RIVERON

YOUR GUIDE TO ADOPTING ASC 842: DISCOUNT RATES, FAIR VALUES, AND MORE

Part 1 of 3 of an Ask the Experts webinar series dedicated to the new lease accounting standard

WEBINAR TEAM

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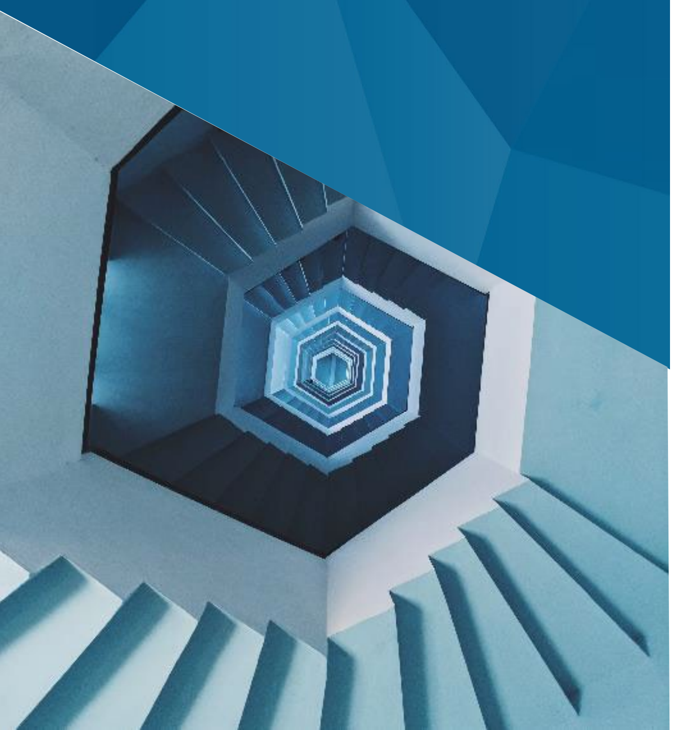
KEY REMINDERS

- Riveron webcasts – past and upcoming
- 4 polling questions must be answered to obtain CPE
- If you have questions, feel free to ask in Q&A option in Zoom
- Webinar evaluation form & CPE certificate will be emailed to you
- On demand video is not eligible for CPE
- You will receive a follow up email including:
  - Access to this webinar recording and deck
  - The ability to join our Webinars Mailing list to receive future invites
  - Presenter contact info

POLLING QUESTION #1



Where are you in the process of adopting ASC 842?

A We have already fully adopted and are operating under ASC 842

B We have implemented a system but have not fully switched over yet

C We are in the process of implementing

D We have not started implementing yet

ASC 842 OVERVIEW

LESSEE ACCOUNTING

ASC 840

- Lease Arrangement: use of an identified asset without substitution rights generally aligns with the new guidance.
- Classification Tests: bright line tests were used for evaluation against using substantially all the value of the asset and/or the economic life of the asset.
- Lease Accounting: classification played a bigger role in financial management as operating leases were kept off-balance sheet.

VS

ASC 842

- Lease Arrangement: new guidance adds "control" to the definition of lease. Embedded leases are now considered in scope and on-balance sheet.
- Classification Tests: no explicit language on thresholds; however, bright lines are offered as a reasonable approach.
- Lease Accounting: recognizes a right-of-use asset and lease liability for all leases with a term greater than 12 months if not deemed immaterial.

FINANCIAL MANAGEMENT CONSIDERATIONS

+ Larger Balance Sheet by Capitalizing Operating Leases
+ Expect a Larger Lease Portfolio with Embedded Leases
+ Reporting at the Asset Level
+ Requires a Net Presentation of ROUA & Lease Liability
+ Operating Deferred Rent Balance Moves into ROUA
+ Expanded Quantitative Disclosures
+ ST Lease Election to Retain off-BS Classification
+ No Material Impact for Existing Capital Leases

HIGHLIGHTS OF THE NEW LEASE GUIDANCE

- The new lease standard, ASC 842, focuses on a lessee model that brings most leases to the balance sheet. A lessee will recognize a liability for its lease obligation and an asset for its right-of-use (ROU) of the underlying asset.
  - Retains distinction between "capital" and "operating" leases.
  - Income statement expense recognition remains similar to legacy GAAP. Operating lease expense will be calculated differently as the sum of interest expense on the lease liability and the amortization of the ROU asset; but the amount should be relatively the same and remain in operating expenses on the income statement
- Revised scope & definition of leasing activities
  - More contracts will now contain leases
  - Contracts (including service contracts) may contain both lease and non-lease components
- Revision of lease classification
  - Classification (operating vs financing) has been modified to eliminate the bright-line tests; however, similar quantitative guidelines still exist
- Subjectivity around the lease term and introduction of the term **"reasonably certain"**
  - Short term exception for agreements of 12 months or less

Note: The majority of the information herein is focused on **lessee** accounting implications, given the lessor model is largely unchanged

ADOPTION ACTIVITIES

- The effects of ASC 842 reach across financial statements, monthly activities and operations. It has a business transformation impact that includes technology, people and processes across the whole organization.
- Private companies that have adopted or are in the process of adopting have encountered two primary “pain points”. Today’s presentation focuses on both.
  - Lease discount rate, specifically for lessees
  - Determining fair value of certain assets

ABSTRACT

- Minimum payments and term
- **Fair value and useful life**

CLASSIFY

- **Discount rate or IBR**
- Operating vs finance

RECORD

- Lease liability calculation
- ROU asset and lease expense calculation

POLLING QUESTION #2

What is your biggest concern with ASC 842?

A Determining appropriate discount rates to use

B Determining inputs for the lease classification process

C Maintaining an effective system or model to provide correct ASC 842 journal entries

D Navigating impairment considerations or other complex topics

LEASE DISCOUNT RATES

Which is right for your company?

LEASE DISCOUNT RATES

When determining discount rates, lessors and lessees must first use the rate implicit in the lease, if available. From a practical standpoint, this is usually only available to the lessor.

For almost all lessee contracts, the company leasing the assets will use the incremental borrowing rate (IBR). The risk-free rate is also available to private companies.

FASB defines the IBR as "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."

RATE IMPLICIT IN LEASE

(usually only available to lessor)

INCREMENTAL BORROWING RATE

(IBR)

RISK-FREE RATE

(private companies only)

LEASE DISCOUNT RATES

	RISK-FREE RATE	INCREMENTAL BORROWING RATE (IBR)
PROS	▶ Publicly available and easy to obtain ▶ No further investment ▶ Easy to audit	▶ Driven by company-specific inputs ▶ Lower lease liability (and ROU asset) ▶ Less work if planning to go public or be acquired by a public company
CONS	▶ Lower rate = higher balance sheet impacts ▶ Will require transition to IBR if going public or being acquired by a public company	▶ Difficult without treasury department and will likely require third-party support ▶ Rates will need to be updated quarterly or at least annually depending on reporting requirements

LEASE DISCOUNT RATES

KEY QUESTIONS TO ASK

WHAT IS THE IMPACT OF USING THE RISK-FREE RATE?

- Do we plan to go public or be acquired within the next 1-3 years?
- Is our lease portfolio large to the point that a low discount rate will have a large impact on our balance sheet?
- Do we have covenants that may be impacted by a large lease liability?

HOW CAN WE CALCULATE AN IBR?

- Do we have a treasury department?
- Do we have a relationship with a third-party valuation services provider? How much would it cost?

WHAT IS OUR COMPANY'S DEBT PROFILE?

- Do we have debt instruments with terms and origination dates materially close to our largest leases?
- Do we have collateralized debt?

DETERMINING AN IBR FOR LEASES

Methods of calculation

INCREMENTAL BORROWING RATE (IBR)

ASC 842 defines the IBR as 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. From this definition, there are several factors to consider:

- Corporate credit rating and borrowing rates
- Lease terms including maturity, defined payments, termination and renewal options
- Credit quality of underlying collateral
- Denominated currency
- Macro-economic and market data

The lessee should estimate an IBR considering the lessor can seek general recourse to other assets of the lessee (analogous to corporate debt).

Only asset-specific collateralization is applicable under the guidance.

CONSIDERATIONS FOR CALCULATING IBR

ASSESS CREDITWORTHINESS/RATING

- Public credit rating
- Synthetic credit rating

OBSERVABLE MARKET DEBT YIELD CURVES

- Lessee-specific issuances
- Comparable public company corporate debt
- Debt indices

ADJUST MARKET DEBT YIELD CURVES

- Foreign currency
- Seniority/subordination
- Lease Term/Maturity

DETERMINING AN IBR FOR LEASES

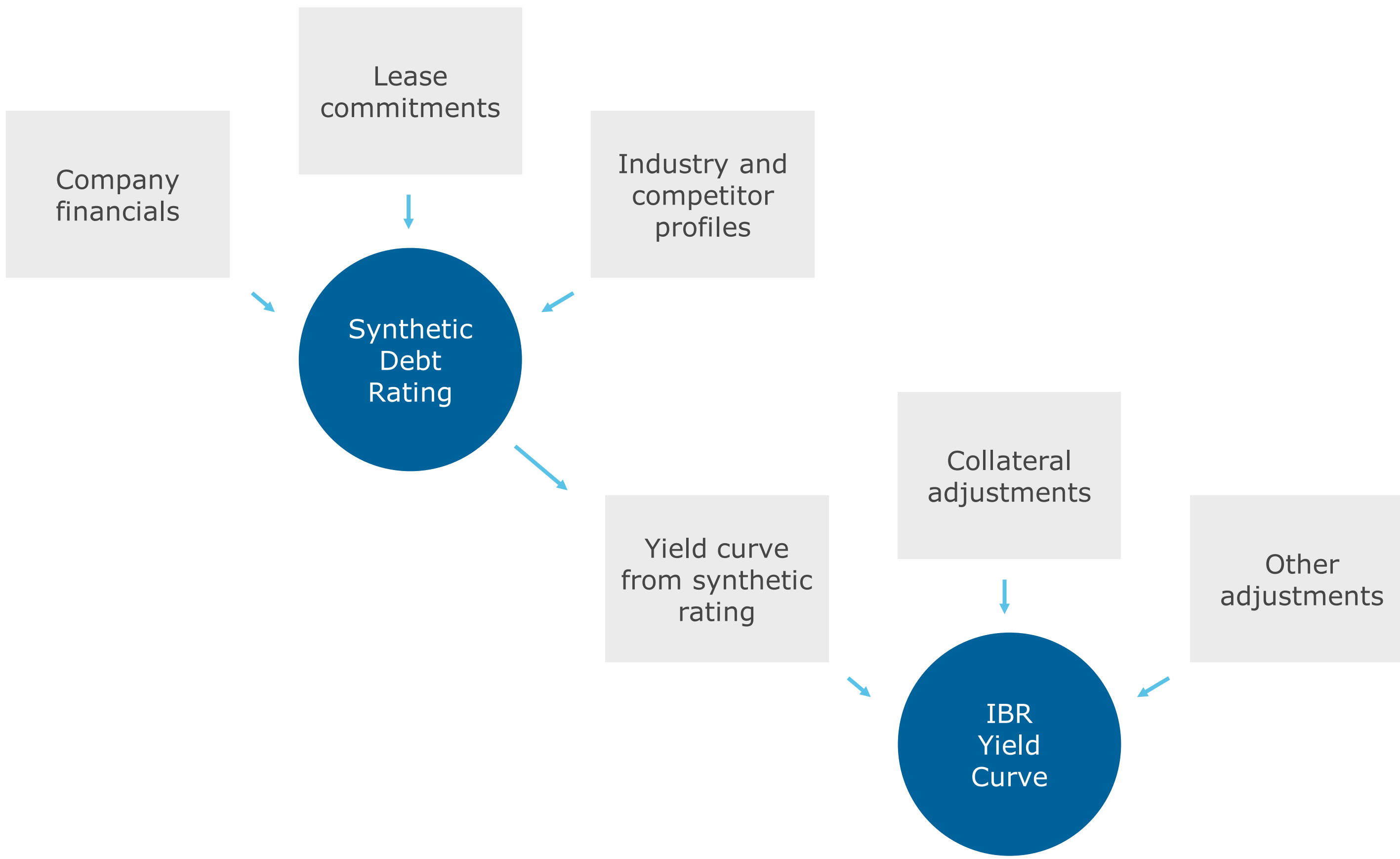
Two Popular Methods:

1. **SYNTHETIC DEBT RATING TO DEVELOP YIELD CURVE**
   - Requires a treasury department or a third-party valuation services provider

2. **ANALYSIS OF SIMILAR, PUBLICLY AVAILABLE DEBT INFORMATION**
   - Requires license or other access to financial market terminals and data tools

DETERMINING AN IBR FOR LEASES

SYNTHETIC DEBT RATING AND YIELD CURVE



DETERMINING AN IBR FOR LEASES

SYNTHETIC DEBT RATING AND YIELD CURVE

PROS

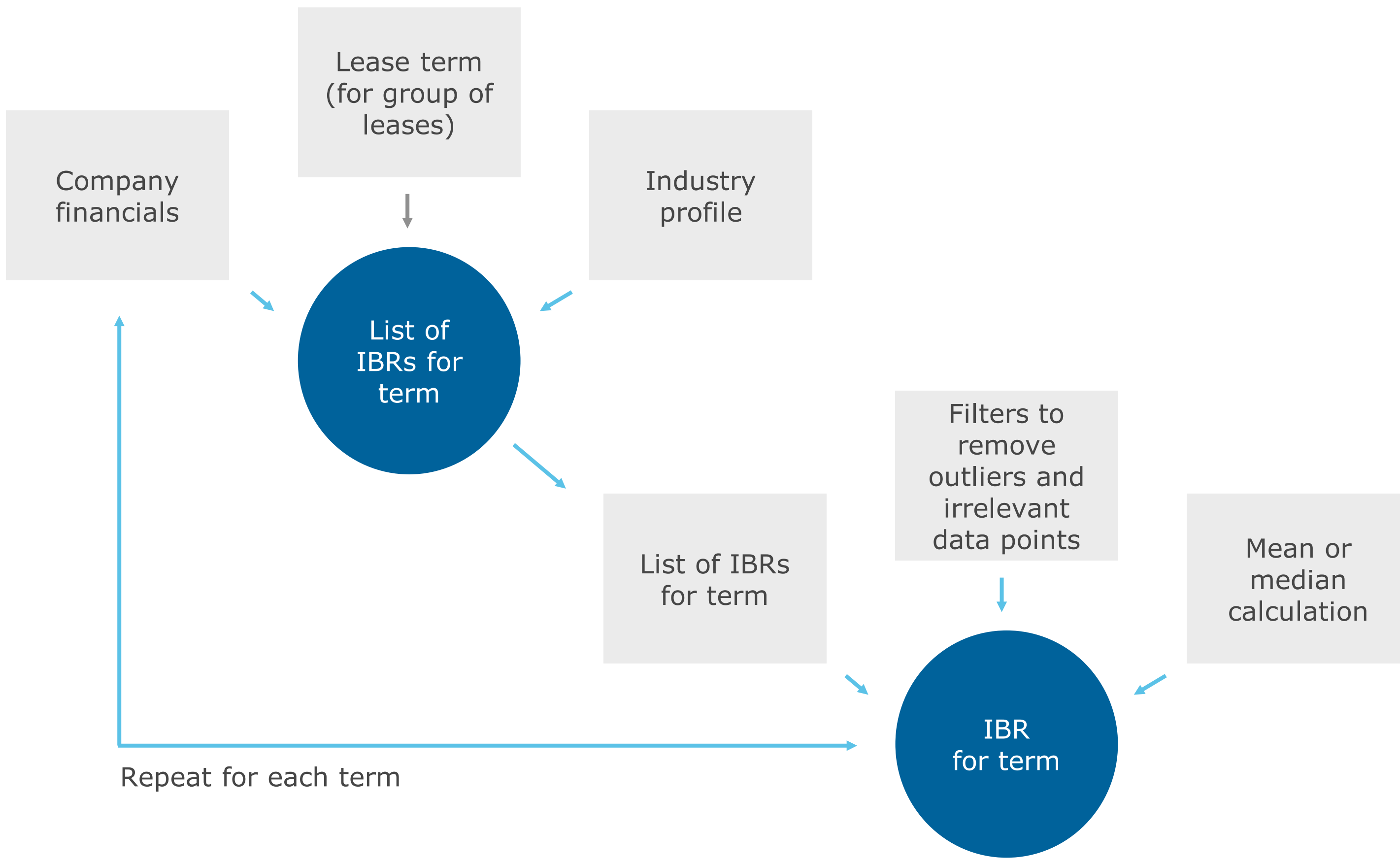
- Usually more accurate and specific to company
- Generally easier to audit, as all outputs are easily traceable to inputs
  - Rates for a given synthetic debt rating are publicly available.
  - Inputs all come from company's financials or other documented sources
- Can leverage existing relationship with valuation specialists

CONS

- If no treasury department, will likely require third-party assistance
- Subjectivity in some inputs
  - Competitor profiles
  - Industry specifics
  - Collateralization adjustments and other adjustments
- Generally more expensive

DETERMINING AN IBR FOR LEASES

ANALYSIS OF SIMILAR, PUBLICLY AVAILABLE DEBT INFORMATION



DETERMINING AN IBR FOR LEASES

ANALYSIS OF SIMILAR, PUBLICLY AVAILABLE DEBT INFORMATION

PROS	CONS
▶ Can be completed fully in-house without use of third-parties ▶ Better control of timing ▶ Control of inputs and filters used ▶ Generally less costly ▶ Company may already have a license for data tools and/or can leverage license for other purposes	▶ More difficult to audit ▶ Inputs may not be well documented ▶ Filters and calculations are relatively subjective ▶ May not be accurate if data tools used do not produce a reasonable population of useful outputs ▶ Will require some training and internal expertise for using the data tools

POLLING QUESTION #3

Are you considering calculating your own IBRs instead of using the risk-free rate?

A No, the risk-free rate works best for us

B Yes, in order to mitigate the balance sheet impact

C Yes, because we may not be able to use the risk-free rate within the next few years

D Yes, for other reasons

DETERMINING FAIR VALUE

Demystifying the lease classification process

DETERMINING FAIR VALUE OF LEASE ASSETS

- Upon adoption, companies may elect to roll forward previous classifications.
  - If not classified correctly under 840, the company will need to reclassify under 842 even if electing practical expedients.
- Need to have documentation for lease portfolio to prove or support each lease.

* Only if properly classified previously under ASC 840.

DETERMINING FAIR VALUE OF LEASE ASSETS

Part of lease classification is consideration whether the present value of the sum of lease payments (and any residual value guarantees) equals or exceeds ***substantially all of the fair value of the underlying asset.***

THEREFORE

Lessee must determine fair value of each leased asset to complete the classification process

DETERMINING FAIR VALUE OF LEASE ASSETS

EQUIPMENT AND FLEET:

- Lessor may include price in contract
- Readily determinable from similar vendor or market source

EASY

REAL ESTATE:

- Lessor typically will not include FV
- Difficult to determine value of partial building
- Lower volume markets with non-uniformity

MODERATE-DIFFICULT

IN THOSE CASES IN WHICH IT IS NOT PRACTICABLE FOR AN ENTITY TO DETERMINE THE FAIR VALUE OF AN UNDERLYING ASSET, LEASE CLASSIFICATION SHOULD BE DETERMINED WITHOUT CONSIDERATION OF THE [PRESENT VALUE OF LEASE PAYMENTS] CRITERIA.

– ASC 842-10-55-3

DETERMINING FAIR VALUE OF LEASE ASSETS

While ASC 842 allows a lessee to skip the present value of lease payments plus guaranteed residual value test when a fair value is not practicable to determine, **auditors generally believe this scenario is unlikely for most organizations.**

- Proportional allocation to partial building/asset (sq. Ft.; Tax percentage, etc.)
- Consideration of higher or lower value portions of asset (higher floors, parts of cell tower)
- Use of third-party data for similar asset

DETERMINING FAIR VALUE OF LEASE ASSETS

EXAMPLE

- 10th floor of a 15-floor building
- Class A office space
- Building value determined at $58 million
  - Determined by comparison to similar buildings in metro area
  - Indexed up due to “Class A” office space and proximity to train station

- Square footage as basis: 3,000 sq. ft. ÷ 55,000 sq. ft. = 5.5% of value
- Index of 0.90 (decrease) since floor does not have windows on all sides
- Already factored in: office space class and neighborhood/proximity to transit
- Total fair value = $58M x 0.055 x 0.9 = $2,871,000

DETERMINING FAIR VALUE OF LEASE ASSETS

BENEFITS OF PROPER CLASSIFICATION

- No audit surprises
- Better data for lease-versus-buy and downstream financial metrics

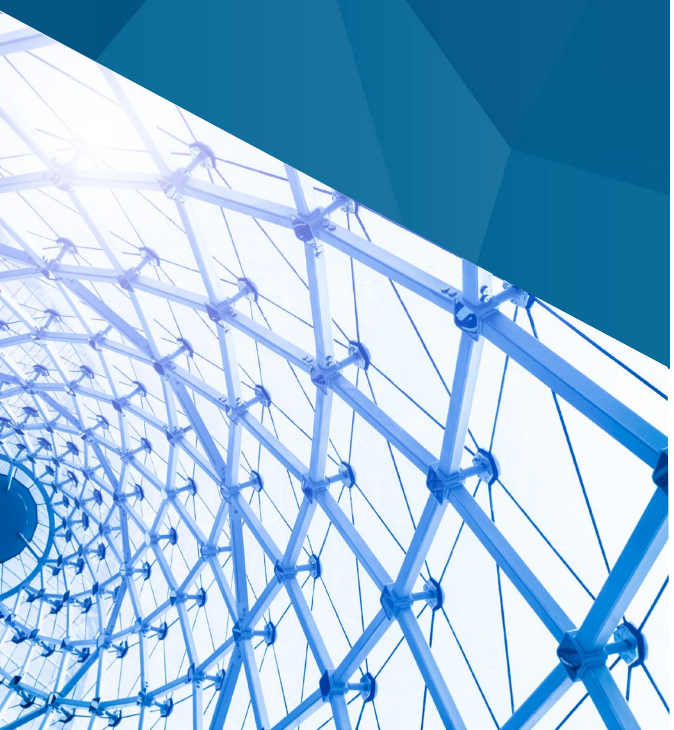
ISSUES WITH MISCLASSIFICATION

- Incorrect EBITDA or debt covenant results
- Failed sale-leaseback or other unfavorable conclusions

NON-ACCOUNTING IMPACTS

- Negotiation points with lessor for favorable lease agreement
- Align with enterprise goals

POLLING QUESTION #4



Which assets do you find are most difficult for your company when performing lease classification analysis?

A Specialized equipment without an active market

B Partial building leases (e.g. floor in an office building)

C Older assets that may have a reduced fair value

D Other types of assets

Q&A

ADDITIONAL RESOURCES

Establishing a Lease Borrowing Rate: ASC 842 Approaches

Lease Accounting for Private Companies: Transition Strategies and Impacts

Related Thought Leadership
View additional insights HERE

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REQUEST TO SPEAK WITH ONE OF OUR EXPERTS