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THE NEW LEASE ACCOUNTING STANDARDS TOPIC 842

PRESENTED BY:

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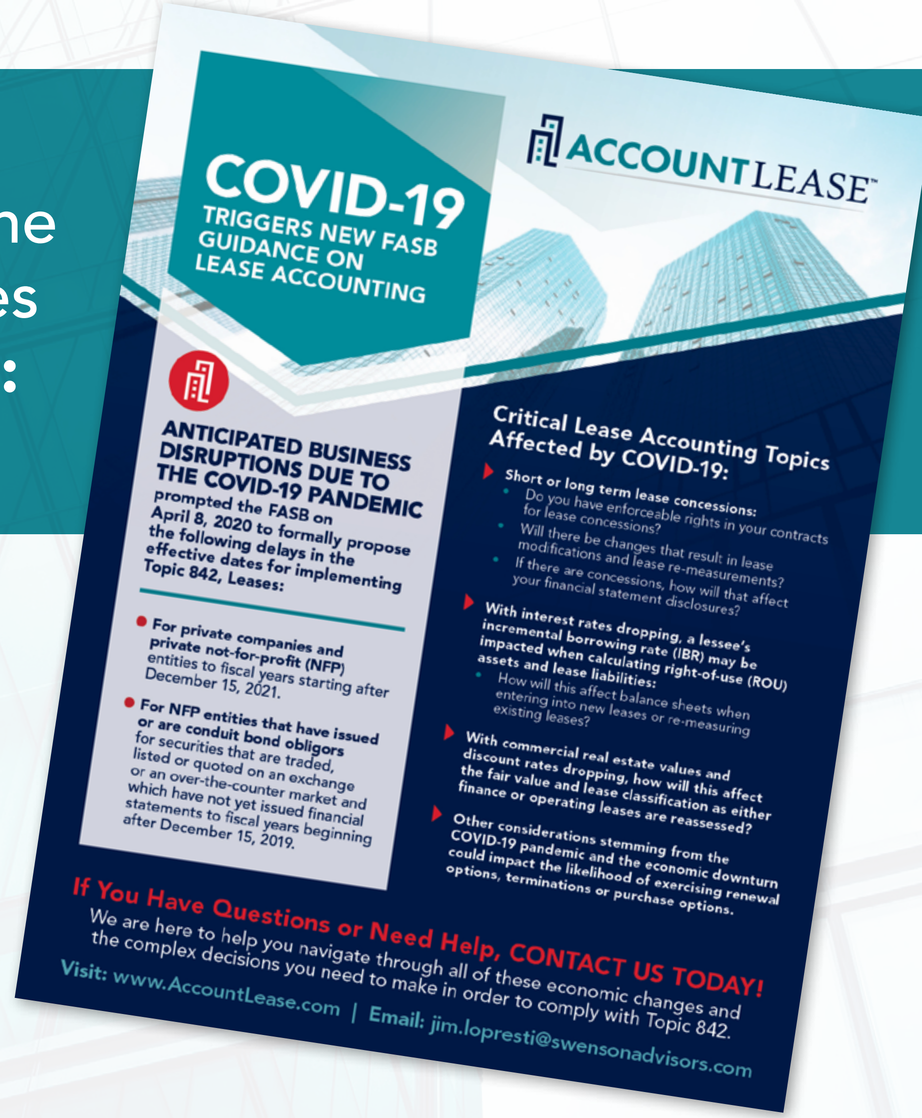
FINAL DELAYS PROMPTED BY COVID-19

On **June 2, 2020,** the FASB issued the following delays in the effective dates for implementing **TOPIC 82 LEASES:**

- **For private companies and private not-for-profit (NFP)** entities to fiscal years starting after **December 15, 2021.**

- **For NFP entities that have issued or are conduit bond obligors** for securities that are traded, listed or quoted on an exchange or an over-the-counter market and which have not yet issued financial statements to fiscal years beginning after **December 15, 2019.**



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JOURNAL OF ACCOUNTANCY
Article No. 6

PANDEMIC ALTERS LEASE ACCOUNTING LANDSCAPE

• April, 2020 •

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WHY IS THE NEW STANDARD NECESSARY?

The old lease model was criticized for **failing to meet the needs** of users of financial statements

The SEC issues a report on off-balance sheet activities in 2005 which **recommended that changes be made** to the existing lease accounting

$1-2 trillion of "off balance sheet" lease commitments existed for SEC registrants

In 2006, the FASB and the IASB embarked on a joint project to **improve the financial reporting of lease activities**

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LEASE DEFINITION AND TYPES OF LEASES

WHAT IS A LEASE?

A LEASE is a contract that conveys the "right to use" an underlying asset for a period of time in exchange for consideration

A CONTRACT IS (OR CONTAINS) A LEASE IF:

A. The use of an identified asset is explicitly or implicitly specified (842-10-15-3)

B. The customer controls the use of the identified asset for a period of time (842-10-15-4).

   Control means that the customer has the right to:

   - Direct the use of the identified assets and
   - Obtain substantially all of the economic benefits during the lease term from directing the use of the identified asset

TYPES OF LEASES

LESSOR

- Sales Type
- Direct Financing
- Operating

LESSEE

- Operating Lease
- Finance Lease

Scope Exception:
Lessees have the option to use today's operating lease accounting model for leases with a lease term of **12 months or less.**

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LESSEE: LEASE CLASSIFICATION

FINANCE LEASE

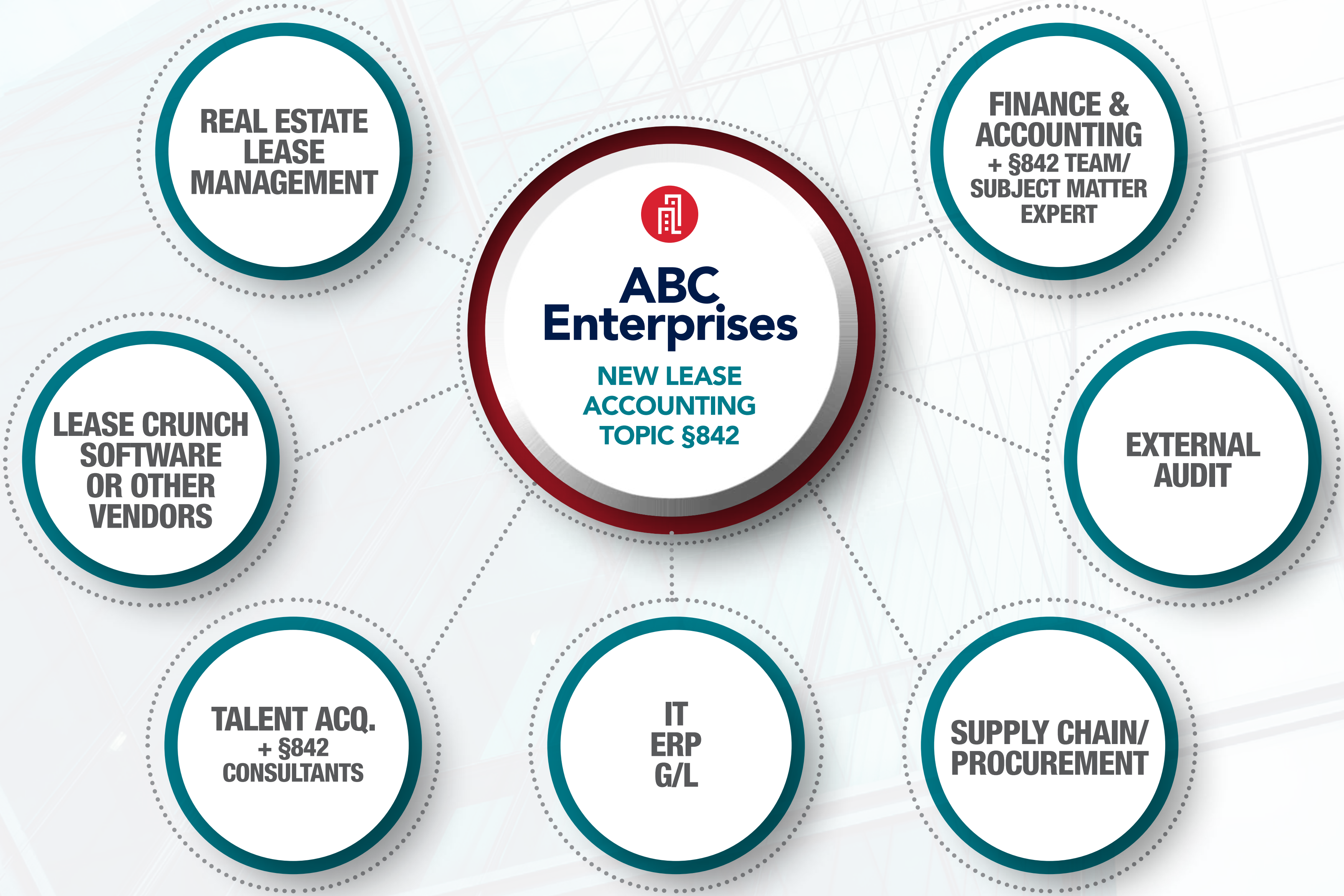
When ANY of the following criteria are met at lease commencement (842-10-25-2):

1. The lease transfers ownership of the underlying asset
2. The lessee is reasonably certain to exercise an option to purchase the asset
3. The lease term is for the major part of the remaining economic life of the asset
4. The present value of the sum of the lease payments equals or exceeds substantially all of the fair value of the underlying asset
5. **NEW –** The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term

OPERATING LEASE

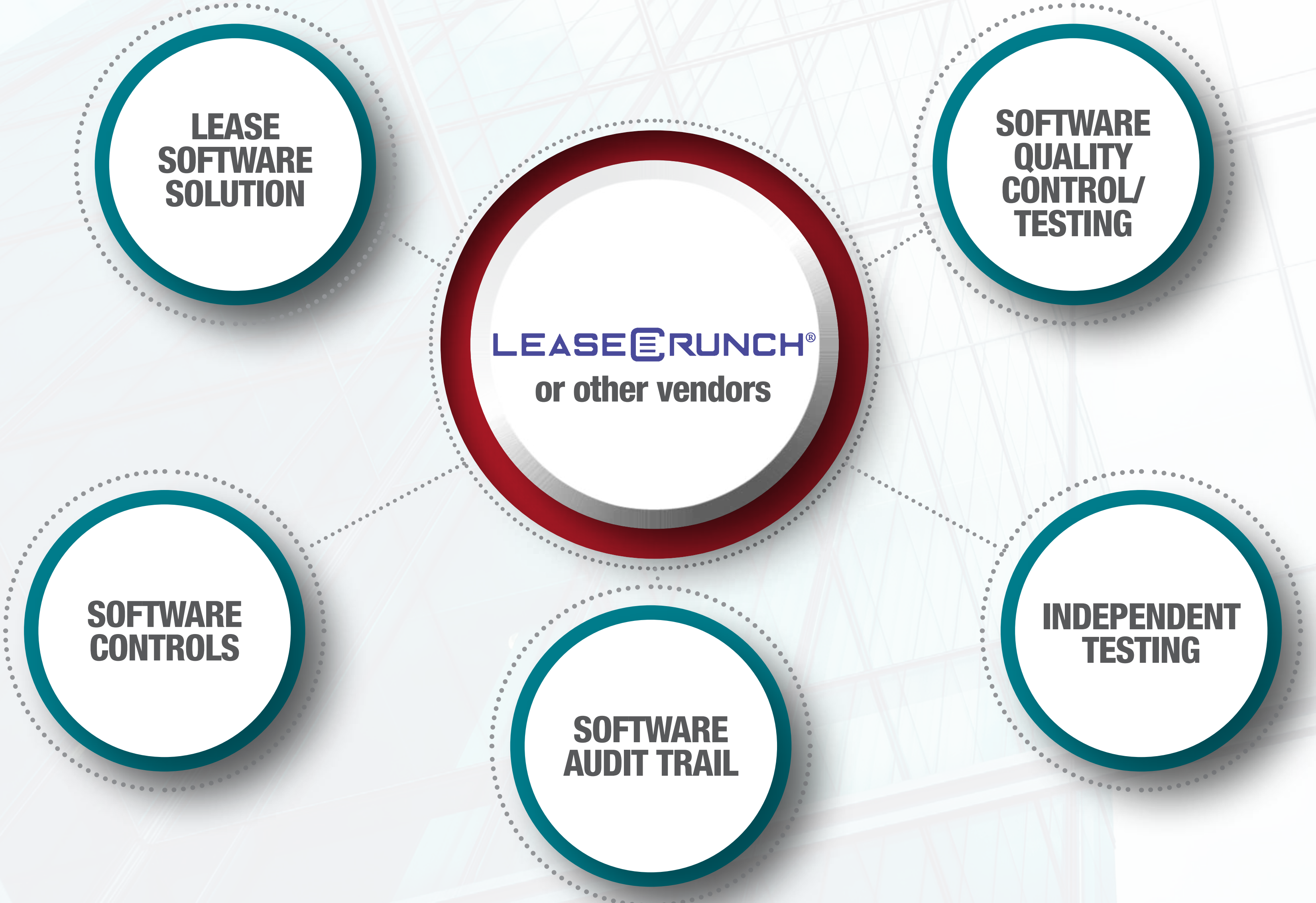
When ANY lease does not meet the criteria above

ABC ENTERPRISES LEASE ACCOUNTING STAKEHOLDERS



KEY DELIVERABLES

LEASE ACCOUNTING SOFTWARE



KEY ACCOUNTING POLICY DECISIONS

PRE-IMPLEMENTATION

(Existing real estate, equipment, and embedded leases)

Apply the Practical Expedients

- Does arrangement contain a lease?
- No lease classification assessment as to finance vs. operating.
- No recognition of initial direct costs.
- No application of hindsight events.
- Non-recognition of leases 12 months or less.

01.01.2022

POST-IMPLEMENTATION

Review all new, amended and renewed leases for:

- Contracts that contain a lease (5 criteria).
- Lease classification as to finance vs. operating (5 criteria).
- Assessment of initial direct costs.
- Associated non-lease costs.
- New internal controls/Footnote disclosures/Continuous updating of leases data base for changes.

INTERNAL CONTROLS LEASE ACCOUNTING

Pre-Implementation Date

Risks

- Lease Data Collection/ Completeness
- Embedded Lease Identification
- 840 Application
- Renewal Assessments/Lease Term
- Lease Payment Accuracy
- Lease/Nonlease Determinations
- Incorrect Data Elements Entered Into Lease Software

Post-Implementation Date

Risks

- Data Completeness
- Discount Rate Determination
- Lease Classification (Operating VS Finance)
- Initial Direct Costs
- Lease VS Nonlease
- Opening Entry Accounting
- Financial Statement Data and Disclosures
- Economic Life of Identified Assets
- FMV of Identified Assets
- Lease Modifications

INTERNAL CONTROLS LEASE ACCOUNTING

Implementation Date and Post Implementation

- 842 training and ongoing CE
- Development of internal 842 team
- Development and training of all stakeholders and new processes
- Application of practical expedients
- Lease renewals process and reasonably certain testing
- Lease classification process and testing
- Lease identification process and testing
- Initial direct cost identification and testing
- Identification of lease liability remeasurement process
- Identification of lease modification
- Identification of separate contract
- Remeasurement of ROU asset and Lease Liability when renewal terms are exercised
- Discount rate process and testing
- Review of accounting entries from LC
- Testing of input and output from LC
- Topside/clearing account process and reconciliation controls
- Analytical testing of ROU asset and Lease Liability balances monthly
- Systems to capture footnote disclosures including short term leases
- Process to front end lease contracting process to address key 842 issues e.g.
  Operating vs Finance
- Maintaining Lease updates and enhancements

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INTERNAL CONTROLS LEASE ACCOUNTING

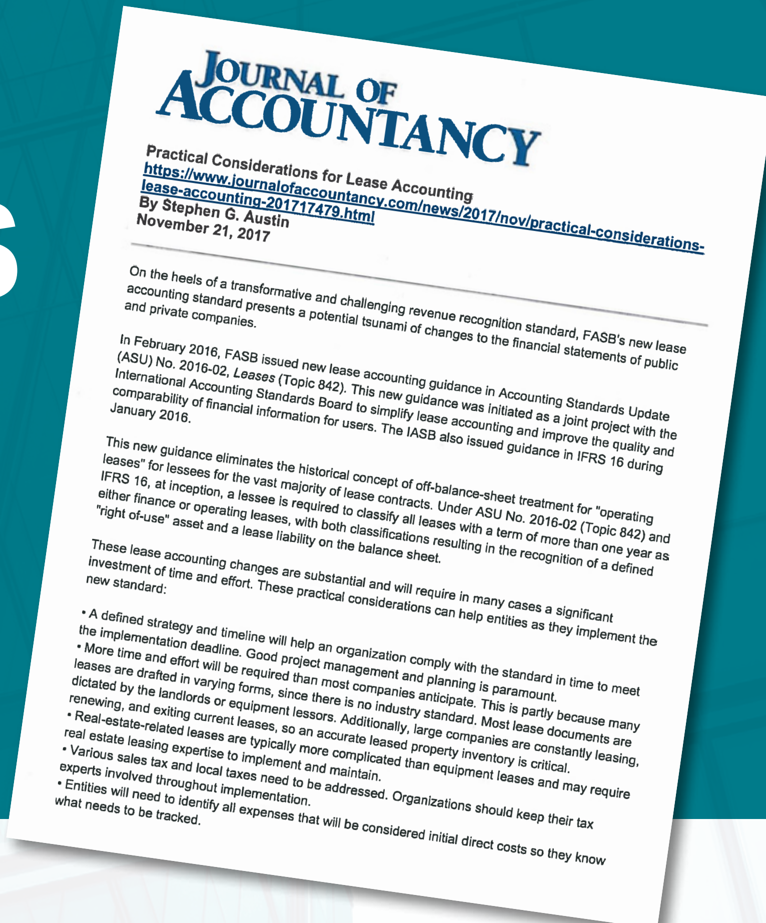
842 Transition Prior to Implementation

- 840 compliance and training
- Evaluation of Practical Expedients
- Testing of Lease Liability calculations
- Testing for completeness for all leases, with focus on embedded leases
- Reconciliation of discounted lease liability to prior footnote and f/s disclosures
- Assessment of lease accounting software and g/l reconciliation
- Process controls and sampling process
- New stakeholder training
- Development of accounting manual and LAP memos for all key decisions

JOURNAL OF ACCOUNTANCY
Article No. 1

PRACTICAL CONSIDERATIONS FOR LEASE ACCOUNTING

• November 21, 2017 •



JOURNAL OF ACCOUNTANCY

Practical Considerations for Lease Accounting
https://www.journalofaccountancy.com/news/2017/nov/practical-considerations-lease-accounting-201717479.html
By Stephen G. Austin
November 21, 2017

On the heels of a transformative and challenging revenue recognition standard, FASB's new lease accounting standard presents a potential tsunami of changes to the financial statements of public and private companies.

In February 2016, FASB issued new lease accounting guidance in Accounting Standards Update (ASU) No. 2016-02, *Leases* (Topic 842). This new guidance was initiated as a joint project with the International Accounting Standards Board to simplify lease accounting and improve the quality and comparability of financial information for users. The IASB also issued guidance in IFRS 16 during January 2016.

This new guidance eliminates the historical concept of off-balance-sheet treatment for "operating leases" for lessees for the vast majority of lease contracts. Under ASU No. 2016-02 (Topic 842) and IFRS 16, at inception, a lessee is required to classify all leases with a term of more than one year as either finance or operating leases, with both classifications resulting in the recognition of a defined "right of-use" asset and a lease liability on the balance sheet.

These lease accounting changes are substantial and will require in many cases a significant investment of time and effort. These practical considerations can help entities as they implement the new standard:

• A defined strategy and timeline will help an organization comply with the standard in time to meet the implementation deadline. Good project management and planning is paramount.
• More time and effort will be required than most companies anticipate. This is partly because many leases are drafted in varying forms, since there is no industry standard. Most lease documents are dictated by the landlords or equipment lessors. Additionally, large companies are constantly leasing, renewing, and exiting current leases, so an accurate leased property inventory is critical.
• Real-estate-related leases are typically more complicated than equipment leases and may require real estate leasing expertise to implement and maintain.
• Various sales tax and local taxes need to be addressed. Organizations should keep their tax experts involved throughout implementation.
• Entities will need to identify all expenses that will be considered initial direct costs so they know what needs to be tracked.

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Article No. 2

LEASE ACCOUNTING:
A PRIVATE COMPANY PERSPECTIVE

• July 1, 2019 •

FINANCIAL REPORTING

Lease accounting: A private company perspective

Organizations implementing the new standard can expect a complex transition and a substantial financial statement impact.

By Stephen G. Austin, CPA; Michael G. Fraunces, J.D.; and Alisia Scudder, CPA

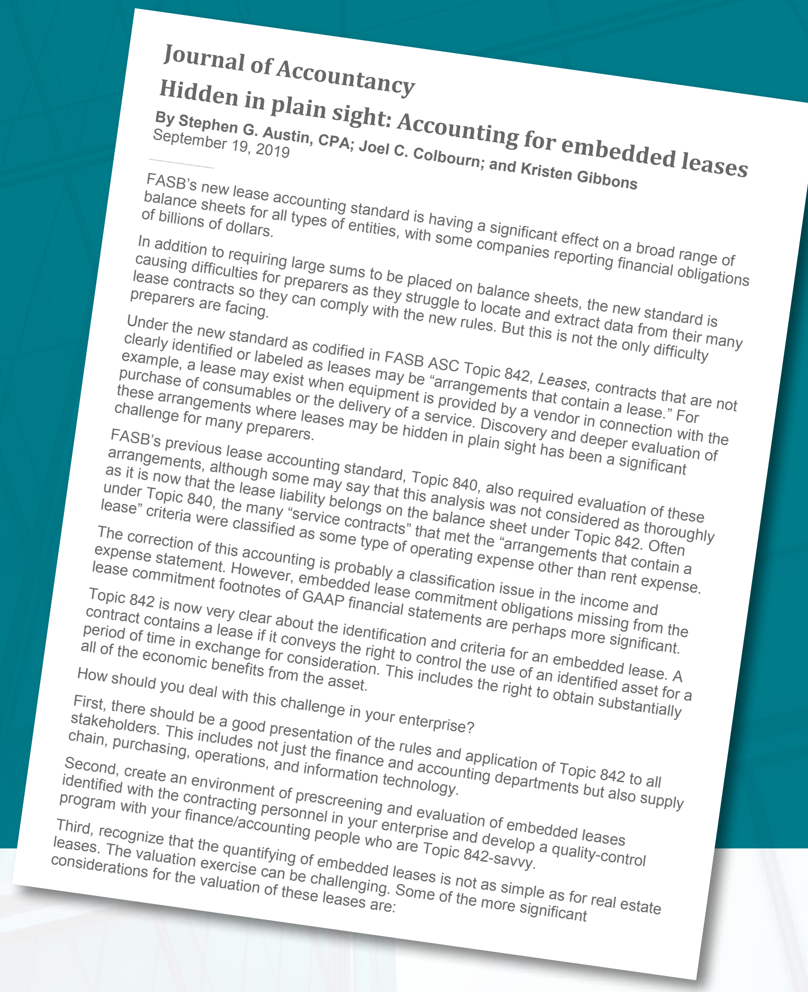
32 Journal of Accountancy

July 2019

JOURNAL OF ACCOUNTANCY
Article No. 3

HIDDEN IN PLAIN SIGHT: ACCOUNTING FOR EMBEDDED LEASES

• September 19, 2019 •



Journal of Accountancy

Hidden in plain sight: Accounting for embedded leases

By Stephen G. Austin, CPA; Joel C. Colbourn; and Kristen Gibbons
September 19, 2019

FASB's new lease accounting standard is having a significant effect on a broad range of balance sheets for all types of entities, with some companies reporting financial obligations of billions of dollars.

In addition to requiring large sums to be placed on balance sheets, the new standard is causing difficulties for preparers as they struggle to locate and extract data from their many lease contracts so they can comply with the new rules. But this is not the only difficulty preparers are facing.

Under the new standard as codified in FASB ASC Topic 842, *Leases*, contracts that are not clearly identified or labeled as leases may be "arrangements that contain a lease." For example, a lease may exist when equipment is provided by a vendor in connection with the purchase of consumables or the delivery of a service. Discovery and deeper evaluation of these arrangements where leases may be hidden in plain sight has been a significant challenge for many preparers.

FASB's previous lease accounting standard, Topic 840, also required evaluation of these arrangements, although some may say that this analysis was not considered as thoroughly as it is now that the lease liability belongs on the balance sheet under Topic 842. Often under Topic 840, the many "service contracts" that met the "arrangements that contain a lease" criteria were classified as some type of operating expense other than rent expense.

The correction of this accounting is probably a classification issue in the income and expense statement. However, embedded lease commitment obligations missing from the lease commitment footnotes of GAAP financial statements are perhaps more significant.

Topic 842 is now very clear about the identification and criteria for an embedded lease. A contract contains a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. This includes the right to obtain substantially all of the economic benefits from the asset.

How should you deal with this challenge in your enterprise?

First, there should be a good presentation of the rules and application of Topic 842 to all stakeholders. This includes not just the finance and accounting departments but also supply chain, purchasing, operations, and information technology.

Second, create an environment of prescreening and evaluation of embedded leases identified with the contracting personnel in your enterprise and develop a quality-control program with your finance/accounting people who are Topic 842-savvy.

Third, recognize that the quantifying of embedded leases is not as simple as for real estate leases. The valuation exercise can be challenging. Some of the more significant considerations for the valuation of these leases are:

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LEASE ACCOUNTING STANDARD REQUIRES NEW AUDITOR JUDGMENTS

• March 1, 2020 •

Journal of Accountancy

Lease accounting standard requires new auditor judgments

New processes and controls will be evaluated by internal and external auditors.

By Stephen G. Austin, CPA; Joel Colbourn; Phillip Doolittle; and Doug Renner

March 1, 2020

Image by solidcolours/iStock

Public companies' required implementation of FASB's new lease accounting standard in 2019 means that financial statement auditors need to be prepared to make new judgments.

Although the private company implementation date for the standard hasn't yet arrived, auditors of both public companies and private companies that prepare financial statements in accordance with GAAP will eventually need to determine whether adequate work has been performed to ensure a reasonable opening entry upon implementation. As part of understanding the entity's processes and controls, auditors also will

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ASC 840 TO ASC 842

Differences

- Operating leases on balance sheet
- Finance leases
- Lease classification
- No deferred or prepaid expense
- Initial direct costs
- Cash flow statement
- Footnote disclosure
- Centralized record keeping

Similarities

- Income statement unchanged
- Capital and finance lease calculations
- Renewal criteria: Reasonably assured = reasonably certain

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SURPRISES WITH THE NEW LEASE STANDARD

SURPRISES WITH THE NEW LEASE STANDARD

Equity Rarely Affected

No use for our Cumulative Effect or Change in Accounting Principle

No Deferred Rent or Prepaid Lease Expense: It all flows through the ROU Asset

Embedded Leases

- Service contracts with assets that qualify as a lease
- Time to review = HIGH
- Number of resulting leases = LOW
- Valuations are challenging

Real Estate Leases

- Operating leases with big impact
- Example: 10 year lease, $10,000 monthly payment = $1 MM ROU asset and lease liability
- Need for real estate expertise

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SURPRISES WITH THE NEW LEASE STANDARD

FASB: No Materiality Explicitly Included

IFRS 16 has individual lease materiality of $5,000

Some organizations follow their Property, Plant and Equipment materiality standards

Calculations

- Incremental Borrowing Rate
- Economic Life
- Fair Value

Related Parties

- Contract provisions rule, specially for lease term
- It's about the economic incentive, not relationships

It's all leases!

Not just real estate

Photocopiers • Vehicles Equipment

COMMON MISTAKES TO AVOID

COMMON MISTAKES TO AVOID

Timing of Systems vs. Process

- Don't leap straight to entering leases in a system.
- Priorities should be:
    - Thoughtful policy elections
    - Understand lease payment process and GL accounts
    - Identify full lease portfolio by asset class

Booking a Cumulative Effect of Change in Accounting Principle

- Adjust ROU Asset instead
- Certain it goes to equity? Contact your CPA firm.

COMMON MISTAKES TO AVOID

Lease Term Renewals

- Not just "I think we'll renew"
- High bar - economic incentives matter
- Related party - relationship doesn't matter for term

Use of Spreadsheets

- Error prone
- Quantitative footnote disclosure is complicated
- Lease revisions- difficult to "freeze" spreadsheet reporting
- CPA firms might charge more to audit a spreadsheet

UNEXPECTED BUSINESS IMPACTS

MATURITY ANALYSIS INCLUDES MORE LEASES

- Not just real estate and office space
- Smaller leases add up

DEBT COVENANTS

- Dependent on individual terms
- Work with bank early
- Could impact availability or cost of capital

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TIPS TO SIMPLIFY IMPLEMENTATION

SIMPLIFY IMPLEMENTATION

BE ORGANIZED

- Project management
- Lease inventory by reviewing payments
- Embedded lease assessment

INCLUSIVE DECISIONS

- Transition vs. Ongoing Identification
- Not Just Accounting
  - Procurement, Location Managers, Finance

HIRE AN EXPERT

- Outsourcing works!
- Stay involved

START EARLY

- Still should be plenty of time - if you don't wait.

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ABC ENTERPRISES TOPIC 842

Project Overview

	MONTH 1	MONTH 2	MONTH 3	MONTH 4	MONTH 5	MONTH 6	MONTH 7	MONTH 8
Phase 1: Project Launch								
Phase 2: Real Estate Leases								
Phase 3: Equipment Leases								
Phase 4: Mid-Point Assessment								
Phase 5: Embedded Leases								
Phase 6: Audit Package								
Phase 7: Procedural Creation & Risk Assessment								
Phase 8: Remediation								
Phase 9: Reports & Finalization								
Phase 10: Advising & Quarterly Review								

LEASECRUNCH®
DEMO

EFFECTIVE USE OF AI & MACHINE LEARNING

AND THE NEW LEASE STANDARD

WHAT IS AI?

BUZZWORDS : WHAT DO THEY MEAN?

Artificial Intelligence:

A field of computer science that pertains to any device that perceives its environment and takes actions that maximize its chance of successfully achieving its goals. Essentially, this is describing machines that mimic "cognitive" functions associated.

Machine Learning:

The study of algorithms and statistical models that computer systems use to effectively perform a specific task without using explicit instructions. With machine learning, a computer program is said to learn from experience (E) with respect to a task (T) and some performance measure (P), if its performance on T, as measured by P, improves with experience E.

Natural Language Processing:

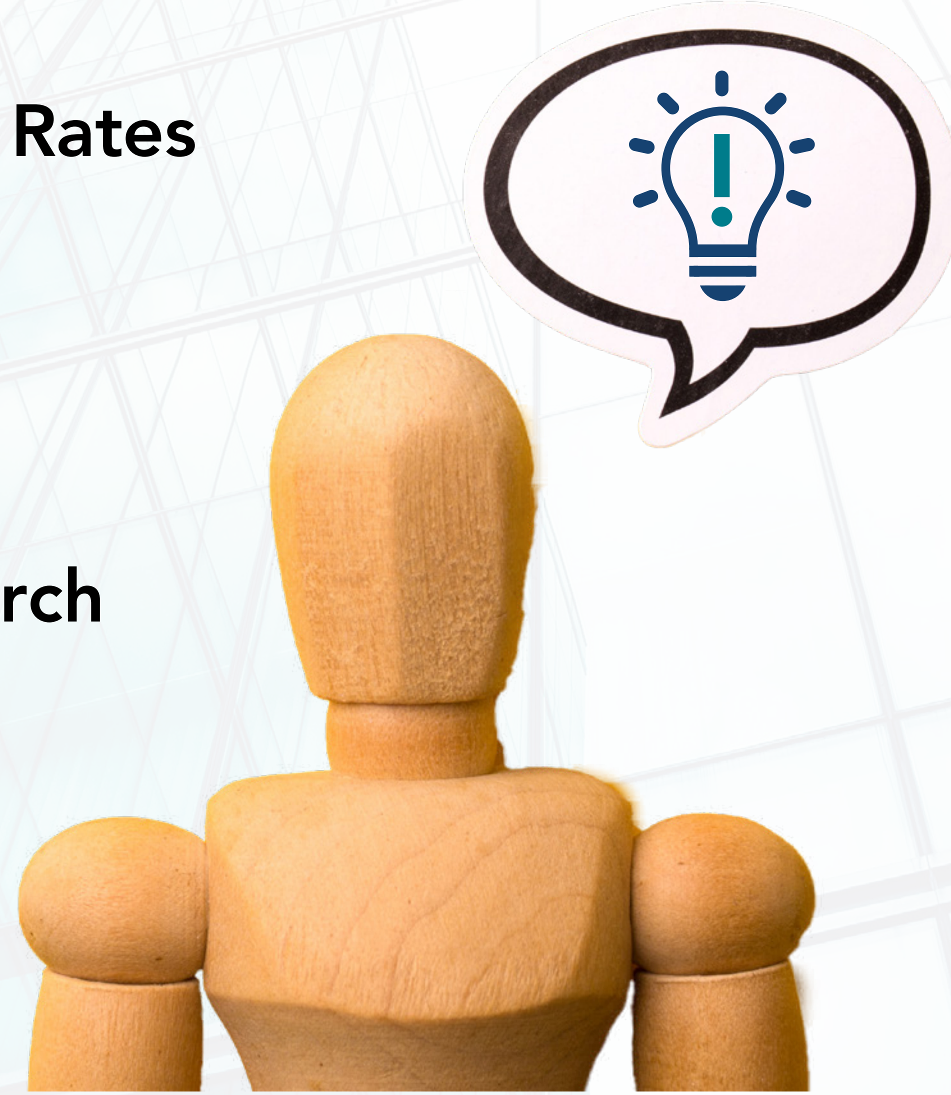
A field of computer science, artificial intelligence, and computational linguistics concerned with the interactions between computers and human (natural) language.

CONTRACT ANALYZER

- Leverages Machine Learning and Natural Language Processing
- Increase in accuracy over human abstraction
- 30%-90% time savings
- Self-training by non-tech professionals to extract custom terms

LEASE ACCOUNTING ADVISORY CONSIDERATIONS

1. Selection of Discount Rates
2. Renewal Options
3. Completeness of Embedded Lease Search
4. Quality Control



NEXT STEPS

Q&A