



BKD

Telecom Lease Accounting

ICA Webinar April 15, 2020



**Our goals
for today**

1

Core Principals
and Rules

2

Financial Impacts

3

Regulatory Effects

What changes?

- All leases will be recognized on the balance sheet of lessees
- Operating leases
 - Lease liability
 - Right of Use Asset
 - Don't appear anywhere under today's rules
- Finance leases (formerly capital leases)
 - Lease liability
 - Lease assets
 - Similar to today's rules



Background

- › Lease guidance has had limited changes since FASB 13 issued in ***November 1976***
- › Decade-long joint project between FASB & IASB
- › Issued February 2016
- › Codified into ASC 842 (superseding ASC 840)
- › Lessor accounting remained relatively unchanged
- › FASB voted in July 2019 to extend application for non-public organizations by one year



Why the change?

- Increase comparability and transparency among entities
- Decade-long joint project between FASB & IASB
- Eliminate off-balance sheet risk and improve comparability
- More reflective of true substance of leasing transactions
- Lessor accounting remained relatively unchanged



Core Principal – Right-of-Use Model

A lessee should recognize the right-of-use (ROU) assets & liabilities that arise from leasing arrangements. All leases create an asset & a liability for the lessee in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*, & therefore, recognition of those lease assets & lease liabilities represents an improvement over previous GAAP, which did not require lease assets & lease liabilities to be recognized for most leases

Effective Dates

- Early adoption is permitted



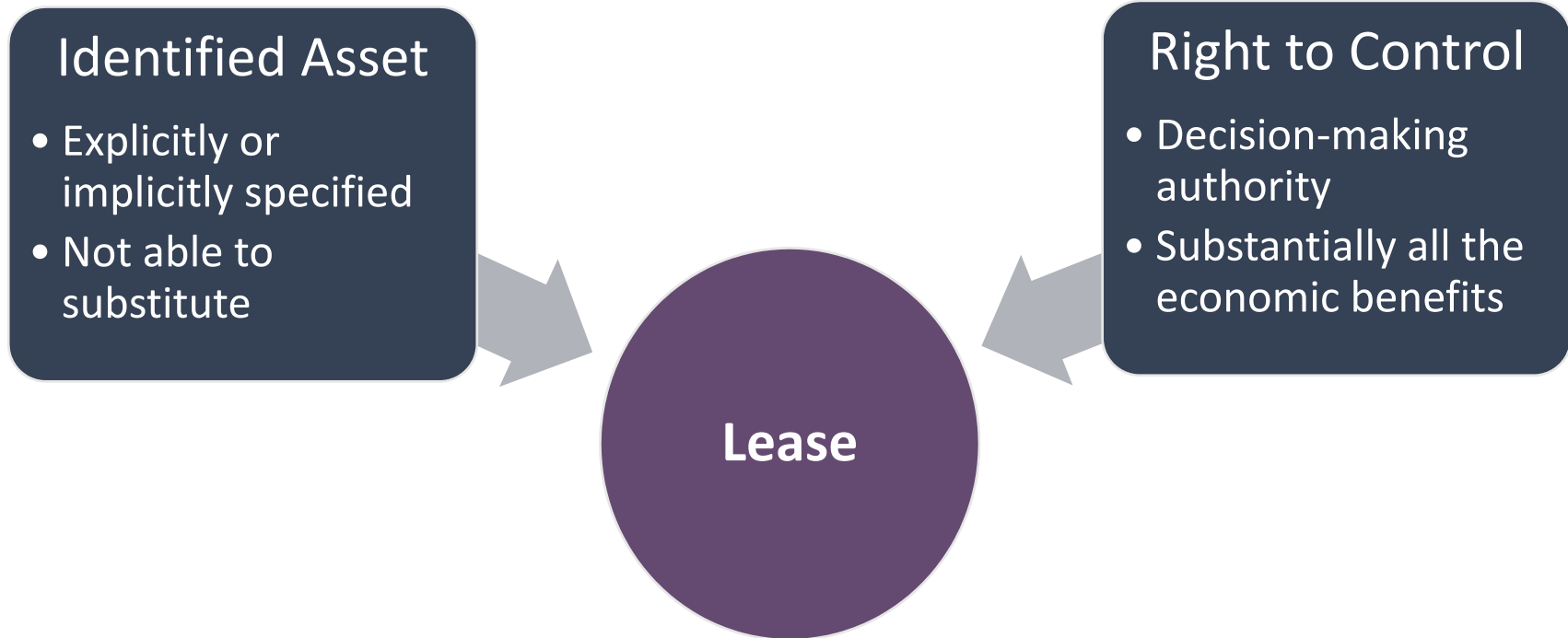
***FASB recently met and voted to delay for one more year....again

¹ A Public entity is defined as any one of these:

- A public business entity
- A not-for-profit entity that has issued – or is a conduit debt obligor for – securities traded, listed or quoted on an exchange or over-the-counter market
- An employee benefit plan that files or furnishes financial statements to the SEC



Determining Whether a Lease Exists



Right to Control the Use of the Asset

A lease contract conveys the right to control the use of the identified asset for a specified period of time in exchange for consideration. A customer controls an identified asset when the customer has both of the following

1

Right to direct its use

The right to direct how & for what purpose the asset is used, including the right to change how & for what purpose the asset is used

2

Right to obtain substantially all economic benefits from its use

By having exclusive use of the asset throughout the period



Short-Term Leases

- › Leases, at commencement date, have a term of <12 months & do not include option to purchase underlying asset that the lessee is reasonably certain to exercise
- › This policy election must be disclosed in the financial statements

Warning: the existence of lease extensions & the likelihood of extending the arrangement must be considered in determining the term

Entities can make a formal policy election to not recognize short-term leases on the balance sheet

Related-Party Leases

Old Guidance – ASC 840

Used substance
over form in
evaluating the
existence of a
lease

New Guidance – ASC 842

Use the legally
enforceable terms
& conditions of
the agreement

In the separate
financial statements
of the related parties,
the classification &
accounting for the
leases should be the
same as for leases
between unrelated
parties

Contracts with Multiple Components

Lease Component

- A separate ROU for an asset
- Lessee can benefit from the ROU of the underlying asset either on its own or together with other readily available resources. The use is neither highly dependent on nor interrelated with other assets
- Payments accounted for as a separate lease

Nonlease Component

- An activity that transfers a separate good or service to the customer, *e.g.*, supplies/disposables
- **Includes maintenance services**
- Allocated payments are nonlease period expense

Not a Separate Component

- Related to administrative tasks to initiate the lease & payment of lessor costs that do not transfer a separate good or service separate from the ROU asset
- **Includes payments for insurance or property taxes**
- Payments are part of lease payment, not separately allocated

Lease Classification

How to determine the accounting for your lease?

- › Lease will be classified as finance lease if it transfers substantially all risks & rewards of ownership (meets one of the five criteria on the next page)
- › Bright-line tests are not required; can be used as a reasonable approach/policy
- › All other leases will be classified as operating leases



Finance Lease Criteria (Similar to Today's Capital Lease)

1

Ownership of asset transfers to lessee by end of lease term

2

Lessee has purchase option that it is reasonably certain to be exercised

3

Lease term is for major part of economic life of asset (n/a for leases that commence "at or near the end" of the underlying asset's economic life, e.g., in the final 25 percent of an asset's economic life)

4

PV of minimum lease payments amounts to at least substantially all of fair value of leased asset

5

NEW: underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term



Lessee Accounting – Initial Measurement

Lease liability (obligation to make lease payments)

- Measured at the present value of the future lease payments*

Right-of-use (ROU) asset

- Lease liability + initial direct cost + lease prepayments – lease incentives received

**Lease liability is computed the same regardless of whether the lease is classified as an operating lease or a finance lease*

Discount Rate

Lessee uses

- › Rate charged by the lessor if the rate is readily determinable
- › Otherwise, incremental borrowing rate
 - Private companies can elect to use a risk-free rate – need to follow consistently & need to weigh benefits & costs



Lessee Model – Subsequent Accounting

Annual expense recognition & subsequent amortization of ROU asset depends on lease classification

› Finance lease

- Unwind liability using the effective interest method
- Front-loaded expense pattern similar to today's capital leases with interest & amortization recognized separately
- Interest determined on the lease liability in each period during the lease term as the amount that produces a constant periodic discount rate
- ROU asset generally amortized on a straight-line basis



Lessee Model – Subsequent Accounting

› Operating lease

- Unwind liability using the effective interest method
- Straight-line expense over term
- ROU asset: reduced by the difference between the annual straight-line lease expense & the annual interest cost on the lease liability, *i.e.*, amortize the asset to achieve straight-line total lease expense



Comparison of Lessee Accounting Models

Finance Lease

- **Balance sheet**
 - Right-of-use (ROU) asset
 - Lease liability
- **Income statement**
 - Interest expense (on lease liability)
 - Amortization expense (on ROU asset)
- **Cash flow**
 - Cash paid for principal payments (financing activities)
 - Cash paid for interest payments & for variable lease payments (operating activities)

Operating Lease

- **Balance sheet**
 - Right-of-use (ROU) asset
 - Lease liability
- **Income statement**
 - Lease/rent expense (straight-line)
- **Cash flow**
 - Cash paid for lease payments (generally operating)

SIMPLIFIED EXAMPLE – TERMS

Simplified Lease Example Details

- Six-year lease
- No renewal options
- Lease payments \$40,000 paid EOY
- Includes 9% interest rate

In this simplified example, the lease liability & the right-of-use asset are both \$179,437 (present value of six payments of \$40,000 each, at a discount rate of 9%)

The journal entry (regardless of financing vs. operating) would be

Dr. Right-of-use asset	\$179,437	
		Cr. Lease liability
		\$179,437

SIMPLIFIED EXAMPLE – RESULTS (FINANCE LEASE)

In this simplified example, if the arrangement is determined to be a *financing lease*, the lessee recognizes both amortization expense & interest expense, with higher expense in the initial years

	Finance Lease				
	Asset	Liability	Amort. Expense	Interest Expense	Total Expense
Commencement	179,437	179,437			
Year 1	149,531	155,586	29,906	16,149	46,055
Year 2	119,625	129,589	29,906	14,003	43,909
Year 3	89,719	101,252	29,906	11,663	41,569
Year 4	59,813	70,365	29,906	9,113	39,019
Year 5	29,907	36,698	29,906	6,333	36,239
Year 6	-	-	29,907	3,302	33,209
Total			179,437	60,563	240,000

Simplified Example – Results (Operating Lease)

In this simplified example, if the arrangement is determined to be a *operating lease*, there is only rent expense & the expense is straight-lined

Operating Lease			
	Asset	Liability	Lease Expense
Commencement	179,437	179,437	
Year 1	155,586	155,586	40,000
Year 2	129,589	129,589	40,000
Year 3	101,252	101,252	40,000
Year 4	70,365	70,365	40,000
Year 5	36,698	36,698	40,000
Year 6			40,000
Total			240,000

The total expense for the lease is the same whether it is a financing arrangement or an operating arrangement – equals total cash paid

FURTHER COMPLEXITIES

Additional Common Terms

- Renewal term options
- Lease incentives
- Direct costs incurred
- Prepaid rent
- Escalating/variable payments
- Interest rate not included
- Other options
- Multiple components
- Inception date different than commencement date
 - Subleases
 - Other

ESCALATING PAYMENTS EXAMPLE – TERMS

Escalating Payment Lease Example

- Six-year lease
- No renewal options
- Lease payments \$30,000 to \$50,000, paid EOY
- Includes 9% interest rate

In this example, the lease liability & the right-of-use asset are both \$174,308 (present value of six payments escalating by \$10,000 every second year from \$30,000 to \$50,000 each, at a discount rate of 9%)

The journal entry (regardless of financing vs. operating) would be

Dr. Right-of-use asset	\$174,308		
		Cr. Lease liability	\$174,308

Escalating Payments Example – Results (Finance Lease)

Escalating payments in a *financing lease*, the lessee recognizes both amortization expense & interest expense, with higher expense in the initial years

Finance Lease						
	Payments	Asset	Liability	Amort. Expense	Interest Expense	Total Expense
Commencement		174,308	174,308			
Year 1	30,000	159,995	159,995	29,051	15,688	44,739
Year 2	30,000	144,395	144,395	29,051	14,400	43,451
Year 3	40,000	117,390	117,390	29,051	12,996	42,047
Year 4	40,000	87,956	87,956	29,051	10,565	39,616
Year 5	50,000	45,872	45,872	29,051	7,916	36,967
Year 6	50,000	-	-	29,051	4,128	33,180
Total	240,000			174,308	65,692	240,000



Escalating Payments Example – Results (Operating Lease)

Escalating payments in a *operating lease*, the lessee recognizes only rent expense on straight-line basis. Difference in the asset amortization & liability is the cumulative difference of payments & expense

Operating Lease				
	Payments	Asset	Liability	Expense
Commencement		174,308	174,308	
Year 1	30,000	149,995	159,995	40,000
Year 2	30,000	124,395	144,395	40,000
Year 3	40,000	97,390	117,390	40,000
Year 4	40,000	67,956	87,956	40,000
Year 5	50,000	35,872	45,872	40,000
Year 6	50,000	-	-	40,000
Total	240,000			240,000



LESSEE BALANCE SHEET PRESENTATION

The below table shows acceptable and unacceptable ways to present these balances on the lessee's balance sheet (note that for simplicity this is an unclassified balance sheet).

Separate Presentation <i>Acceptable</i>		Presentation with Other Assets and Liabilities and Disclosed Separately <i>Acceptable</i>		Combined Presentation <i>Not Acceptable</i>	
Balance Sheet Period Ended December 31, 20X1		Balance Sheet Period Ended December 31, 20X1		Balance Sheet Period Ended December 31, 20X1	
ROU assets – operating leases	25,000	ROU assets – operating leases	25,000	ROU assets	25,900
ROU assets – finance leases	900	Property, plant and equipment	2,000	Property, plant and equipment	1,100
Property, plant and equipment	1,100				
Operating lease liabilities	25,150	Operating lease liabilities	25,150	Lease liabilities	26,000
Finance lease liabilities	850	Other liabilities	1,850	Other liabilities	1,000
Other liabilities	1,000				
		<u>Disclosure</u>			
		For the period ended December 31, 20X1, right-of-use assets from finance leases of \$900 are included as part of property, plant and equipment.			
		For the period ended December 31, 20X1, lease liabilities from finance leases of \$850 are included as part of other liabilities.			

Disclosure Objective

Enable users of financial statements to assess amount, timing & uncertainty of cash flows arising from leases

- › Policies & nature of leases
- › Significant assumptions
- › Quantitative disclosure examples
 - Financing lease costs, operating lease costs, short-term lease costs & variable lease costs
 - Weighted average remaining lease term, weighted average discount rate & supplemental noncash transaction information
 - More info: sublease income, sale-leaseback gains & others



Implications

- › Bond or loan covenants (definitions of lease or debt)
- › Financial statement ratios
- › Borrowing capacity
- › Rating agency impacts
- › Implementation time & resources
- › Policies, processes, controls, systems & people



Impacts: Covenant Compliance

Arrangements

Inventory all arrangements with compliance/covenant calculations

Analysis

Analyze terms & alignment with old vs. new GAAP

Conclusions

Conclude, communicate & confirm

Whether ASU 2016-02 will have an impact on these covenants & ultimately, compliance with them, may depend on how the borrowing documents define “debt” or “indebtedness” including whether such terms are in accordance with existing U.S. GAAP at signing of arrangements or U.S. GAAP in place at each reporting date

Mitigating the Risk of a Covenant Default

Review financial covenants in borrowing agreements to determine if ASU 2016-02 will affect compliance

Key assessments

- › Assess whether borrowing documents allow calculations in accordance with GAAP in effect on date of delivery of document
- › Assess if balance sheet-based covenants are adversely impacted
- › Assess if operating leases are considered “debt” or “indebtedness”
- › If risk of default, assess amending borrowing documents

If operating leases are considered debt, every time an operating lease is entered into, additional debt test has to be met

Impacts: Accounting & Reporting

Adoption Project

- › Education & communication
- › Project team & resource considerations
- › Timeline, project management, adoption methods
- › Assessment of risk of material misstatement on financial statements
- › Centralized vs. decentralized
- › Inventory of all lease agreements, service contracts & other arrangements that might contain ROU assets
- › Assessment of arrangements & adoption
- › Adoption disclosures

Impacts: Accounting & Reporting

Ongoing: Policies, Processes & Controls

- › Definitions requiring management's judgment, *e.g.*, definition of lease, lease term, & terminology, *e.g.*, "insignificant," "reasonably certain," "substantially all"
- › Ongoing remeasurement requirements, *e.g.*, index or rate changes, modification to contract terms, lessee's assessment of options to extend or terminate or purchase underlying asset
- › Increased ongoing disclosure requirements
- › Update policies, processes & controls & related control documentation

Agreements to Consider



Optional Relief

Optional Relief	
Transition Elections	Accounting Policy Elections
Expedient package – identification, classification, initial direct costs*	Separation of lease & nonlease components for both lessee & lessor
Hindsight	Portfolio approach
Land easements	Short-term leases
Prior-period presentation	Materiality thresholds (capitalization policy)
	Discount rate (non-PBEs only)
	Presentation of taxes

**These three must be elected as a package*



Regulatory impacts

- FCC Order 18-179 adopted FASB rules
 - Operating leases
 - Lessor to record long-term lease receivable in acct 1410
 - Lessor must also recognize a deferred inflow of resources equal to the lease receivable plus any up-front payments received from lessee that relate to future periods in acct 4300
 - Lessee treatment is the same
 - 1410 for ROU asset
 - 4300 for lease liability

Common Telecom Leases

- All Companies (Cost or Average)
 - Dark Fiber Leases
 - Becoming more and more common
 - Non-Regulated and Non-Tariffed
 - Flat rate pricing from large mobile providers seeking state-wide or area-wide pricing
 - Competition
 - NECA tariff pricing concerns/issues
 - Switch Sharing
 - TS Freeze



Settlement impacts

- Average Schedule – Operating leases are an option, but does not specifically impact your company's revenues
 - More of a case by case basis
 - Evaluate overall on financial and non-financial costs and benefits
- Cost Companies – Operating leases may still be viable even after rule changes
 - Need to work directly with your cost consultant as each company can be different

What to Do Now?

1

Read the standard & related resources; identify a champion or task force to study the new standard

2

Review debt covenants & other arrangements; draw preliminary conclusions relative to how accounting change will be viewed in relation to the terms

3

Determine if resource bandwidth & competencies exist within the organization or if outside assistance is needed

4

Educate audit committees, boards & other stakeholders

What to Do Now?

5

Engage facilities, procurement, IT & finance staff (& third party, if deemed necessary)

6

Identify right-of-use asset arrangements & inventory the arrangements

7

Analyze arrangements for accounting changes & document

8

Adopt & develop disclosures

BKD LeaseVision



AI-Powered Software

Our tool powered by artificial intelligence (AI) extracts key lease terms from various lease types, helping you to quickly review leases.



Implementation Road Map

From checklists to timelines, our road map can provide an in-depth process framework for a smooth implementation.



Excel-Based Calculation Tool

Our Excel-based tool can help you perform calculations and develop lease amortization schedules.

Software Options

- 3rd Party Software Options
 - simpLease
 - Visual Lease
 - Lease Query
 - uGAAP



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Thank You!

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