THE NEW LEASE ACCOUNTING STANDARDS

TOPIC 842

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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.
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.
**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.

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**TYPES OF LEASES**

**LESSOR**
- Sales Type
- Direct Financing
- Operating

**LESSEE**
- Operating Lease
- Finance Lease

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**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**.
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

ABC Enterprises
NEW LEASE ACCOUNTING TOPIC §842

- REAL ESTATE LEASE MANAGEMENT
- LEASE CRUNCH SOFTWARE OR OTHER VENDORS
- TALENT ACQ. + §842 CONSULTANTS
- IT ERP G/L
- SUPPLY CHAIN/PROCUREMENT
- FINANCE & ACCOUNTING + §842 TEAM/SUBJECT MATTER EXPERT
- EXTERNAL AUDIT
KEY DELIVERABLES

- Real Estate Leases
- Embedded Leases
- Accounting Entries
- Accounting Systems Interface
- IT Integration
- Internal Controls Transition
- Equipment Leases

Key Deliverables by 1/1/2021
LEASE ACCOUNTING SOFTWARE

LEASE SOFTWARE SOLUTION
SOFTWARE QUALITY CONTROL/TESTING
SOFTWARE CONTROLS
INDEPENDENT TESTING
SOFTWARE AUDIT TRAIL

or other vendors
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.

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.

01.01.2022
### 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 ElementsEntered 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

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
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
PRACTICAL CONSIDERATIONS FOR LEASE ACCOUNTING

• November 21, 2017 •

On the heels of a transformative and challenging revenue recognition standard, FASB’s new lease accounting standards present a substantial change 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 released in a joint project with the International Accounting Standards Board to simplify lease accounting and enhance the comparability of financial information for users. The ASU also issued guidance in IVS 18 during January 2018.

The new guidance eliminates the historical concept of off-balance-sheet treatment for “operating leases” for tenants for the vast majority of leases contracts. Under ASU No. 2016-02 (Topic 842) and IVS 18, lessees are required to capitalize 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 corresponding 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:

1. A clear 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.
2. More time and effort will be required than many companies anticipate. This is likely because many leases are drafted in varying terms, some of which are not industry standard. Many lease documents are complicated by the terms of equipment leases. Addendum, lease cancellation, and renewal terms are common features.
3. Real-estate-related leases are typically more complex than equipment leases and may require that existing lease agreements be revised and rewritten. Organizations should keep their tax advisors involved throughout implementation.
4. Entities will need to identify all leases that will be considered total direct costs so they know what needs to be tracked.
LEASE ACCOUNTING: A PRIVATE COMPANY PERSPECTIVE

• July 1, 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 financial and 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:
LEASE ACCOUNTING STANDARD REQUIRES NEW AUDITOR JUDGMENTS

• March 1, 2020 •
### ASC 840 TO ASC 842

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<td>Lease classification</td>
<td>Renewal criteria: Reasonably assured = reasonably certain</td>
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<tr>
<td>No deferred or prepaid expense</td>
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<td>Initial direct costs</td>
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<td>Cash flow statement</td>
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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

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

Embedded Leases

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

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EFFECTIVE USE OF AI & MACHINE LEARNING AND THE NEW LEASE STANDARD
WHAT IS AI?
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.

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.

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