FASB's Lease Under ASC 842

Case Study

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Due date

1. a) What is the definition of the FASB's lease under ASC 842?

FASB ASC 842 defines a lease as an "arrangement that conveys the right to control the use of an identified asset for a period of time in exchange for the considerations" (Tango, 2022). This definition provides the right to acquire all the economic benefits and the right to control the use of the asset over the stipulated leasing period.

b) Describe how the definition of finance (previously called capital) leases and operating leases in Topic 842 differs from pre-existing Generally Accepted Accounting Principles (GAAP) for the lessee.

Topic 842 specifies that the lessee should characterize a lease based on whether the agreement is effectively a purchase of the actual asset. Lease arrangements that transfer the control of the underlying asset to the lessee are defined as finance leases while operating leases. The lessee will have the right to control the use of the underlying asset but not the right to control the asset itself (PWC, 2021). Under the pre-existing GAAP, capital leases affected the balance sheet and were recorded as a liability, while operating leases had no significant impact on the balance sheet figures.

c) Do you believe the new standard is an improvement from the perspective of (i) financial statement users and (ii) lessees? Explain your answer to each question.

The new changes provide significant adjustments in how financial reporting is done. For financial statement users, the new standard requires a significant amount of both qualitative and quantitative new financial statement transparency, as the vast majority of operating leases are recorded in the balance sheet. Similarly, lessees must recognize and calculate the present values of coming lease payments to ascertain their lease liability. Notably, this is an improvement for the lessees.

2. Is CTC's conclusion that the leases still should be considered operating leases appropriate under ASC 842?

One of the classification criteria for financial leases requires that the present value of the total remaining lease payments be equal to or exceed the fair value of the underlying assets (PWC, 2021). CTC's total present value of the lease payments is estimated to be $23 million, while the fair value of CTC's leased assets is about $44 million. Notably, the present value of CTC's lease payments ($23) is significantly less than the underlying asset's fair value, indicating that the leases should still be considered operating leases under ASC 842.

3. Write a memo explaining in simple terms the FASB's reasoning as it applies to Newton's situation. Also include potential concerns with the FASB's reasoning.

Newton's situation is that the potentially dangerous debt situation might lead to the violation of the debt covenant with their creditors and tarnish CTC's creditworthiness, limiting it from obtaining future loans and could render it bankrupt. However, FASB's reasoning offers that the limited access to credit because of the violation of debt covenants can be remedied by adjusting the financial records for operating lease obligations not recognized in the statement of the entity's financial position under the pre-existing GAAP. The implication of this provision to the Newton's is that their operating leases will not be treated as debts, meaning that the operating leases will not affect CTC's financial health. This will prevent CTC from breaking the debt covenant and ensure its access to credit. Thus, the existing debt covenants are unlikely to impede CTC. The potential concerns with this reasoning include the provision that operating leases are considered operating liabilities and not debts, meaning that the amounts of operating leases do not influence the important ratios used in debt covenants. Another concern is that Topic 842 allows the extension of effective dates, which enables many entities' existing loan agreements to expire before the entities report under Topic 842.

4. a) Under ASC 840, in FY 2016, will any of the following financial ratios lead to violations of debt covenants based on prior GAAP: debt-to-equity ratio, current ratio, return on assets, and interest coverage ratio?

Debt to equity ratio = Total liabilities / total shareholders' equity
= \$8976/ \$12,783
= 0.70, which is good because it is below 2.0.

Current ratio = Current assets / Current liabilities
= \$5,934/ \$2,076
= 2.858, which is good according to debt covenants because it is greater than 1.0.

Return on assets = Net income / Total assets
= \$2096/ \$12,783
= 0.164 = 16.14%, which is good because it is above 13%, as required in the debt covenant.

Interest Coverage ratio = Income before income taxes / Interest expense
= \$3224/ \$414
= 7.787, which is a good value because it is above 2.0, as recommended in the debt covenant.

Therefore, based on these evaluations, there is no financial ratio that will lead to a violation of debt covenants.

b) Under ASC 842, in FY 2016, will any of the following financial ratios lead to violations of debt covenants based on current GAAP: debt-to-equity ratio, current ratio, return on assets, and interest coverage ratio?

The financial ratios would not lead to the violation of debt covenants under the current GAAP.

5. a) What clauses should be added that would allow the covenants to be calculated as they are at current GAAP?

The first clause that should be added to avoid violating the debt covenant is to adjust the CTC's bond contract to allow for an explicit exemption for the debt covenant defaults resulting from the GAAP accounting change. This adjustment clause would eliminate the increase in liabilities under the new clause, adversely affecting CTC's financial position. In addition, a new clause should be added to adjust the high-interest rate on the bond because the high rate will lead to an unfavorable interest coverage ratio, leading to a violation of the debt covenant.

b) Identify options that you might suggest to the Newton's in their negotiations.

I would suggest that the Newton's exploit the option of extending the effective dates provided under Topic 842 so that CTC can have enough time to modify the agreement. Besides, I would advise the Newton's to appeal to the bank not to dissolve the existing good customer relationship due to the potential technical defaults arising from the GAAP accounting change. FASB lists this recommendation under the concerns for the additional lease liabilities.

6. Since GAAP requires lessees to report assets and liabilities for all but very short-term leases, is there still an advantage to long-term leases for the Newton's? Identify and discuss any advantages or disadvantages to continuing to lease. What recommendation will you make to the Newton's concerning continuing the long-term retail leases?

Although the long-term leases increase CTC's liabilities, limiting its opportunities for financial leverage, Newton's can still have some advantages on the long-term leases, such as tenant improvement allowance for their long-term retail leases and stability without worrying about frequently relocating, as this would affect their customer base. The advantage of continuing to lease is that it will help the Newton's to maintain a steady cash flow since leasing payments are spread out over time. Besides, the Newton's will benefit from a 100% financing option available for leasing; this is particularly important for them, given the financial health of their business. In addition, another advantage of leasing is the flexibility of relocation and tax benefits. I recommend that Newton continue their long-term retail leases and bargain for benefits such as a tenant improvement allowance. Long-term leases are particularly important for the retail branches because they sustain the customer base. Therefore, the long-term leases should continue as Newton’s renegotiates with the creditors for sustainable credit options.

References

Tango. (2022). Defining a Lease Under FASB ASC 842. Retrieved from: https://tangoanalytics.com/blog/defining-a-lease-under-fasb-asc-842/#:~:text=First%2C%20let's%20agree%20on%20how,points%3A%20control%20and%20identified%20asset.

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