How The New Accounting Standard Change May Impact Your Equipment Lease Portfolio

ASC 842 From a Lessee's Perspective

KaufmanHall

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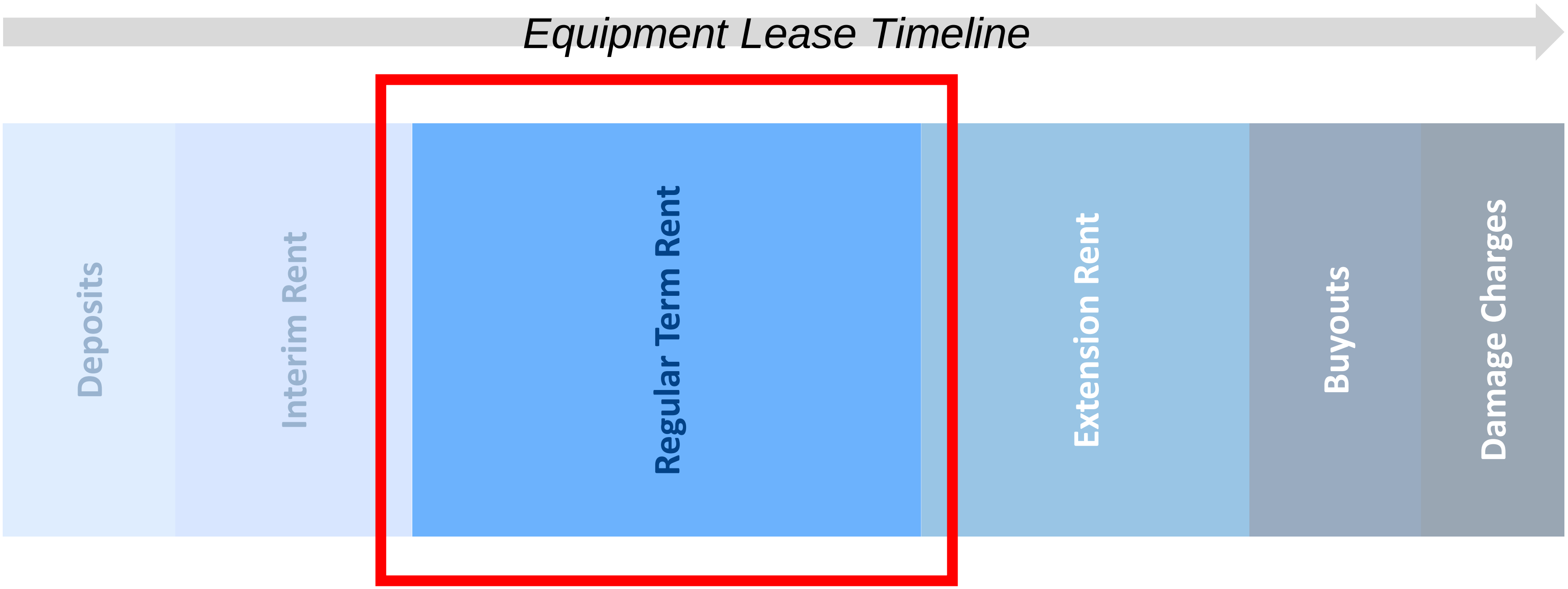
Impact of Equipment Lease Accounting Standards Change

The accounting standards change may increase equipment leasing cost and risk

- Accounting Standards Codification Topic 842 (ASC 842) is being implemented, depending on how an entity is classified and its fiscal year, between 12/15/2018 through 12/15/2021
- Key Risk Factor: Current FASB 13 assumptions held by many CFO's & Treasurers is that if it's on the balance sheet, then there is no risk. Will not hold true under ASC 842.
- Operating lease regular term rents remain less that 100% value of equipment
- 12-month short-term exception: New creative "rental" structures
- Embedded Leases: Non-lease elements have to be reported separately from equipment
- Variable payments, such as interim rent, extension rent, and other fees, will typically be treated as an operating expense and be "off balance sheet"

Visibility Gap—Equipment Lease Payments on Balance Sheet



Under ASC 842, regular term rent is the only portion of the lease required on balance sheet. It is also often the only portion of the lease evaluated by lessees. However, it does not represent the true economic cost.

Recent Equipment Lease Market Trends

Lessors have become creative in utilizing embedded leases that include a mix of equipment, services, software, and consumables

Reagent/disposable agreements with "free" equipment

Enterprise Partnership Solution

Per-use agreements

Under the new ASC 842 guidelines, these all fall under the "Embedded Leases" category. The burden falls to lessee to disaggregate the lease components and record the equipment portion on the balance sheet.

Per-click agreements

Technology Management Plan with Unitary Payments

Cloud agreements

Example 1: Per-Use Agreements

Such agreements can be beneficial if you understand the contract terms and impact on your organization upfront

Contract Terms:

- Equipment: medical robots
- 7-year term, no title transfer; if equipment upgrades are required prior to term end, lessee can upgrade to another machine for a new 7-year term.
- Target uses set over term, with a minimum and a maximum usage caps
- Service included

What Lessor Sees:

- Lessee is locked-in for a minimum of 7 years.
- The useful lifetime of equipment is < 7 yrs so it guarantees upgrades that extend for another 7-yr term.

What Lessee Sees:

- Positive agreement allowing for risk-sharing across multiple locations
- Only charged if using equipment
- Can optimize and forecast profit per usage

Accounting Impact:

- This is an embedded lease. The present value of payments related to the equipment needs to be recorded on the balance sheet.
- The service needs to be separated from equipment portion—may be difficult to disaggregate

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Example 2: Strategic Agreements

Such agreements may be extremely challenging to account for in your books

Contract Terms:

- Equipment: imaging equipment
- 5-year term, 70 units worth $30+ million acquired at different periods during the 60 months; Lessee commits to all equipment, services and optional services upfront.
- Unitary payment structure; monthly payments may vary, calculated ad-hoc
- Limited information on cost disaggregation

What Lessor Sees:

- Lessee is locked-in for 5 years with a large capital commitment upfront.
- Purchase of equipment now that will be delivered and used years in the future.
- Freedom to adjust Unitary Payments and set committed services.

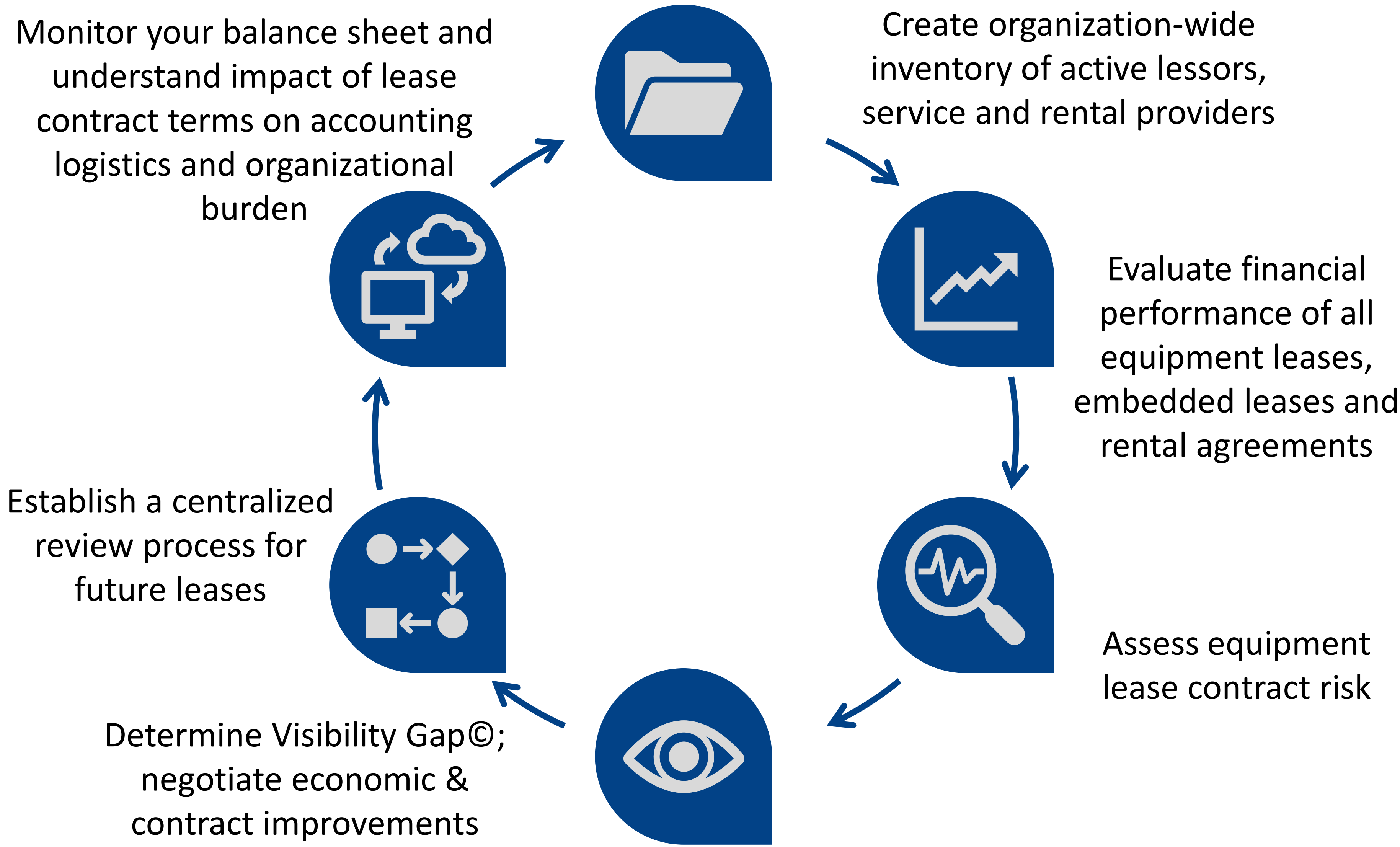
What Lessee Sees:

- Fixed discount per unit and service from the lessor
- Smooth cash outlay curve
- Transparency over cost of equipment and payments

Accounting Impact:

- This is an embedded lease. The equipment portion needs to be separated and recorded on balance sheet—may be difficult to disaggregate.
- How do you account for equipment that you purchase now but will acquire in the future?

Best Practices—Equipment Lease Portfolios



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GASB 87 vs ASC 842

Key Term	GASB 87	FASB ASC 842
Operating/Capital Lease Distinction	No distinction, all leases treated as financings	Distinction retained, no requirement to separate principal / interest components for Operating Leases
Short-Term Leases	Max possible term under the lease contract of 12 months (or less), ***including any options to extend***, regardless of their probability of being exercised	Lease term of 12 months or less
Initial Lease Liability Recording	Present value of expected payments expected during the lease term	Present value of the lease payments (regular term)
Lease Term	The noncancelable period of the lease, together with: (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, and (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option…	
Embedded Leases	Account for the lease and non-lease components as separate contracts. If determining a best estimate is not practicable, multiple components in a lease contract should be accounted for as a single lease unit.	Identify the separate lease components within the contract. Lessee may choose not to separate non-lease components from lease components and instead to account for each component associated with that lease as a single lease component.
Remeasurement	A lease modification that does not qualify as a separate lease should be accounted for by remeasuring the lease liability and adjusting the related lease asset by lessee	If a contract modification…extends the term of an existing lease ***other than through the exercise of a contractual option*** to extend or terminate the lease
Effective Dates	FYs beginning after 12/15/2019	Public entities: FYs beginning after 12/15/2018 Private entities: FYs beginning after 12/15/2021

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