

ASC 842: LEASE ACCOUNTING

THE IMPLEMENTATION JOURNEY



June 26, 2019

WELCOME – AGENDA

- **AGENDA**

- Overview of ASC 842
- Beginning the Journey
- Process and Software Considerations
- Control and Documentation Considerations
- Q&A

ASC 842 Overview

EFFECTIVE DATES

Effective Dates

- **Public** - annual periods, beginning after December 15, 2018
 - *January 1, 2019 for calendar year entities*
- **Non-public** – annual periods beginning after December 15, 2019
 - *Annual periods beginning on January 1, 2020 for calendar year entities*

WHY A NEW STANDARD?

Operating leases have become a significant source of off balance sheet financing making it difficult for investors to understand working capital requirements and return on assets. Economically similar transactions were being accounted for differently and agreements were often structured to achieve a desired accounting effect.

This new model is intended to:

- ✓ Provide **greater visibility** regarding a company's **capital needs** and **obligations**
- ✓ Improve consistency of presentation by **requiring all leases** to be presented **on the balance sheet**
- ✓ Improve **comparability** of lease practices across entities and industries
- ✓ Provide **more useful disclosures** to the users of the financial statements

KEY CHANGES

- **LESSEE MODEL – Primarily Impacts Lessee Model**

- Almost all leases will now be recorded as assets and liabilities on the balance sheet.
- Eliminates bright-line tests for lease classification (*but not really*).
- Expanded disclosure of lease activities and key judgements / estimates.
- Some changes to the definition of a lease.

- **LESSOR MODEL –**

- No meaningful changes from current accounting (*minor changes to align guidance with ASC 606*).

SCOPE: WHAT'S OUT?

ASC 842-10-15-1 THIS TOPIC **DOES NOT** APPLY TO ANY OF THE FOLLOWING:

- a. Leases of **intangible assets**
- b. Leases to explore for or use of **minerals, oil, natural gas, and similar nonregenerative resources.**
- c. Leases of **biological assets**, including timber.
- d. Leases of **inventory.**
- e. Leases of **assets under construction.**

SCOPE: WHAT'S IN?

Definition of a Lease - A contract, or part of a contract, that conveys the right to *control the use of* identified property, plant, or equipment (*an identified asset*) for a *period of time* in *exchange for consideration*.

Two Conditions – Identified Asset & Customer Control

Under **ASC 842-10-15-2**, an entity is required at contract inception to *identify whether a contract contains a lease*. (More about that later)

SHORT-TERM LEASE EXCLUSION

Leases with an initial term (upon adoption) of 12 months or less can be excluded under a practical expediency (842-20-25-2).

- The lease term must include periods for which the lessee is economically compelled to renew. Considerations include:
 - Is the asset specialized in nature or difficult to replace?
 - Is the asset necessary to fulfill long-term obligations?
 - Would it be economically disruptive to exit the lease?

IDENTIFIED ASSET

Lease assets must either be **explicitly** or **implicitly** identified a specific asset that is the subject of the contract.

- **Explicitly identified** – The asset is defined in the contract.
- **Implicitly identified** – It's understood what asset is being provided. Considerations include:
 - Has the assets specialized for you?
 - Do you have physical control of the asset?
 - Is the asset likely to be substituted over contract period? (*only substantive substitution rights are considered*)

CUSTOMER CONTROL

Lessee must be able to both **direct the use of the asset** and **obtain substantially all economic benefit**.

- **Right to direct use** – Right to direct use of asset including how its used (subject to protective rights).
 - Can you idle the asset?
- **Right to substantially all economic benefit** – Substantially all is 90% or more.
 - Is it a multi-use asset?
 - Do you have exclusive right to a defined portion of the asset?

LEASE & NON-LEASE COMPONENTS

Lessees may elect (by asset class) to combine lease and non-lease components (842-10-15-37).

- Non-lease components include: maintenance, repairs, property tax, insurance, etc.
- **Advantage** – Accounting is less complex (no need estimate non-lease component or to allocate payments among lease and non-lease components)
- **Disadvantage** – Increases the lease asset and liability.

FINANCE LEASE CRITERIA

No bright lines (*but one reasonable approach*) - finance if:

1. Transfer of ownership
2. Purchase option that reasonably certain to be exercised
3. Lease is for majority of economic life (75% reasonable approach)
4. Present value of payments = substantially entire fair value of asset (90% reasonable approach)
5. Specialized asset without alternative use

APPLYING ASC 842: AREAS OF FOCUS

1. Lease Term
2. Lease Classification and Purchase Options/Guarantees
3. Lease Payments
4. Discount Rate
5. Initial Direct Cost
6. Financial Statement Presentation

FINANCIAL STATEMENT PRESENTATION

- **Balance Sheet**

- Operating lease – Right-of-use asset (*long-term*)
- Finance lease – Capital asset (*long-term*)
- Operating lease – liability (*current & non-current*)
- Finance lease – liability (*current & non-current*)

- **Income Statement**

- Operating lease – (*operating expense – excluded from EBITDA*)
- Finance lease – (*amortization = operating; interest = financing – both added back to EBITDA*)

OTHER PRACTICAL EXPEDIENTS

Grandfather assessment under ASC 840 – ASC 842-10-65-1(f)

- Elected as a package, as of adoption:
 - Retain conclusions regarding if a contract contain a lease
 - Retain lease classification conclusions (operating vs finance)
 - Retain capitalized origination costs

Use hindsight to determine lease term

- Can use hindsight (include actual renewals) in determining lease term.

TRANSITION

Modified Retrospective Transition Approach

An entity elects to change its date of initial application to the beginning of the period of adoption and:

- Apply ASC 840 in the comparative periods.
- Provide the disclosures required by ASC 840 for the comparative periods.
- Recognize the effects of applying ASC 842 as a cumulative-effect adjustment to retained earnings as of the effective date;

The entity would not:

- Restate comparative periods
- Provide the disclosures required by ASC 842 for the comparative periods.

Beginning the Journey

THE JOURNEY – GETTING STARTED

Organize the Project and Project Team

- **Impacts People and Process:** Accounting (CFO, Controllers, etc), IT, Procurement, AP, Treasury, Legal, Tax and “Asset Owners.”
- **Project Team** – Project Owner, Core Team, Support, Ongoing Monitoring
- **Elements and Phases** - Assess, design, implement, quality control and documentation.
- **Maintain a Project Plan:** Key Activities, timing, resources, quality control.
 - Plan for working with a software vendor.
- Getting to Day 1: Adoption entries.
- Day 2: Making it work going forward...
- **Observations:**
 - “Everyone” underestimates (relative to their circumstances).
 - Consider getting external assistance and guidance, early, as warranted.
 - Take credit for this as part of control environment for adoption.

KEY OBJECTIVES

- **Take inventory** of the existing identified leases (and related agreements) under ASC 840. The initial Lease Tracker (this will be updated during the project).
- **Identify potential previously unidentified** leases or agreements with potential lease elements.
- **Identify** agreements that may require **key judgements** related to:
 - Whether it's a lease.
 - Period-of-Use (renewal and termination options)
 - Non-lease elements
 - Classification concerns
 - Other
- **Understand user needs** for potential lease accounting software solution and related impacts (processes, coding, entries, etc.)
- **Plan** for implementation activities

Process & Software Considerations

WHAT? I NEED NEW SOFTWARE?

ANSWER: PROBABLY

- Lease accounting calculations can get complex
- Number of leases may require more auditable tracking and reporting
- Your ERP system likely has not been updated yet
- Real estate systems often have been enhanced for 842...
...but may not support equipment well

GOOD NEWS:

***The software market is healthy with valid options
ranging from enterprise scale to fit for small businesses***

LEASE ACCOUNTING ROADMAP CONSIDERATIONS

- How many leases do I have?...
...drives scale of software
- What type of leases do I have?...
...drives breadth of features/licensing
 - Real estate vs. equipment
 - Long term vs. short term
- How do I manage leases now?...
...drives buy vs. upgrade options
- How is Procurement done?...
...drives process design and ERP changes

LEASE ABSTRACTION AND DATA LOAD APPROACHES

- **“Big Bang” Data Upload** *(includes upgrade of existing Real Estate system)*
 - Lease data generally already loaded in a system as structured fields and meta-data
 - Analyze and define new accounting data outside the lease accounting system
 - Upload all lease accounting data to new system or to accounting module of real estate system
- **“Assembly Line” Workflow**
 - Lease data may exist as paper or scanned documents but data fields are not structured
 - Set-up a repetitive process to digitize, abstract, and perform accounting review of lease capitalization as leases are gathered
 - Lease accounting software is the platform on which assembly line is operated

***A common outcome is a hybrid:
Some data is structured and can be uploaded.
Some leases are not digitized and are worked individually.***

Control and Quality

Control Considerations

THE JOURNEY – COMMON KEY JUDGMENT MATTERS

- **Is it a lease or contain a lease element?**
 - Embedded in service or product agreements.
 - Implicit assets.
 - Substitution Rights.
 - Control vs shared or no control.
- **Renewal and termination Rights/Options**
 - Certainty, reasonable certainty.
 - Bilateral vs. unilateral
 - Evergreen's or month-to-month....or we just keep it and keep paying....
 - Termination rights.
- **Allocating contract consideration**
 - Can be difficult and highly subjective. Many took the election for most asset categories.
- **Classification** (Finance or Operating Lease)
- **Discount Rates**

THE JOURNEY – ADOPTION QUALITY CONTROL



GETTING TO "DAY 1" – "We have our adoption entries as of 1/1/20!"

"Please, oh, please.....I hope the auditors agree with it all...."

EXAMPLE KEY RISKS CONSIDERATIONS - "What could go wrong?"

- **Assess the completeness of the population**
 - The entity has not identified all arrangements that are or contain a lease under ASC 842. (C)
 - The entity has not identified all lease modifications in accordance with ASC 842. (C)
- **Assess the completeness and accuracy of the data that is used to apply the transition provisions.**
 - The lease data used to calculate the transition adjustments does not agree with the terms and conditions of the contract. (E/O, C, M/V, R/O)
- **Apply the ASC 842 accounting framework and determine transition adjustments and disclosures**
 - The entity does not appropriately classify the lease (operating vs financing) (M/V, P/D)
 - The entity does not use an appropriate discount rate to measure the lease liability. (M/V, P/D)
 - The entity does not appropriately measure the lease liability. (M/V, P/D)
 - The entity does not appropriately measure the right-of-use (ROU) asset. (M/V, P/D)
 - The entity does not appropriately assess the lease term. (M/V, P/D)
 - The entity does not appropriately account for the income tax effects of adopting the new standard. (M/V, P/D)

THE JOURNEY – ADOPTION QUALITY CONTROL (cont.)

CONSIDERATIONS ON CONTROLS

- **“What could go wrong?”** - Be prepared to answer how you managed/controlled those risks.
- **Lease search procedures** – Demonstrate and update through cut-off. Learn from it.
- **Data upload – QC** on the results for each lease or group of leases. Does it make sense....in addition to secondary check.
- **Perform an overall reconciliation** - ASC 840 Undiscounted Obligations to ASC 842 Undiscounted (or discounted) Liabilities.
- **Mechanics of journal entries** - Work through allocation of expenses to various departments, g/l account usage. Be alert to disclosure requirements (e.g. variable consideration, short-term lease activity, etc).
- **Prepare position papers** as warranted for specific leases or key consideration.

THE JOURNEY – ADOPTION QUALITY CONTROL (cont.)

OTHER DOCUMENTATION CONSIDERATIONS – Make it easy for others to follow along with what you did to ensure compliance. It is your basis and the auditors will be asking.

- **ASC 842 Adoption Summary Memo** – What the Project Team did, what it found, overall findings and results and reference to supporting files or documents.
- **Supporting Memorandums and Position Papers**
 - Key Agreements, when warranted.
 - Key Area, such as asset categories with complex matters.
 - Key Judgements: Periods, Classification, Other
 - Depending on software, some of this can be embedded into the lease asset record file.
 - “Boil” up the key or complicated matters. Don’t leave it in the detail.

THE JOURNEY – PREPARING FOR “DAY 2”

- **Learn from the Adoption Process** – What can be improved?
- **Lease identification, review and approval procedures** - Delegation of authorities – Revisit. Don't forget about modifications.
 - You can begin to **make improvements** to your ASC 840 procedures **even before adoption**.
- **System integration (or lack thereof)** - May drive processing procedures between “asset owners”, procurement/AP, accounting. These will need to be reconsidered and adjusted as appropriate.
- **Software Administrator** and Rules – Be prepared to manage.
- **Training** - Begin to get the new users of the lease accounting software involved before Day 1. Even if they have a limited role in Adoption, it will help them in preparing to begin Day 2.
- **Stakeholder Communication** – Board, Management, Auditors, Bankers, Internal Groups

Q&A

About the Presenters

Jared Benedict Managing Partner of Technical Accounting, Vaco - Jared leads AHP's Technical Accounting Group (TAG) Practice. The TAG Practice provides advisory and consulting services on complex financial reporting and financial control matters. The TAG Practice assists clients with implementing new standards, evaluating financial reporting implications of acquisitions and key transactions, and serving as a "Virtual" Accounting Policy department for clients.

Jared brings his experience as a former Big 4 auditor along with his roles in private companies to lead team's in high-quality service to our clients.

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Rex Holmes Managing Director, Vaco - Rex has over 30 years of experience serving clients and brings his knowledge and talents to enable clients to solve problems, tackle challenges and address change. As a former Big 4 audit partner and a private advisor to companies, he brings a wealth of experience in finance and accounting operations, corporate governance, and risk management.

Rex and the AHP/Vaco team have assisted dozens of clients with adoption and implementation of ASC's 606 ("Revenue Recognition") and 842 ("Lease Accounting").

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