Mini Case Study – Explicit Lease

- Read the Contract and identify the major lease criteria on page 7 of the handout.
- Feel free to work with others, as needed
- We will debrief the case as a group
- Be prepared to share your answers with the broader group

You have **10 minutes** to complete these requirements
Lease criteria:

- What type of asset is leased?
- What is the lease term?
- Is the implicit rate in the lease readily determinable?
- What are the lease inception and commencement dates?
- What are the lease payments?
- Does the lease have:
  - Lease incentives?
  - Initial direct costs?
  - A purchase option?
  - A termination provision?
  - A renewal option?
  - A residual value guarantee?
  - A non-index based escalation clause?
  - An index based on escalation clause?
  - Variable lease payments other than index based?
  - Non-lease components?
  - Noncomponents?
  - Lease deposit due?

- Operating or Finance Lease?
Accounting Impact

Recognition of lease liability

\[
\text{Lease Liability} = \text{Present Value of the Lease Payments Not Yet Paid}
\]

Discount rate used to determine present value is either the rate implicit in the lease or the lessee's incremental borrowing rate (see Section 7.2).

How to determine the Implicit Rate in the Lease

- Present value of lease payments
- Present value of expected future value of residual asset
- Fair value of underlying asset less investment tax credits retained by lessor
- Deferred initial direct costs of lessor

How to calculate the lease liability

- Lease Term
- Discount Rate
- Lease Payments, excluding:
  - Variable payments not based on an index
  - Non-lease components
  - Lease Deposit Paid, because it is refundable.
# Accounting Impact

## Calculation of the Lease Liability

<table>
<thead>
<tr>
<th>Key Contract Terms</th>
<th>Periodic Payment Schedule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment terms (month/quarter/year)</td>
<td>Monthly</td>
</tr>
<tr>
<td>Periods per year</td>
<td>12</td>
</tr>
<tr>
<td>Payment terms (Beg/End)</td>
<td>Beginning</td>
</tr>
<tr>
<td>Total lease term (months)</td>
<td>60</td>
</tr>
<tr>
<td>Periodic lease payment (initial)</td>
<td>$35,625</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Dates

<table>
<thead>
<tr>
<th>Lease commencement date</th>
<th>Lease end date</th>
</tr>
</thead>
<tbody>
<tr>
<td>T0</td>
<td>T60</td>
</tr>
</tbody>
</table>

### Assumptions

| Discount rate | 4.00% |

<table>
<thead>
<tr>
<th>Period</th>
<th>Beginning Lease Liability</th>
<th>Interest Component</th>
<th>Payment</th>
<th>Ending Lease Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$2,035,992</td>
<td>$ -</td>
<td>$35,625</td>
<td>$2,035,992</td>
</tr>
<tr>
<td>1</td>
<td>2,035,992</td>
<td>6,787</td>
<td>35,625</td>
<td>2,007,154</td>
</tr>
<tr>
<td>12</td>
<td>1,713,430</td>
<td>5,711</td>
<td>36,875</td>
<td>1,682,267</td>
</tr>
<tr>
<td>24</td>
<td>1,332,535</td>
<td>4,442</td>
<td>38,125</td>
<td>1,298,851</td>
</tr>
<tr>
<td>36</td>
<td>920,843</td>
<td>3,069</td>
<td>39,375</td>
<td>884,537</td>
</tr>
<tr>
<td>48</td>
<td>477,100</td>
<td>1,590</td>
<td>40,625</td>
<td>438,065</td>
</tr>
<tr>
<td>60</td>
<td>(0)</td>
<td>(0)</td>
<td>(0)</td>
<td>(0)</td>
</tr>
<tr>
<td>Total</td>
<td>215,883</td>
<td>2,287,500</td>
<td>(0)</td>
<td>(0)</td>
</tr>
</tbody>
</table>

Discount rate: 4.00%
Accounting Impact

Calculation of the ROU Asset

\[
\text{ROU Asset} = \text{Lease Liability} + \text{Initial Direct Costs} + \text{Prepaid Lease Payments} - \text{Lease Incentives}
\]

<table>
<thead>
<tr>
<th>Period</th>
<th>Beginning Right-of-Use Asset</th>
<th>Amortization Component</th>
<th>Ending Right-Of-Use Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$0</td>
<td>$0</td>
<td>$2,071,617</td>
</tr>
<tr>
<td>1</td>
<td>2,071,617</td>
<td>31,338</td>
<td>2,040,279</td>
</tr>
<tr>
<td>12</td>
<td>1,721,555</td>
<td>32,414</td>
<td>1,689,142</td>
</tr>
<tr>
<td>24</td>
<td>1,325,660</td>
<td>33,683</td>
<td>1,291,976</td>
</tr>
<tr>
<td>36</td>
<td>913,968</td>
<td>35,056</td>
<td>878,912</td>
</tr>
<tr>
<td>48</td>
<td>485,225</td>
<td>36,535</td>
<td>448,690</td>
</tr>
<tr>
<td>60</td>
<td>38,125</td>
<td>38,125</td>
<td>(0)</td>
</tr>
<tr>
<td>Total</td>
<td>2,071,617</td>
<td>(0)</td>
<td>(0)</td>
</tr>
</tbody>
</table>

ROU Asset = 2,035,992 + 35,625
Implicit Lease
Demonstrating your understanding

Mini Case Studies - Instructions

• Read the Facts for the four scenarios as summarized below.
• Evaluate whether the arrangement provides the customer the right to control the use of the asset
• Feel free to work with others, as needed
• We will debrief each case as a group
• Be prepared to share your answers with the broader group

You have 15 minutes to complete these requirements
Identifying a lease within TU and TUHS

Decision tree

1. Is there an identified asset?
   - Yes
   - No

2. Does the customer have the right to obtain substantially all of the economic benefits from use?
   - Yes
   - No

3. Who has the right to direct how and for what purpose the asset is used throughout the period of use?
   - Customer
   - Supplier
   - Neither

4. Does the customer have the right to operate the asset?
   - Yes
   - No

5. Did the customer design the asset?
   - Yes
   - No

Contract contains a lease

Contract does not contain a lease
Right to control the use
Case 2.A

**Aircraft**

**Facts:**
Customer enters into contract with FlyCo for the use of an identified aircraft for three years

- Customer determines where, when, and who will travel on the aircraft
- A FlyCo crew operates the aircraft, and Customer is not permitted to provide alternate crew
- There are contractual and legal restrictions on where the aircraft can fly
- Per the contract, FlyCo is allowed to substitute an aircraft with one that has exact same specifications
Aircraft (cont.)

Analysis:
The contract *does* contain a lease:

- Contract depends on an identified asset
  - Aircraft is an explicitly identified asset
  - Substitution right is not substantive

- Customer has the right to control the use of the aircraft during the three-year period as it has the right to...
  - Obtain all of the economic benefits from the use of the aircraft over the term
  - Direct the use of the aircraft through its ability to dictate when, where, or if the airplane will be used

Restrictions on where the aircraft can fly are protective rights that do not impact the control assessment
Right to control the use
Case 2.B

Contracts for shirts

Facts:
Company enters into contract to purchase a particular type and quantity of shirts from Manufacturer over a two-year period:

• Manufacturer only has one production facility to fulfill the contract and meet the needs of Company

• Quantity of shirts ordered by Company does not result in it taking substantially all of the capacity of Manufacturer’s production facility

• Manufacturer makes all decisions about the operations of the plant, including staffing levels and changes to production capacity


Right to control the use
Case 2.B

Contracts for shirts (cont.)

Analysis:
The contract *does not* contain a lease

- Company does not have the right to obtain substantially all of the economic benefits from use of the plant:
  - Manufacturer could decide to use the plant to fulfill other contracts by increasing capacity or improving efficiency

- Company does not have a right to direct the use of the plant
  - Manufacturer operates the production facility and is responsible for determining how and for what purpose the facility is used
  - Company’s rights are limited to specifying output from plant

*Company’s rights are no different than the rights provided to any other customer*
Right to control the use
Case 2.C

Print management services

Facts:
Company enters into a three-year contract with Vendor by which Vendor will install and manage all of the printing equipment used by Company:

• Supplier is responsible for all costs associated to the installation, operation and removal of such equipment
• Supplier owns all equipment being used for the services under the agreement
• Company has the sole right to use the equipment during the contract period
• Supplier is responsible for all maintenance activities related to the equipment and has discretion on when supplies such as toner will be ordered
• Supplier is permitted to swap out the printers during the contract period with Company’s permission
Right to control the use
Case 2.C

Print management services (cont.)

Analysis:
The contract does contain a three-year lease of various printers:

• Contract depends on the use of multiple implicitly identified assets
  o While the contract does not list the serial numbers of the printers that will be used to deliver the services, the printers are implicitly identified once they are installed at Company’s locations
  o Substitution right is not substantive

• Company has the right to control the use of the printers:
  o Company has the right to obtain substantially all of the economic benefit from using the printers
  o Company has the right to direct activities related to the use of the printers through its abilities to decides when, whether, or even if the printers will be used
Right to control the use
Case 2.D

Internet service agreement

Facts:
Customer enters into a two-year internet service agreement with TeleCo that relies on the use of various routers and modems:

- Equipment is designed to work only with TeleCo’s services.
- Equipment is maintained on Customer’s premises and TeleCo does not have a substantive substitution right during the service period.
- Customer selects the type of routers and modems to be installed and where it will be installed on its premises.
- TeleCo is responsible for installing and configuring the equipment to provide a certain quality of internet service during the period.
- Customer uses the equipment as part of its business operations on daily basis.
Right to control the use
Case 2.D

Internet service agreement (cont.)

Analysis:
Contract does contain a two-year lease of various routers and modems:

• Contract depends on various identified assets:
  o Routers and modems are implicitly identified.
  o Substitution right is not substantive.

• Customer has the right to control the use of the routers and modems:
  o Customer has the right to obtain substantially all of the economic benefit from using the asset.
  o Customer makes all of the relevant decisions about how and when the routers and modems will be used.