implicit in the lease is rate that causes the PV of the net investment in the lease to equal sum of:

- Fair value of asset minus related investment tax credit
- Capitalized initial direct costs incurred by **lessor**
- If rate cannot be determined, use incremental borrowing rate
- **Private companies may elect a policy for all leases to use risk-free discount rate UNLESS the rate implicit in the lease is known**

Discount Rate

On January 1, 2022, Dealership Co. commences an operating lease for its facility for a term of 10 years. Dealership Co. will pay \$50,000 per month during the lease term. At the commencement date, Dealership Co.'s incremental borrowing rate is 5% and the risk-free rate of return for a similar period is 1.78%. As an incentive to enter into the lease, the Lessor pays Dealership Co \$250,000 in cash at commencement.

What is the impact of using the risk-free rate of return vs. incremental borrowing rate?

	Risk-free Rate	Incremental Borrowing Rate	Difference
Lease Liability	\$5,500,749	\$4,733,709	\$767,040
ROU Asset	\$5,250,749	\$4,483,709	\$767,040
The liability and asset are both higher by \$767,040 for an individual lease.			

Key Questions in Accounting for Leases

Do I have a lease?

What is the term?

What is the discount rate?

Any non-lease components?

GUIDANCE

- Non-lease components accounted for separately
- Practical expedient available
- Example: equipment lease contract also includes maintenance services
- Allocate contract consideration and initial direct costs to components based on relative standalone price of separate components

Non-lease Components

- Example 1:
 - Lease component - contract for the right to use equipment
 - Non-lease component – lessor provides regular equipment maintenance
- Example 2:
 - Lease component – contract for the right to use several floors of an office building
 - Non-lease component – lessor provides cleaning services to lobby, elevators (common area maintenance)

**NOTE: Practical expedient may be relevant for many dealership leases

Lessor Considerations

- Great news – ASC 842 will not have a profound change to lessor accounting

SALES-TYPE LEASE

- Has characteristics of a sale as the lessee effectively obtains control of the underlying asset
- Lessor derecognizes the leased asset and recognizes profit or loss as if it were selling the asset and records a net investment in the lease on the balance sheet
- Recognize selling profits and losses at the lease's commencement

DIRECT FINANCING LEASE

- Lessor derecognizes the leased asset and records a net investment in the lease on the balance sheet
- Recognize selling losses at lease commencement and selling profits over the lease term

OPERATING LEASE

- Most operating leases under ASC 840 remain operating leases
- Leased asset continues to be recognized as a fixed asset on lessor's books
- Income recognized on income statement on straight-line basis as rental income

Impact on the Financials

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Finance vs. Operating Lease Classification

FINANCE LEASE

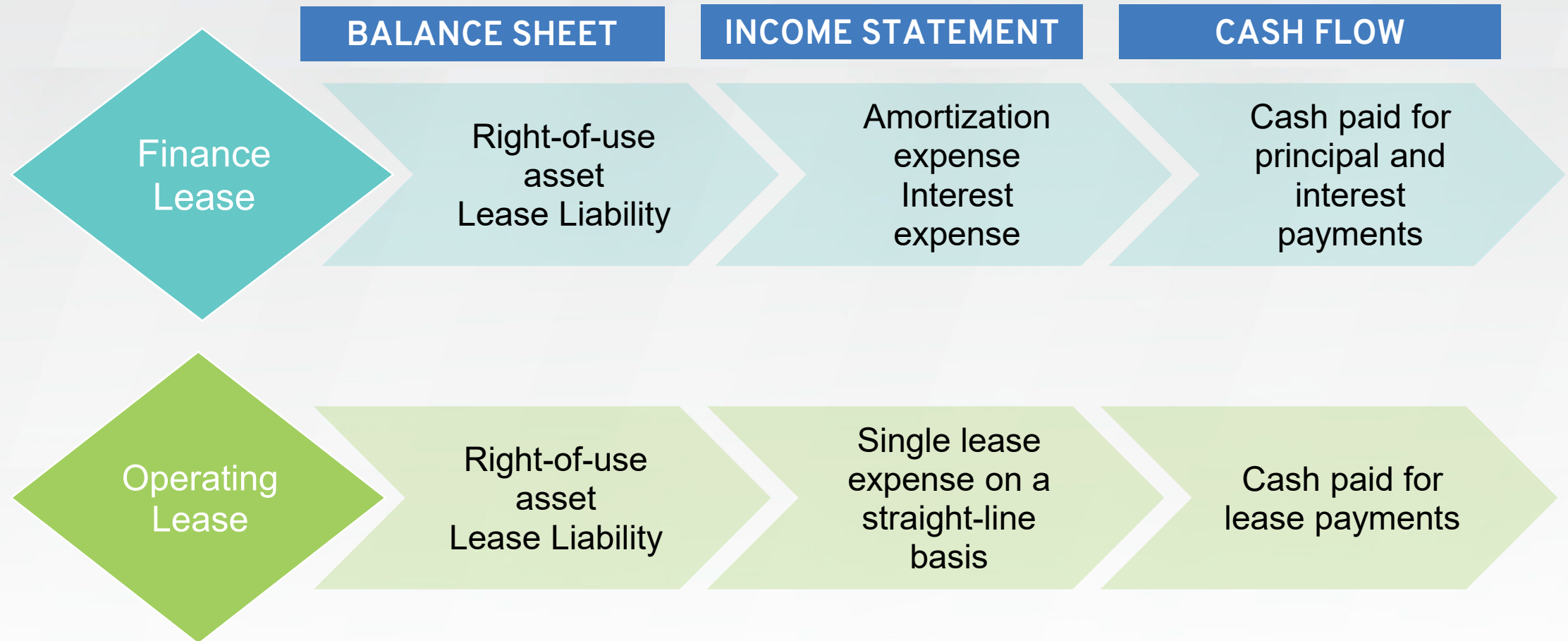
Substantially the same as a capital lease **plus**

- Lease of specialized asset for which no alternative use at end of lease term

OPERATING LEASE

All leases that do not meet criteria for finance lease

Lease Accounting Overview

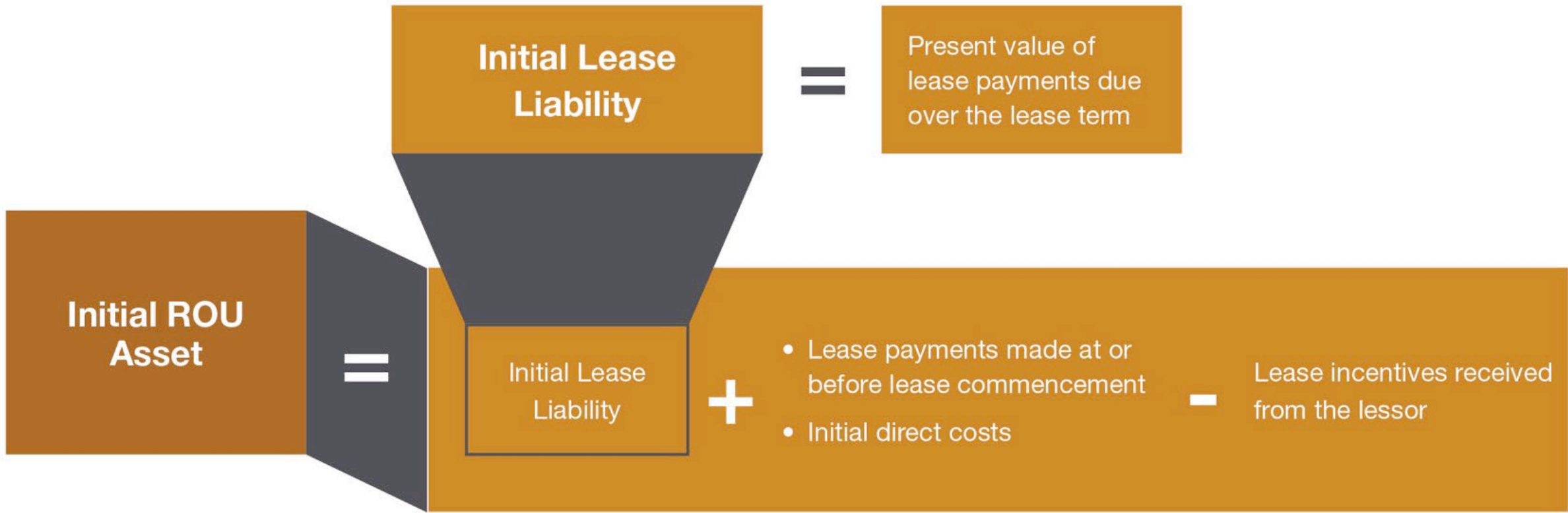


Operating Lease Walkthrough

Facts:

- **Lease term:** 6 years
- **Lease payments:** \$40,000 annually paid at end of each year
- **Initial direct costs:** \$1,500
- **Discount rate:** 9%

Initial Measurement




Operating Lease Walkthrough

Facts:

- Lease term: 6 years
- Lease payments: \$40,000 annually paid at end of each year
- Initial direct costs: \$1,500
- Discount rate: 9%

<u>Lease Liability</u>		<u>ROU Asset</u>	
Period	Lease Payment		
Year 1	40,000	Lease liability	\$ 179,437
Year 2	40,000	+ initial direct costs	1,500
Year 3	40,000	+ lease prepayments	-
Year 4	40,000	- lease incentives received	-
Year 5	40,000	= ROU Asset	<u>\$ 180,937</u>
Year 6	40,000		
Total	<u>\$ 240,000</u>		
PV at 9%	<u>\$ 179,437</u>		



Operating Lease Walkthrough

Facts:

- Lease term: 6 years
- Lease payments: \$40,000 annually paid at end of each year
- Initial direct costs: \$1,500
- Discount rate: 9%

Entry to record the lease

Account	Debit	Credit
Right-of-Use Asset	180,937	
Lease Liability		179,437
Cash (or Deferred Initial Direct Costs)		1,500

Operating Lease Walkthrough

Facts:

- Lease term: 6 years
- Lease payments: \$40,000 annually paid at end of each year
- Initial direct costs: \$1,500
- Discount rate: 9%

Calculation of straight-line lease expense for operating lease

Sum of lease payments (six payments of \$40,000)	\$ 240,000
+ Initial direct costs	<u>1,500</u>
= Total remaining lease costs	241,500
÷ Lease term	<u>6 years</u>
= Straight-line total lease expense	<u><u>\$ 40,250</u></u>

Operating Lease Walkthrough

Operating Lease	<i>Liability Amortization²</i>				<i>ROU Asset Adjustment</i>			
	A	B	C	D	E	F	G	H
	Lease Payment	Beginning Lease Liability	Liability Accretion	Ending Liability $B-(A-C)$	Beginning ROU Asset	ROU Asset Adjustment ³ $H-C$	Ending ROU Asset $E-F$	Lease Expense ^{4,5}
Year 1	40,000	179,437	16,149	155,586	180,937	24,101	156,836	40,250
Year 2	40,000	155,586	14,003	129,589	156,836	26,247	130,589	40,250
Year 3	40,000	129,589	11,663	101,252	130,589	28,587	102,002	40,250
Year 4	40,000	101,252	9,113	70,365	102,002	31,137	70,865	40,250
Year 5	40,000	70,365	6,333	36,698	70,865	33,917	36,948	40,250
Year 6	40,000	36,698	3,302	-	36,948	36,948	-	40,250
Total	240,000		60,563			180,937		241,500

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Operating Lease Walkthrough

Operating Lease	<i>Liability Amortization²</i>				<i>ROU Asset Adjustment</i>			
	A	B	C	D	E	F	G	H
	Lease Payment	Beginning Lease Liability	Liability Accretion	Ending Liability $B-(A-C)$	Beginning ROU Asset	ROU Asset Adjustment ³ $H-C$	Ending ROU Asset $E-F$	Lease Expense ^{4,5}
Year 1	40,000	179,437	16,149	155,586	180,937	24,101	156,836	40,250

<u>Operating Lease</u>		
Account	Debit	Credit
Lease Expense	40,250	
Lease Liability		16,149
ROU Asset Reduction		24,101
Lease Liability	40,000	
Cash		40,000

Operating Lease: Balance Sheet

Assets	
aaaa	\$ XX,XXXX
ROU asset	\$ XX,XXXX
aaaa	\$ XX,XXXX
	<hr/>
	\$ XXX,XXXX
Liabilities	
bbbb	\$ XX,XXXX
Lease liability	\$ XX,XXXX
bbbb	\$ XX,XXXX
	<hr/>
	\$ XXX,XXXX
Equity	
cccc	\$ XX,XXXX
	<hr/>
	\$ XXX,XXXX

- **ROU Asset:**

- + Separate from finance lease ROU asset

- + Non-current

- **Lease Liability:**

- + Separate from finance lease liability

- + Will be classified as current and non-current

Operating Lease: Subsequent Accounting

Assets	
aaaa	\$ xx,xxxx
ROU asset	\$ xx,xxxx
aaaa	\$ xx,xxxx
	<hr/>
	\$ xxx,xxxx
Liabilities	
bbbb	\$ xx,xxxx
Lease liability	\$ xx,xxxx
bbbb	\$ xx,xxxx
	<hr/>
	\$ xxx,xxxx
Equity	
cccc	\$ xx,xxxx
	<hr/>
	\$ xxx,xxxx

ROU asset

Asset equal to lease liability adjusted for

- + Prepaid or accrued lease payments
- + Remaining lease incentives
- + Unamortized initial direct costs
- + Asset impairment

Liability

Liability equal to PV of remaining lease payments at discount rate determined at inception

Operating Lease: Income Statement

Sales	\$	xx,xxxx
Cost of Sales	\$	xx,xxxx
		<hr/>
	\$	xxx,xxxx
		<hr/>
Expenses		
aaaa	\$	x,xxxx
aaaa	\$	x,xxxx
Lease expense	\$	x,xxxx
aaaa	\$	x,xxxx
		<hr/>
	\$	xx,xxxx
		<hr/>
Net Income	\$	xxx,xxxx

Income Statement

Single **lease expense**, same as current GAAP – recognized straight-line over the lease term

Operating Lease: Cash Flow Statement

aaaa	\$ xx,xxxx
Noncash operating lease expense	\$ xx,xxxx
Change in operating lease liability	\$ xx,xxxx
Cash from operating activities	\$ xxx,xxxx
bbbb	\$ xx,xxxx
bbbb	\$ xx,xxxx
bbbb	\$ xx,xxxx
Cash from investing activities	\$ xxx,xxxx
cccc	\$ xx,xxxx
cccc	\$ xx,xxxx
Cash from financing activities	\$ xxx,xxxx
Change in cash	\$ xx,xxxx
Beginning cash	\$ xx,xxxx
Ending cash	\$ xx,xxxx

Cash Flow Statement

Lease expense reported as an operating activity

Noncash represents change in operating ROU asset.

Finance Lease: Balance Sheet

Assets	
aaaa	\$ xx,xxxx
ROU asset	\$ xx,xxxx
aaaa	\$ xx,xxxx
	<hr/>
	\$ xxx,xxxx
Liabilities	
bbbb	\$ xx,xxxx
Lease liability	\$ xx,xxxx
bbbb	\$ xx,xxxx
	<hr/>
	\$ xxx,xxxx
Equity	
cccc	\$ xx,xxxx
	<hr/>
	\$ xxx,xxxx

- **ROU Asset:**

- + Must be on separate line item from operating lease ROU asset

- + Non-current

- **Lease Liability:**

- + Must be on separate line item from operating lease liability

Finance Lease: Income Statement

Sales	\$ xx,xxxx
Cost of Sales	\$ xx,xxxx
	<hr/>
	\$ xxx,xxxx
Expenses	
aaaa	\$ x,xxxx
Amortization	\$ x,xxxx
Interest	\$ x,xxxx
aaaa	\$ x,xxxx
	<hr/>
	\$ xx,xxxx
Net Income	\$ xxx,xxxx

Income Statement

Amortize ROU asset, straight line over useful life or lease term

Recognize **interest expense** related to lease liability

Finance Lease: Cash Flow Statement

aaaa	\$ xx,xxxx
aaaa	\$ xx,xxxx
Interest expense	\$ xx,xxxx
Cash from operating activities	\$ xxx,xxxx
bbbb	\$ xx,xxxx
bbbb	\$ xx,xxxx
bbbb	\$ xx,xxxx
Cash from investing activities	\$ xxx,xxxx
Principal payments	\$ xx,xxxx
cccc	\$ xx,xxxx
Cash from financing activities	\$ xxx,xxxx
Change in cash	\$ xx,xxxx
Beginning cash	\$ xx,xxxx
Ending cash	\$ xx,xxxx

Cash Flow Statement

Interest expense reported as operating activity

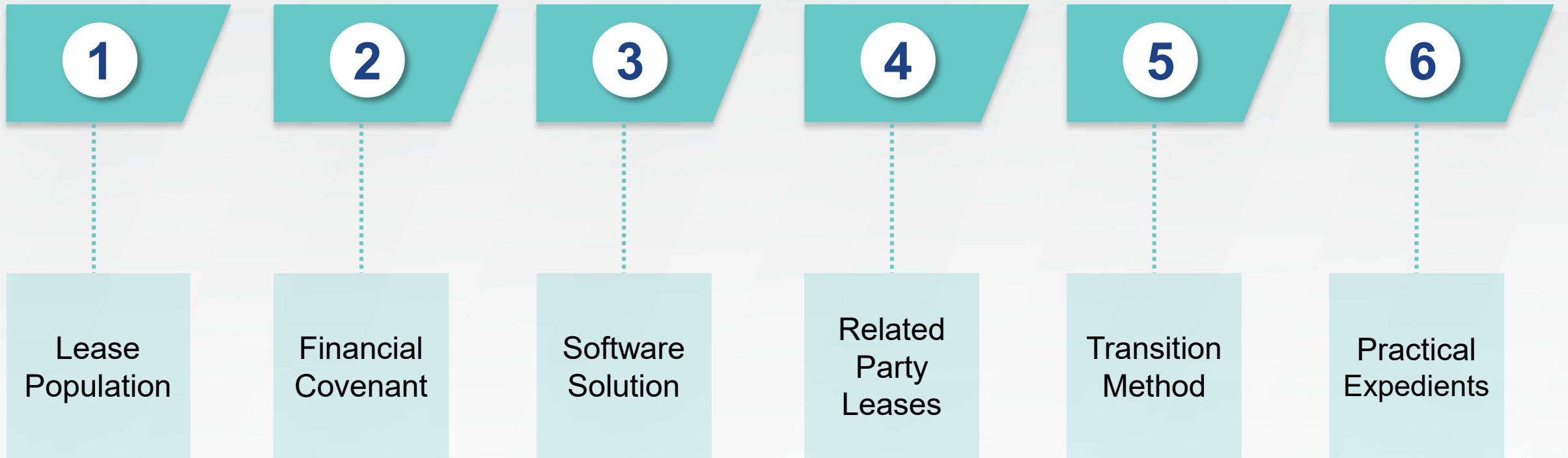
Lease principal payments reported as financing activity

Industry Considerations

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Industry Considerations



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Considerations

1

Lease Population

1. **Highly data dependent** – identification of current lease population is critical to ensure calculation data is accurate
2. **Time consuming** - collecting data encompassing several years and a variety of renewals and modifications can take time, so plan ahead

Considerations

2

Financial Covenant Considerations

1. Adoption of ASC 842 may impact debt arrangements contemplating working capital or debt to equity ratios
2. ***Begin conversations*** with lenders to discuss ASC 842 and your financial covenant compliance
3. Lenders may exclude the impact of adoption on existing covenants, but not guaranteed
4. Ongoing financial covenant compliance requirements ***should be memorialized in writing***

Impact to Performance Metrics and Ratios

ROU Asset

- Noncurrent

Lease Liability

- Current and noncurrent

Ratio	Formula	Result
Current Ratio	Current Assets/ Current Liabilities	Decrease
Quick Ratio	(Cash + Short-term Investments + Receivables) / Current Liabilities	Decrease
Working Capital	Current Assets – Current Liabilities	Decrease
Working Capital Turnover	Revenue/Working Capital	Increase
Asset Turnover	Revenue / Average Total Assets	Decrease
Return on Assets	Net Income / Assets	Decrease
Debt to Equity	Total Debt / Equity	Increase

Considerations

3

Software Solution

Consider using a software solution to calculate and track various pieces of information necessary for accounting and disclosing your leasing activities:

1. Do I need a software?
 - a. How many leases do I have, 10-15 or 50-100?
 - b. How dynamic are my leases? Are they static or constantly changing?
2. More information on the next webinar

Considerations

4

Related Party Leases

Related party leases are accounted for based on the legally enforceable terms of the arrangement:

1. Related party leases with limited or no documentation, or arrangements that are “evergreen” or “perpetual” - may raise questions as to whether such arrangements are legally enforceable, and may result in unanticipated financial reporting consequences upon the adoption of ASC 842
2. Prepare a population of all related party leases and clearly document the intended terms

ASC 840

- Accounting based on substance over form.

ASC 842

- Accounting based on legally enforceable terms.

Considerations

5

Transition Method

When evaluating the available methods, consider users of your financial statements and resource allocation.

COMPARATIVE - Will result in restating all prior period (comparative) financial statements presented to reflect consistent accounting treatment for leases

NON-COMPARATIVE - Will result in accounting for leases under ASC 842 beginning with the year of adoption without restating prior periods (non-comparative), resulting in presentation under two separate standards

Considerations

6

Practical Expedients

These expedients may ease the transition burden, but there are implications for transition and go forward accounting depending on the expedients elected or not elected.

Considerations – Practical Expedients

PACKAGE OF THREE PRACTICAL EXPEDIENTS

Allows an entity:

- Not to reassess whether any expired or existing contracts are or contain leases
- Not to reassess lease classification for any expired or existing leases
- Not to reassess initial direct costs for any existing leases.

This package must be elected together as a package. In our experience, most companies have elected this package of expedients.

HINDSIGHT

Allows for a reassessment of lease term at the adoption date and must be elected for all lease arrangements. Generally, this expedient results in the need for additional transition resources and, in our experience, very few companies elect this expedient. However, it should be considered as it may provide relevant information to financial statement users.

RISK-FREE INTEREST RATE (only available for private companies)

Allows the use of risk-free interest rate when calculating initial lease liability. Election of this expedient will likely result in a higher lease liability upon adoption.

SHORT-TERM LEASES

Leases with initial terms of 12 months or less are not required to be accounted for on the balance sheet, but disclosure requirements still apply. This expedient may be elected by class of underlying asset.

COMBINATION OF LEASE AND NON-LEASE COMPONENTS

This expedient allows for the combination of lease and non-lease components and may ease the burden of needing to separate components and allocate contract consideration. Election may be made by class of underlying asset and may impact the magnitude of the lease liability and classification of the lease depending on facts and circumstances.

Conclusion

Want to talk more about leases?

Join us for Leases for Dealerships Part Two

- October 19, 2022
 - 10:00AM Central
-
- Go to www.FORVIS.com to register.

Thank you!

forvis.com

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