

2018

SuperTRUMP with FASB ASC Topic 842, Leases

REFERENCE GUIDE

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Ivory Consulting Corporation

ASC Topic 842, Leases

White Paper - 2018

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Introduction

This document describes the changes to SuperTRUMP to incorporate *Accounting Standards Codification (ASC) Topic 842, Leases*. These changes affect interfaces, calculations, and reports. The transaction elements most affected are residual guarantees, tax credits, IDC fees, implicit interest rate, classification from both the lessor and lessee perspectives, and accounting. This functionality will be available in a generic release of SuperTRUMP in mid-2018 known as SuperTRUMP 12.

Classification Overview

The purpose of classification is to determine, from an **accounting** perspective, not **tax** nor **legal**, the “owner” of the equipment. Each party (lessor and lessee) tests ownership from its own point of view using slightly different criteria. It is possible that both parties will determine that they **do** or **do not own** the equipment.

For both parties, a lease classified as an **operating lease** is “owned” only by the lessor. While the lessee will always conclude that one of them owns the equipment, the lessor may conclude (again, only from its point of view) that no one owns the equipment.

From the lessee’s point of view there are only two possible outcomes: ownership is taken (**finance lease**) or is not taken (**operating lease**).

From the lessor’s point of view, there are three possible outcomes: the lessee takes ownership (**sales-type lease**), the lessor keeps ownership (**operating lease**) or neither party takes it (**direct financing lease**). We use the term **finance lease** to refer to **sales-type leases** and **direct finance leases**, collectively.

A **short-term lease** has a term of 12 months or less; it is essentially an operating lease for which the lessee has no accounting requirement, specifically in the form of a Right-of-Use Asset shown in report **Calculation of ROU Asset** in report group **Lease accounting, finance, ASC 842**.

In a **sales-type lease**, the lessee becomes the “accounting owner” of the equipment (from the lessor’s perspective); any lessee residual guarantees – but not 3rd party guarantees – that lessor and lessee have elected to include in the transaction are included in meeting this designation.

In a *direct finance lease*, the lessor loses its status as the “accounting owner” of the equipment as a result of any 3rd party residual guarantees or residual value insurance that have been optionally structured into the lease; however, ownership does **not** pass to the lessee. Thus, there is no accounting owner. Below is a summary of the ownership categories.

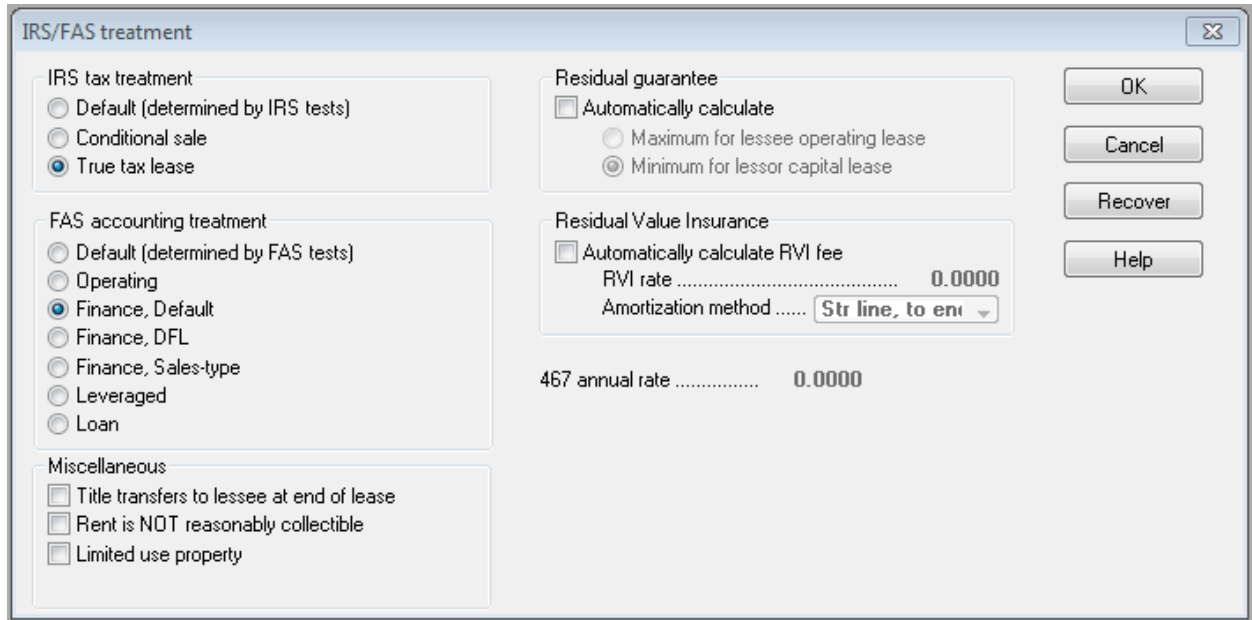
	Lessor’s Perspective	Lessee’s Perspective
Lessor Owns	Operating	Operating
Lessee Owns	Sales-Type	Finance
Neither Owns	Direct Finance	-

Screen Changes

In **Controls | Accounting**, there is a new radio button labeled **Standard** with selections **FAS 13** or **ASC 842**. This switch will affect certain other windows, notably **Parameters | IRS/FAS Treatment**, where the selections with the box **FAS accounting treatment** will show the new names accordingly (see second illustration below). **Controls | Accounting** also includes a checkbox **Set standard based on 842 start date** that allows the user to specify the date of the transition from FAS 13 to ASC 842. When this is selected, the radio buttons at the top show the appropriate standard selected (and the other one disabled). This decision is based on whether the earliest delivery date (or in lender mode, takedown date) is on or after the **842 start date**, which defaults to January 1, 2019.

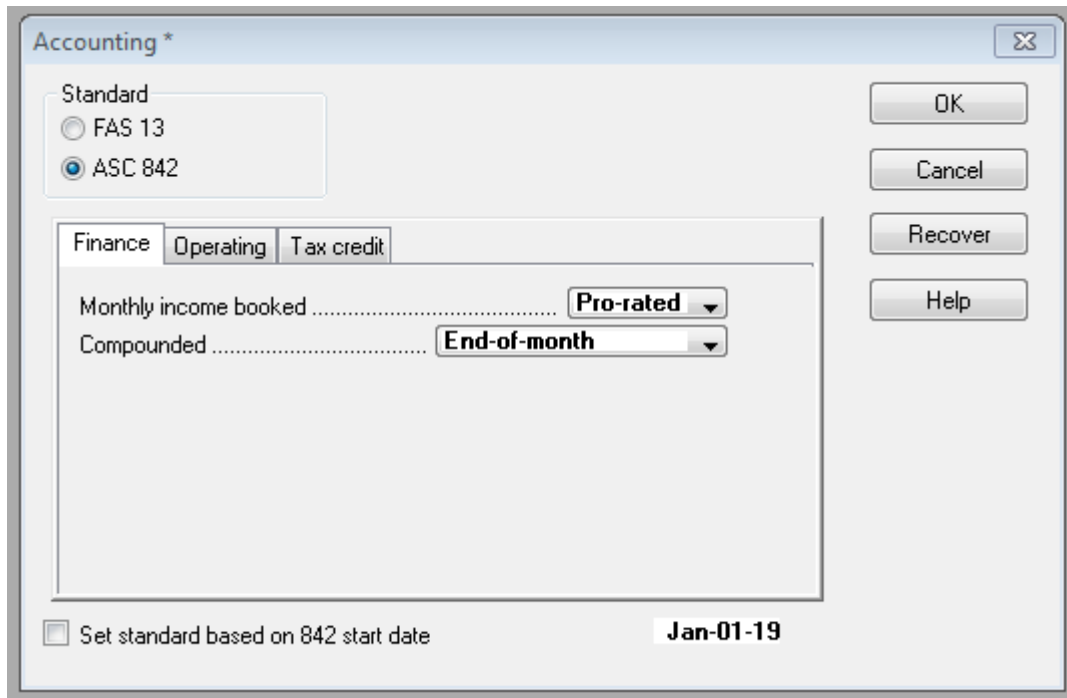
The screenshot shows the 'Accounting' dialog box with the following elements:

- Standard** section:
 - FAS 13
 - ASC 842
- Navigation tabs: Finance, Operating, Tax credit
- Monthly income booked: Pro-rated (dropdown)
- Compounded: End-of-month (dropdown)
- Buttons: OK, Cancel, Recover, Help
- Checkbox: Set standard based on 842 start date
- Date: Jan-01-19

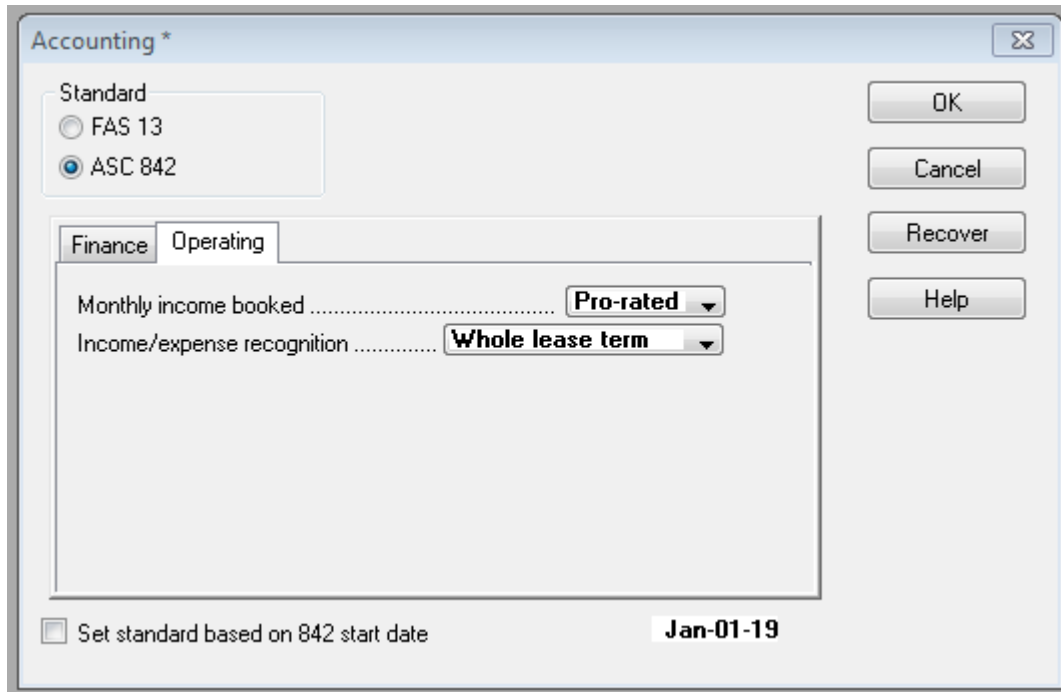


The three tabs within **Controls | Accounting (Capital/Finance, Operating, and Tax Credit)** have been rearranged.

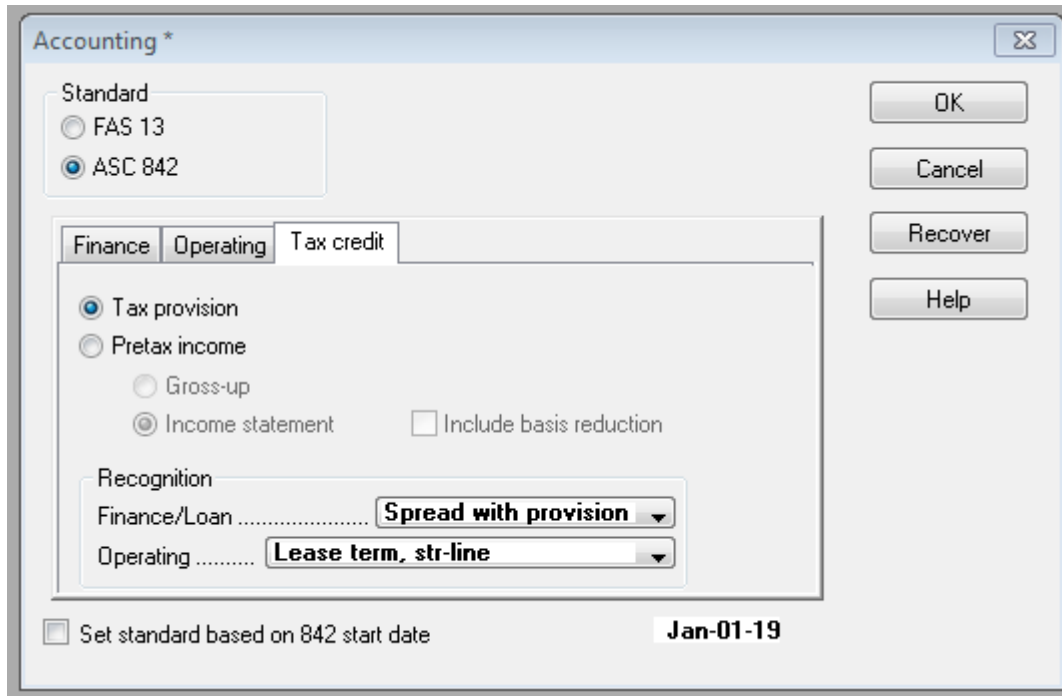
The **Capital/Finance** tab has two combo-boxes, **Monthly income booked** and **Compounded**.



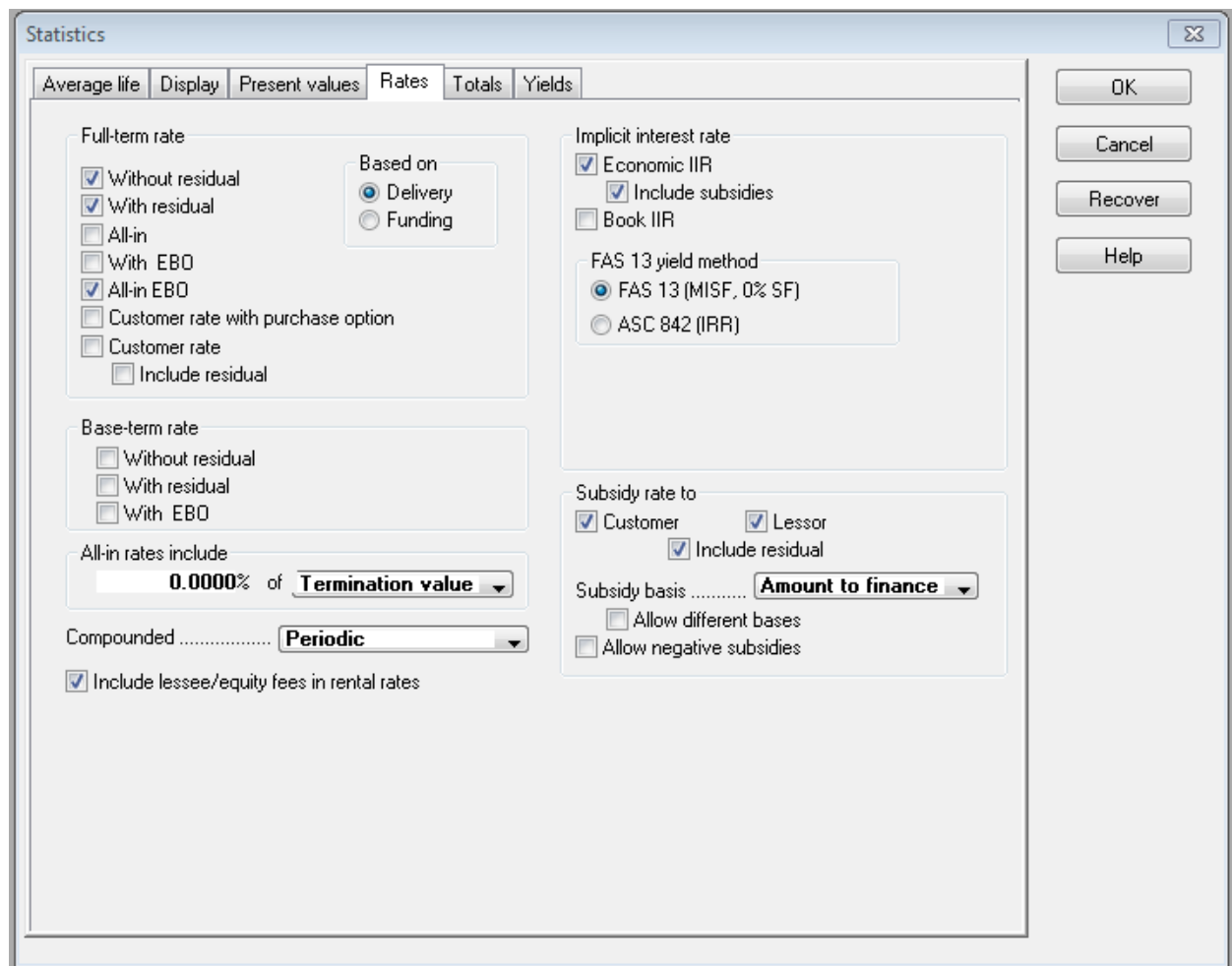
The **Operating** tab has two combo-boxes, **Monthly income booked** and **Income/expense recognition**.



The **Tax credit** tab has a radio button to allow the selection of **Pretax income** or **Tax provision**. When **Pretax income** is selected, a checkbox **Include basis reduction** allows that reduction to be included with the tax credit, and a radio button allows **Gross-up** or **Income statement** for the method. The tax credit recognition allows two selections for finance/loan: **Spread with provision** and **cash dates**, and three selections for operating: **Book depreciation term, str-line**; **Lease term, str-line**; and **Tax payment dates**.



In **Controls | Statistics | Rates**, the items within the **Implicit interest rate** box have changed. Under **Book IIR**, there is a new radio button **FAS 13 yield method**. It allows the user to select the original FAS 13 yield calculation, which is the MISF yield using a 0% sinking fund rate, or the ASC 842 method, which is the IRR yield.



Calculation of the Implicit Interest Rate

The Implicit Interest Rate (IIR), in general, is the rate that discounts the rent and residual to the asset cost. It is used principally in the lessor’s PV test (the “90% test”). There are some differences between FAS 13 and ASC 842, both in the calculation and in the parameters that are included. This is especially true for fees, subsidies, and periodic income.

Under ASC 842, fees that are *IDC* or *capitalized* for accounting are included in the IIR, even if they have no cash effect. For this purpose, the accounting selection prompt has been renamed **Finance / Loan / IIR** and is used for both finance and operating leases. This is in contrast to FAS 13, under which they are included if they are *equity/capital* type.

Subsidies are treated similarly. The first accounting combo-box has been relabeled **Finance / Loan / IIR**; as with fees, subsidies are included for selections *capitalized* and *IDC*. Accounting for the subsidy uses the selection in this combo-box or the **Operating** combo-box, as applicable. In FAS 13 subsidies are included in the IIR based on the checkbox **Include subsidies (in FAS 13 IIR)** in **Controls | Statistics | Rates**.

Periodic incomes are included in the IIR for both FAS 13 and ASC 842 if the checkbox **In FAS Min Lease Payments** is selected (**Parameters | Periodic Income | Options | General**). However, in contrast to fees, they must have a cash effect to be included.

The Financial Accounting Standards Board issued a technical amendment in July to respond to numerous questions from the leasing and financing industry. The correction addresses the situation of a negative implicit interest rate (IIR), which can occur if total rent is below the cost of the asset, usually because of tax credits. This amendment specifies a rate of zero in such a case.

A refinement has been made to SuperTRUMP v12.1 for this.

[Optional, depending on implementation] If the IIR would naturally be negative, the program now warns the user on the QuickScreen and in the Summary Report of this situation and replaces the rate with 0 wherever the IIR is used. The proof of the IIR will still show the naturally-calculated value, negative or positive.

Classification Reports

The new report group **Classification, ASC 842** is present in lessor mode (and combined lessor and lender mode) if the ASC 842 standard is selected in **Controls | Accounting**. It contains four new reports: **Classification, lessee**; **Classification, lessor**; **Present value test, lessor**; and, **Present value test, lessee**.

The traditional FAS 13 reports are unchanged and are still in the group **Classification, FAS**.

Classification Tests

The **Standard** selection, **FAS 13** or **ASC 842** in **Controls | Accounting**, determines which classification logic is applied. ASC 842 introduces two new classification tests and slightly changes the present value tests of FAS 13. The first five determine if a lease is a **sales-type**

lease and, if not, the last two tests determine whether it is an **operating lease** or a **direct finance lease**.

If **any** of the following five conditions are true, then the lease is a **finance lease** for the lessee and a **sales-type lease** for the lessor:

1) Title Transfer Test

The lease automatically transfers title to the equipment at the end of the lease. This uses the pre-existing checkbox **Title transfers to lessee at end of lease** in **Parameters | IRS/FAS Treatment | Miscellaneous**.

2) Bargain Purchase Option Test

It is *reasonably certain* that the lessee will purchase the asset. Quantitatively, it is assumed that if the lessee can purchase the equipment for less than its FMV, they will. This test compares the purchase option amount in **Parameters | Asset | Residual** with its FMV in **Parameters | Asset | IRS/FAS classification**. In a multi-asset transaction, this test is performed on each asset individually. If any asset has a bargain purchase option, then the entire transaction is deemed to be a finance lease.

3) Economic Life Test

The lease covers 75% or more of the asset's **remaining** economic life. If the lease starts in the last 25% of the asset's life, skip this test for the purposes of classification. When there are multiple assets in a lease, the Economic Life of the "predominant asset" (§842-10-25-5) should be used. (*Note: SuperTRUMP assumes that the asset with the highest cost is predominant. If multiple assets have the same highest cost, the first asset with that amount will be used.*)

4) Limited Use Property Test

The equipment is of such a specialized nature that it would be useless for the lessor to have it returned. This uses the pre-existing checkbox **Limited use property** in **Parameters | IRS/FAS Treatment | Miscellaneous**.

5) 90% Test without 3rd Party Guarantees

The present value of the rent and lessee-guaranteed residual is greater than or equal to 90% of the FV reduced by any ITC. In a multi-asset lease, the test is performed on the aggregated assets, rents, and residual guarantees. (*Note: the ITC is not mentioned in the classification section itself, but is hidden away in §842-10-55-8.*)

If none of the tests are true, then the lessee classifies the lease as an **operating lease**.

The following two additional tests apply only to the lessor. If **both** are true, the lessor classifies the lease as a **direct finance lease**; otherwise the lessor classifies it as an **operating lease**.

6) 90% Test with 3rd Party Guarantees

The 90% test is performed again, this time including RVI & 3rd party residual guarantees in addition to lessee guarantees. If there are no such guarantees, this part of the test will be skipped.

7) It is **probable** that the lessor will receive the rents and any residual guarantees. This uses the pre-existing checkbox **Rent is NOT reasonably collectible** in **Parameters | IRS/FAS Treatment | Miscellaneous**. (This defaults to **off**.)

Lease Classification in Lessee Mode

SuperTRUMP allows specifying lessee classifications as **Default**, **Finance Lease**, or **Operating Lease**.

If **Default** is used, the program will set the classification based on the FASB tests. This classification affects the treatment of fees and the accounting report group.

The screenshot shows a dialog box titled "Lease: IRS/FASB treatment". It has a close button in the top right corner. The dialog is divided into two main sections:

- Tax treatment:** This section contains two radio buttons. "Conditional sale" is unselected, and "True tax lease" is selected.
- Accounting treatment:** This section contains three radio buttons. "Default" is selected, "Finance Lease" is unselected, and "Operating Lease" is unselected.

On the right side of the dialog, there are four buttons stacked vertically: "OK", "Cancel", "Recover", and "Help".

Lease and Non-Lease Quantities

ASC 842 provides for differentiated treatment of fees and other transaction elements that are part of the lease and those that are outside of it (*non-lease*). The user will indicate “lease-related” by selecting *IDC* or *Spread with Income* for the accounting treatment in *Parameters / Fee | Accounting treatment Capital/Loan*.

The screenshot shows a software dialog box titled "Lease: Fee [4 of 7] *". The dialog is divided into several sections:

- Description:** SL
- Amount:** 125.00 (selected with a radio button), Percent: 0.0227 (radio button), % of: Cost (dropdown)
- Type:** Expense (selected with a radio button), Income (radio button)
- Active:** Active, No cash effect
- Date paid:** May-01-97
- Accounting treatment:** Method: Straight-line (dropdown menu is open showing options: Straight-line, Cash, IDC, Straight-line, None)
- Federal Amortization:** Method: Str line, fixed (dropdown), Basis %: 100.0000, Starting: May-01-97, Term: 3.000, Salvage: 0.00, ADS convention: Half-year (dropdown)
- State Amortization:** in FAS minimum lease payments, Method: Str line, to end (dropdown), Basis %: 100.0000, Starting: May-01-97, Term: 15.075, Salvage: 0.00, ADS convention: Facts & circ (dropdown)
- Associated with:** Asset (dropdown)
- Which:** Asset 2 (dropdown)

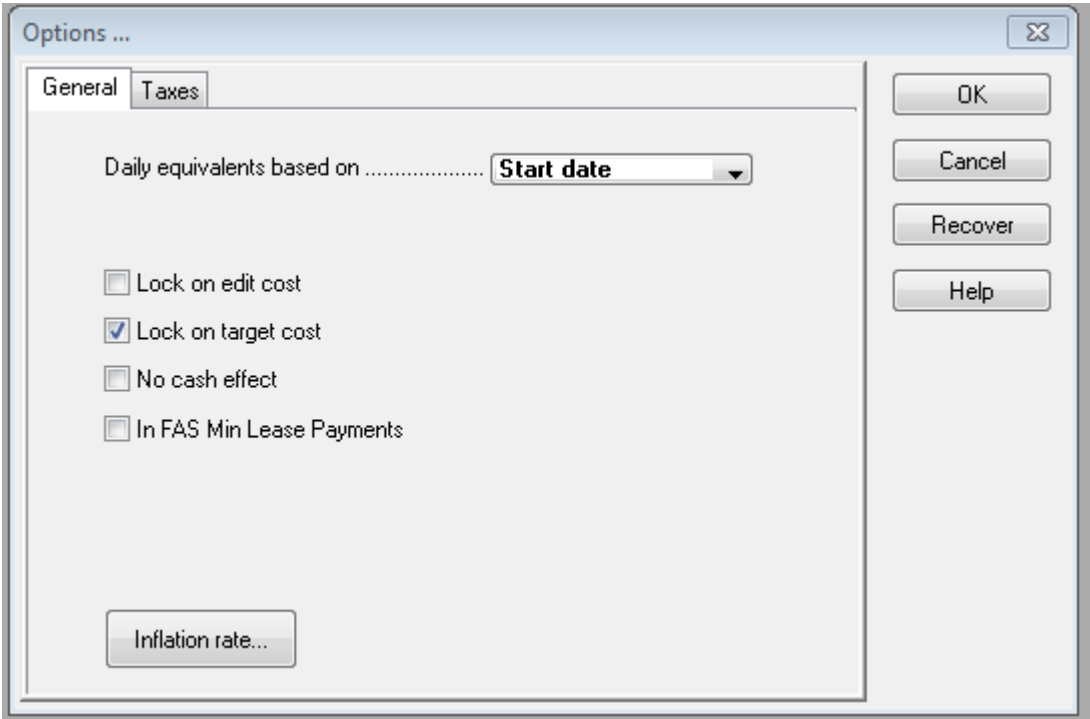
Buttons on the right side include OK, Cancel, Recover, and Help.

Fee Treatment in Lessee (Lease vs. Purchase) Mode

The capability to model various accounting treatments has been added to fees on the lease side in LVP mode. Also, a new checkbox *in FAS Minimum Lease Payments* is available to indicate that the fee is part of the *Minimum Lease Payments*. (This functionality corresponds to the checkbox *Lessee Obligation* on the lessor side.) If the checkbox is not selected, the payee is assumed to be a third party and not associated with the lessor.

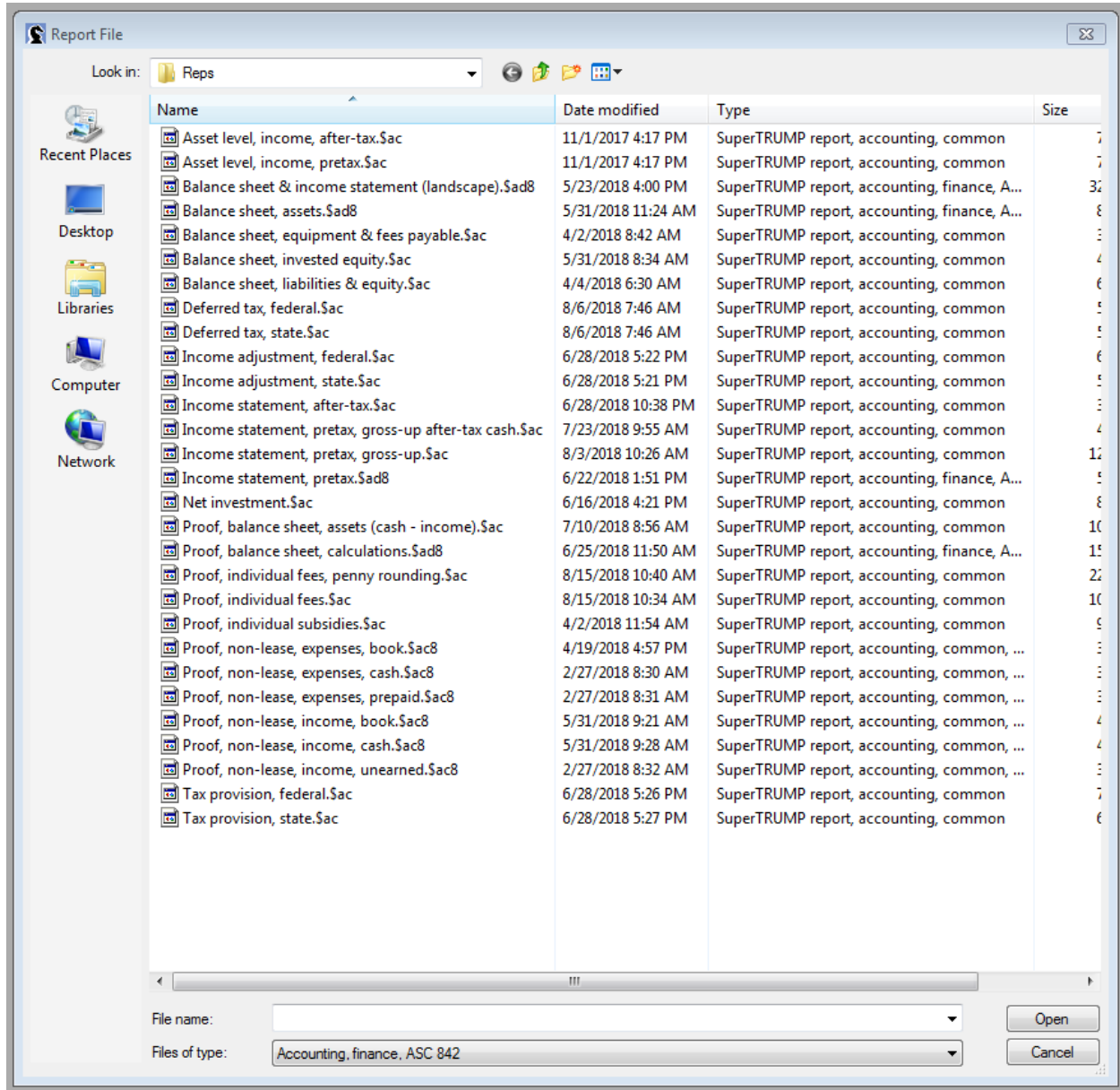
Periodic Cash Flows in Lessee (Lease vs. Purchase) Mode

The capability to model periodic income and expense flows allows lessees to accurately represent flows for insurance, maintenance, or other purposes. For **Lease: periodic expenses**, a new checkbox **In FAS Min Lease Payments** is available in **Options** on the **General** tab to indicate that the fee is part of the **minimum lease payments**. If this checkbox is not selected, the payee is assumed to be a third party and not associated with the lessor. The checkbox is not present for periodic income received by the lessee, nor is it present for periodic income or expense flows for the purchase.

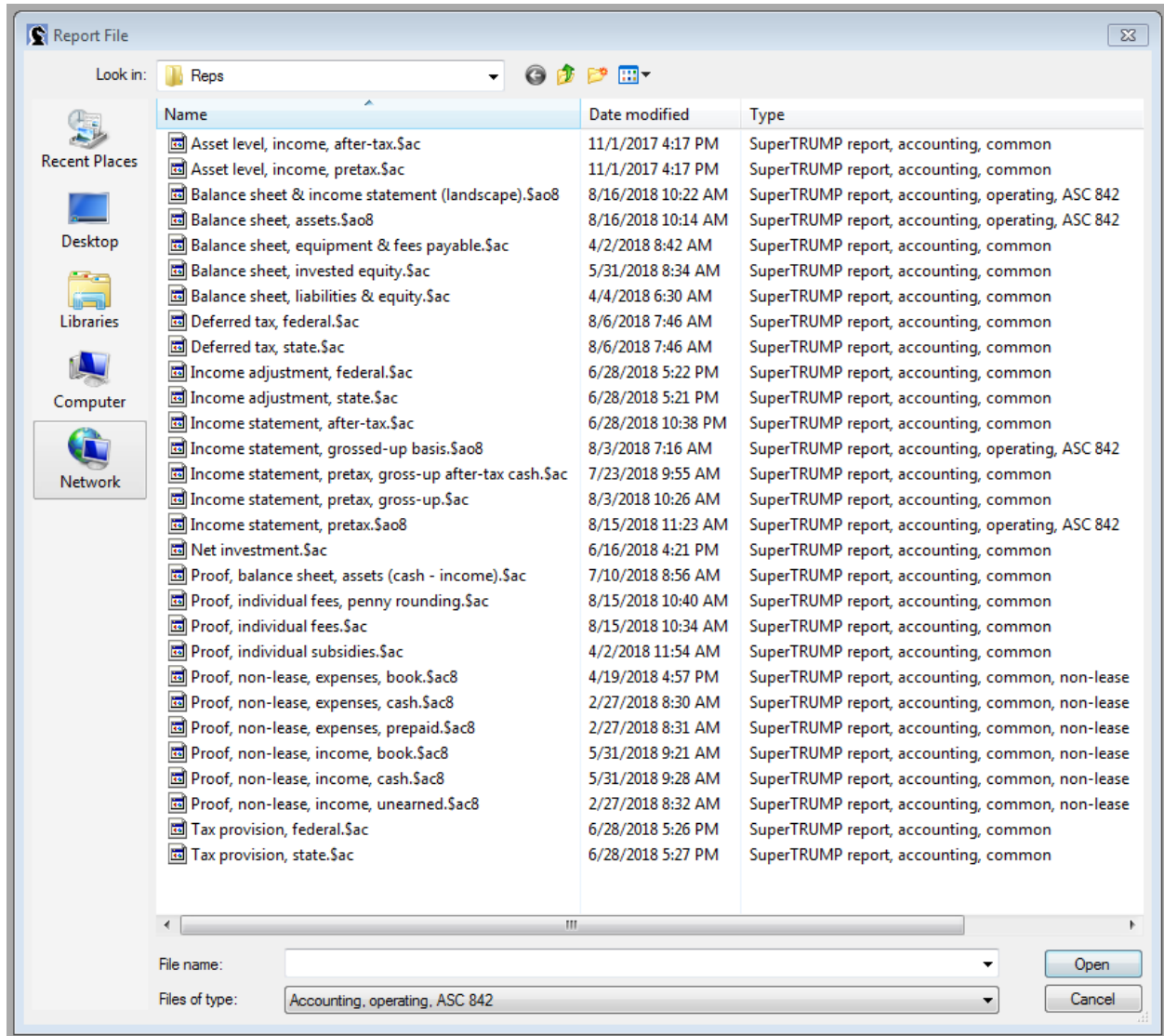


Accounting Reports

A new report group **Accounting, finance, ASC 842** is present for finance leases when the ASC 842 standard is selected in **Controls | Accounting**. It contains the reports illustrated below.

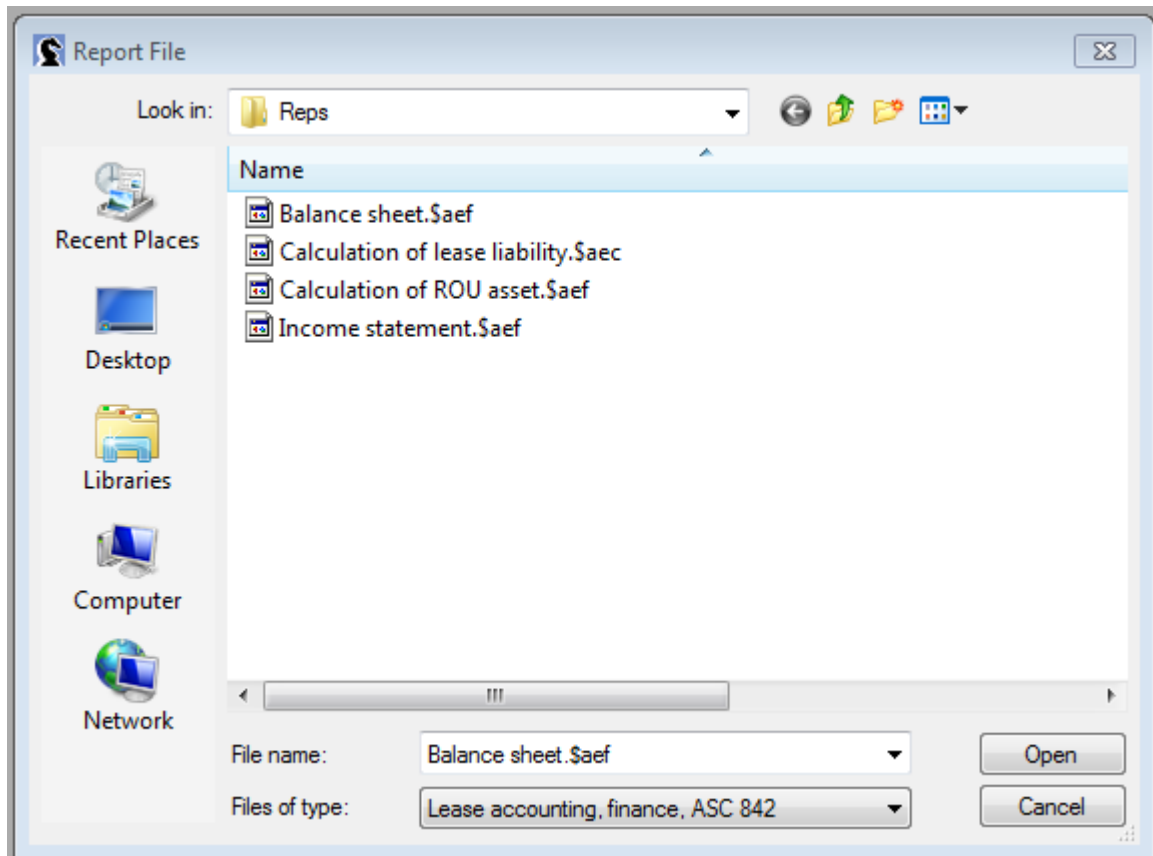


The reports available for **Accounting, operating, ASC 842** are as follows:



Accounting Reports in Lessee Mode

The following illustration shows the new reports – available for both finance and operating – in lessee mode (lease vs. purchase) if **equipment at end of financing (Controls | LvP)** is set to **Return or Sell**.



Accounting Reports in Combined Lessor & Lender Mode

Accessed in **File | Mode | Lessor & Lender** and commonly referred to as *both mode*, this functionality allows the tax and cash calculations for leases and loans to be analyzed on a combined basis. Accounting reports, however, apply only to the lease. The loan portion is considered a non-lease lending loan.
