LEASE ACCOUNTING UPDATE FOR HEALTH CARE ORGANIZATIONS

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Today’s instructors

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Overview
ASC 842

This is what we are covering today

This is what we are NOT covering today
ASC 842 big picture

- Revolutionary change in lease accounting
- Impacts all companies with leases in all industries
- Most leases will be recorded on balance sheet, similar to capital leases under ASC 840
- Leases will be classified as either operating leases or finance leases for income statement purposes
- Information technology systems can be significantly impacted and organizations, especially those with multiple business units and geographies, could have different requirements
- Implementation requires involvement throughout an organization—not just within accounting/finance
Why is implementation difficult?

- Decentralized lease process
- Volume of data and documents to manage
- Transition accounting requirements
- Systems considerations
- Lease and nonlease components
- Identifying and accounting for embedded leases
- New controls
- Global operations
- Tax impacts
- Covenant impacts
- Resource constraints
Effective date

• ASC 842 is effective for annual periods beginning after:
  - 12/15/18 for public business entities
  - 12/15/19 for all other entities

• Companies may make an election to restate or not restate comparable financial statements when first adopting the standard
**“Package” of practical expedients**

- An entity may elect not to reassess:
  - whether expired or existing contracts contain leases under the new definition of a lease;
  - lease classification for expired or existing leases; and
  - whether previously capitalized initial direct costs would qualify for capitalization under ASC 842.

- Must elect as a package and must be consistently applied to all leases

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
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<tr>
<td>- Reduced costs and level of effort due to not having to reassess expired and existing leases and unamortized initial direct costs as at 1/1/2019</td>
<td>- Increased right of use assets and liabilities because assets that are currently classified as leases under ASC 840 may not be leases under ASC 842 (due to lacking control)</td>
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<td>- Minimal differences between US GAAP and IFRS if the IFRS modified approach and the practical expedients are elected.</td>
<td>- Requires that current lease accounting to be correct (i.e., does not grandfather errors)</td>
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Accounting requirements
Right of use assets and lease liabilities

• At the commencement date, a lessee shall measure:
  - A lease liability at the present value of the remaining lease payments
  - A right of use asset consisting of:
    a) The amount of the initial measurement of the lease liability
    b) Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received
    c) Any initial direct costs incurred by the lessee
Right of use assets and lease liabilities – transition considerations

- For leases classified as operating leases under ASC 842, at the date of initial application, a lessee records
  - A lease liability based on
    - The remaining minimum rental payments (as defined under Topic 840) and
    - Any amounts probable of being owed by the lessee under a residual value guarantee
  - A right of use asset based adjusted for at the initial measurement of the lease liability adjusted for existing amounts related to:
    - Prepaid or accrued lease payments
    - Lease incentives
    - Unamortized initial direct costs
    - The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease
    - Favorable or unfavorable lease intangibles
Lease term

Any non-cancellable periods

Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option

Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option

Periods covered by an option to extend (or not terminate) the lease in which the exercise option is controlled by the lessor

- FASB said that “reasonably certain” has the same meaning as “reasonably assured” in ASC 840
  - Reasonably certain is interpreted as a high standard
- Purchase options should be assessed in the same way as options to extend lease term or terminate lease
Lease term

• Lessees reassess lease term if:
  - There is a significant event or a significant change in circumstances within the lessee’s control that directly affects whether the lessee is reasonably certain to (1) extend the lease, (2) not terminate the lease or (3) purchase the underlying asset
  - There is an event that is written into the contract that obliges the lessee to exercise or not to exercise an option to extend or terminate the lease
  - The lessee elects to exercise an option even though it had previously determined that it was not reasonably certain to do so
  - The lessee elects not to exercise an option even though it had previously determined that it was reasonably certain to do so

• Lessees do not reassess lease term for existing leases in transition unless electing the hindsight expedient
Lease term - short-term lease exception

- A lessee can elect, by class of underlying asset, not to apply the recognition requirements of ASC 842 to short-term leases and instead to recognize the lease payments as lease cost on a straight-line basis over the lease term.
- Considerations
  - Identify asset classes
  - Consider the materiality of the current short-term population
  - Consider how the company plans to track short-term leases, e.g., creating new GL accounts for short-term leases, tracking in a spreadsheet, etc.
  - Consider controls relating to the tracking of short-term leases

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<td>• Lower ROU assets and liabilities due to excluding short-term leases from the recognition requirements of ASC 842</td>
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<td>• May lead to cost relief during transition if decision has been made to not abstract and record short-term leases in the lease technology solution</td>
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<table>
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<tr>
<td>• Administrative burden to track short-term leases separately if not entered into the selected lease technology solution</td>
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<tr>
<td>• Additional disclosure requirements relating to short-term leases that have not been accounted for under ASC 842</td>
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Lease term – transition considerations

An entity may elect to use hindsight in determining the lease term, and in assessing the likelihood that a lessee renewal, termination, purchase option will be exercised; and
Must elect as a package and must be consistently applied to all leases.

**Advantages**

- Reassessments and remeasurements will be performed prior to 1/1/2019, thus reducing the impact of modifications post 1/1/2019

**Disadvantages**

- Increased cost and level of effort to reevaluate the lease term and reassess any lessee options (renewal, termination or purchase) on 1/1/2019
- Need to recalculate balances with book values dependent on lease term, i.e., deferred rent, leasehold improvements, etc.
Example: use of hindsight

Background

• Client X entered into a five year building lease on 1/1/2017; the contract had an option to extend the lease for an additional five years.
• At the inception of the lease, Client X was not reasonably assured that the renewal option would be exercised, therefore the lease term excluded the optional renewal period.
• By 1/1/2019, Client X has constructed significant leasehold improvements that it deems will have remaining economic value to it after the renewal date and is thus reasonably certain to exercise the renewal option.
• Assume Client X has elected to not present comparative financial statements under ASC 842.

Analysis

• **A:** If Client X elects to apply the hindsight practical expedient, Client X will include the optional five year renewal period on 1/1/2019, therefore, the remaining lease term will be eight years (three years remaining on the initial lease term, and the additional five years in the renewal period).
• **B:** If Client X elects not to apply the hindsight practical expedient, Client X will exclude the optional five year renewal period as it was not included in the original term at lease inception; therefore, on 1/1/2019, the lease will have a remaining lease term of three years.
Lease payments

- Lease payments included in the calculation of the lease liability under ASC 842 include:
  - Fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to the lessee
  - Exercise price of a purchase option or termination option that is reasonably certain of being exercised
  - Amounts probable that the lessee will owe under residual value guarantees (Maximum possible amount of RVG payment included for lease classification)
  - Variable lease payments that depend on an index or rate
Lease payments – variable lease payments

- The only variable lease payments included in the calculation of the lease liability are payments that depend on a rate or index, i.e., LIBOR, and are measured using the index or rate at lease commencement.
- Variable lease payments that are performance or usage-based are not in the calculation of the lease liability.
- Payments based on a change in an index, e.g. CPI, are not in the calculation of the lease liability.
Lease payments – transition considerations

• In transition, for operating leases, lessees are required to measure the lease liability using the present value of the “remaining minimum rental payments” (as defined in ASC 840)

• Unclear whether minimum rental payments should include fixed payments for gross leases

• Lessees should carryforward their policies under ASC 840
  - If lessees included fixed executory costs in minimum rental payments for disclosure of the “five-year” table, lessees should follow the same policy for ASC 842 transition
  - Lessees can generally elect to combine lease and non lease components in transition if electing to do so post effective date as well

• Upon transition, minimum rental payments should not include any escalations that result from prior changes to an index or rate (e.g., CPI).
  - However, a company may use current payments if it has a historical policy of updating the base rate in its disclosure of minimum rental payments under ASC 840 to reflect a change in index
Embedded leases

• Certain arrangements that are not structured as leases may contain “embedded leases”

• Types of contract that often contain embedded leases include:
  - Purchase and supply arrangements
  - Logistics contracts
  - Contract manufacturing arrangements
  - Multiple-element service arrangements (e.g., IT, telecom, energy-savings)

• If a contract *contains* a lease, it does not automatically indicate that the entire contract *is* a lease, i.e., it may also contain nonlease components
Embedded leases – ASC 840

• If electing the package of practical expedients, companies must first assess embedded leases under ASC 840 when adopting ASC 842.

• Practical expedients do not grandfather incorrect assessments under ASC 840 and/or a failure to assess for embedded leases under ASC 840.

• Companies often did not assess embedded leases under ASC 840.  
  - Lack of assessment and/or failure to identify leases under ASC 840 does not necessarily mean historical financial statements are incorrect.  
  - Under 840, if the arrangement is or contains a lease, the lease is often classified as an operating lease, which is accounted for similar to service arrangements for both lessees and lessors; impact is often only related to disclosure.
Embedded leases – ASC 840

• A contract contains a lease under ASC 840 if:
  - PPE is explicitly or implicitly identified, **AND**
  - *Any* of the following criteria are met:
    • The customer has the ability or right to operate (or direct others to operate) the PPE while taking more than a minor amount of the output or utility,
    • The customer has the ability or right to control physical access to the PPE while taking more than a minor amount of the output or utility, or
    • It is remote that another party (or parties) will take more than a minor amount of the output or utility of the PPE and the pricing of the arrangement is not fixed per unit of output or at market
Embedded leases – ASC 842

• A contract contains a lease under ASC 842 if:
  - PPE is explicitly or implicitly identified, **AND**
  - **Both** of the following criteria are met:
    - Customer has the right to direct “how and for what purpose” the asset is used
    - The customer has the right to obtain substantially all the benefits from the asset during the period of use
Embedded leases – substitution rights

- A contract does not contain a lease under:
  - ASC 840, if it is both practical and economically feasible for the supplier to use alternative PPE
  - ASC 842, if the supplier has a substantive substitution right. A substitution is substantive when:
    - The supplier has the practical ability to substitute alternative assets throughout the period of use, **AND**
    - The supplier would benefit economically from the exercise of its right to substitute the asset
Scenario:

- Hospital enters into a contract with a medical device manufacturer to purchase disposables. Medical device manufacturer provides hospital with the equipment with which the disposables are used.
- Hospital must purchase a minimum volume of disposables over the term of the arrangement. There are no separate charges for the equipment.
- Upon expiration or termination of the arrangement, all equipment will be returned to manufacturer.
- Manufacturer performs servicing and maintenance during the first year of the agreement, but only has the right to substitute the equipment if equipment is defective.
- Hospital pays any cost of damages to the equipment and agrees to maintain insurance adequate to cover the equipment.
ASC 840 analysis:

• Is PPE explicitly or implicitly identified?
  - Yes – The equipment is explicitly identified in the arrangement and it is not practicable and economically feasible for manufacturer to use a different asset.

• Does customer have the right to control the use of the equipment?
  - Hospital has the right to operate the equipment
  - Hospital controls physical access to the equipment
  - Hospital will take 100% of the output of the equipment and the pricing of the arrangement is neither fixed per unit nor at market per unit.

The arrangement contains a lease under ASC 840 because the equipment is specifically identified and the customer is deemed to control its use.
Embedded leases – example (continued)

ASC 842 analysis:

• Is PPE explicitly or implicitly identified?
  - Yes – The equipment is explicitly identified in the arrangement, and manufacturer does not have substantive substitution rights.

• Does customer have the right to control the use of the equipment?
  - Customer has the right to obtain substantially all of the economic benefits from the equipment.
  - Customer directs the use of the equipment.

The arrangement contains a lease under ASC 842 because the equipment is specifically identified and the customer is deemed to control its use.
Lease and nonlease components

• For contracts that include the use of multiple assets, the right to use an underlying asset should be accounted for as separate lease component if:
  - The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee, AND
  - The right of use is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract.

• Entities can apply a portfolio approach when application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio
  - For example, applying a portfolio approach to four-year leases of new automobiles of the same make and model, entered into in the same month with the same terms and conditions.
Lease and nonlease components

• Contracts may contain separate lease and nonlease components.
• Lessees allocate fixed payment (plus variable payments that depend on a rate of index) in a contract to lease and nonlease components on the basis of relative standalone selling price.
• Lessees (and lessors, if certain criteria are met) can make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated nonlease component(s) as a single lease component.
• Maintenance provided by landlord is considered a nonlease component.
• Taxes and insurance are neither lease components nor nonlease components. Fixed payments related to such items are just considered additional consideration.
Lease and nonlease components – example

Scenario

• Lessee leases office space in a building for 3 years
• Lessee is required to make the following annual payments:
  - $100 base rent
  - Variable payments, based on lessor’s actual maintenance costs

Analysis

• Maintenance is a nonlease component
• If lessee elects to separate lease and nonlease components
  - The $100 base rent must be allocated between lease and maintenance in order to determine amounts allocated to lease payments and maintenance
  - Variable payments related to maintenance would be allocated between maintenance expense and lease expense on the same basis as base rent is allocated
Lease and nonlease components

• Separate lease components must always be accounted for separately (with limited exceptions for the “portfolio” approach).

• Lessees can elect to separate or combine lease and nonlease components on an asset class by asset class basis

• Lessees often elect to combine lease and nonlease components:
  - Challenges with obtaining standalone selling prices
  - Complexity with applying allocation guidance
  - Systems considerations
Discount rate

• The discount rate for the lease is the “rate implicit in the lease”
  - If rate implicit in the lease cannot be readily determined, lessees use their incremental borrowing rate.
  - Generally, lessees do not consider the implicit rate to be readily determinable.

• Incremental borrowing rate is defined as “the rate of interest that the lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.”
Discount rate

- Incremental borrowing rate is specific to each lease and must consider
  - Lease term
  - Collateral
  - Other economic factors, e.g., currency

- The collateral used to determine the incremental borrowing rate is not limited to the underlying asset.
  - The starting point should be the rate a company could borrow on an uncollateralized basis based on its overall credit rating.
  - This rate would then be adjusted for collateral.

- Rates may need to be adjusted for leases denominated in foreign currencies.
- Private companies may elect to use a risk-free rate
Discount rate

• In some cases, this rate may be the parent’s incremental borrowing rate.
  - Central treasury function
  - Parent provides explicit or implicit guarantee of its subsidiary’s lease payments

• In transition, companies may elect to determine the rate based on original term or remaining term for all existing leases.
Transfer of Ownership at the End of the Lease Term

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term

Purchase Option Reasonably Certain to Be Exercised

- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonable certain to exercise

Major Part of the Remaining Economic Life

- The lease term is for the major part of the remaining economic life of the underlying asset

Substantially All of the Fair Value of the Underlying Asset

- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset

Underlying Asset Is Specialized

- 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
## Lessee accounting model

### Initial Measurement

- Recognize right-of-use assets and lease liabilities for all leases not considered short-term leases
- Lease liability is the present value of the lease payments not paid yet
- ROU asset is the lease liability adjusted for IDC, lease incentives, prepaid (deferred) payments
- A short-term lease is one with a maximum lease term of 12 months or less that doesn't include an option to purchase the underlying asset that the lessee is reasonably certain to exercise

### Subsequent Measurement

- Lease liability is amortized using effective rate
- Finance lease: recognize interest expense and amortization of ROU asset (front loaded expenses)
- Operating lease: recognize single lease cost (straight line expenses)
- Impairment of right-of-use assets is evaluated and accounted for using the guidance in ASC 360-10-35
**Lease classification - lessors**

<table>
<thead>
<tr>
<th>Sales-type lease</th>
<th>Direct financing lease</th>
<th>Operating lease</th>
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<tbody>
<tr>
<td>• The lease meets any one of the lessee classification criteria</td>
<td>• The present value of the sum of lease payments and any residual value guaranteed by the lessee and another third party unrelated to the lessor equals or exceeds substantially all the fair value of the underlying asset, and</td>
<td>• The lease does not meet sales-type or direct financing classification criteria</td>
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<td>• It is probable that the lessor will collect the lease payments plus any amounts necessary to satisfy a residual value guarantee</td>
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Lessor accounting model

Sales-type leases
- The underlying asset will be derecognized and a net investment in lease will be recognized.
- The selling profit or loss and initial direct costs\(^1\) will be recognized at the lease commencement.
- If collectability is probable, derecognize underlying asset and recognize a net investment in the lease and selling profit (loss).
- If collectability is not probable, recognize lease payments received as a deposit liability (i.e., do not derecognize underlying asset because sale is deferred).

Direct financing leases
- The selling profit and initial direct costs will be deferred and included in the measurement of the net investment in the lease.
- Selling loss will be recognized upfront.

Operating leases
- The underlying asset will remain on the lessor’s balance sheet.
- Recognize lease payments as income over lease term, generally on a straight-line basis.
- The initial direct costs will be deferred and expensed over the lease term on the same basis as lease income.

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\(^1\) If the fair value of the underlying asset equals its carrying amount, initial direct costs are deferred at the commencement date and included in the measurement of the net investment in the lease.
Sale-leaseback

• ASC 842 sale-leaseback criteria applies to both real estate and equipment (both integral and non-integral)

• The following circumstances would preclude a sale:
  - Leaseback is a finance lease
  - Seller-lessee has a substantive repurchase option. An option is substantive if:
    • Not at fair value (at exercise)
    • Involves a non-specialized asset that is readily available in the marketplace

• Seller-lessee purchase options of real estate (even at FV) or any fixed price purchase option would preclude sale treatment
Sale-leaseback

• If a sale-leaseback qualifies for sale-leaseback accounting treatment, the seller-lessee:
  - Derecognizes underlying asset
  - Recognizes a lease liability and right-of-use asset (same as any lease)
  - Classifies the lease
  - Recognizes a gain or loss adjusted for off-market terms (if any)

• If a sale-leaseback does not qualify for sale accounting treatment, both lessors and lessees would account for transaction as a financing
Build-to-suit

• Change in paradigm for build-to-suit lease arrangements from risks and rewards model to control model

• A lessee is considered the owner of a leased asset during the construction period under ASC 842 if the lessee is deemed to be able to control the construction project

• A lessee considered the owner of the asset prior to lease commencement (i.e. during a construction period) will reflect the asset on its balance sheet and must apply the sale leaseback guidance at the end of a construction period to determine whether the asset may be derecognized and a lease classified
The following examples demonstrate (individually or in the aggregate) that the lessee controls an underlying asset that is under construction:

- The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (e.g., by making a payment to the lessor)
- The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessee
- The lessee legally owns the land and property improvements (e.g., building on the land) or the non-real estate asset (e.g., ship) that is under construction
- The lessee controls the land that property improvements will be constructed on and does not enter into a lease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the property improvements
- The lessee leases the land that the property improvements will be constructed on and the term of the lease (together with lessee renewal options) is for substantially all of the economic life of the property improvements, and the lessee does not sublease the land before the beginning of construction for the same time period (or longer) than the lessee controls the land
Technology Considerations
Why do I need technology to support ASC 842?

For complicated lease contracts, companies will require up to 75 different data points. Multiply that by 1,000 or 2,000 leases and the amount of data that you have to gather is probably not going to work on spreadsheets anymore.

- Accounting Today

Companies with as few as 25 – 50 leases may struggle with excel tracking of the lease data points and events to comply with ASC842

- RSM
### ASC 842 approach

#### Assessment and Strategy

- **Project Initiation and Planning**
  - Plan impact assessment
  - Understanding of business strategy, organizational overview, business systems

- **Business Requirements**
  - Current lease portfolio
  - Contracts deep dive
  - Current org design
  - Current tech landscape
  - Current biz processes

- **842 Impact Assessment**
  - Key impacts of ASC 842
  - Critical gaps
  - External auditor findings

- **Operational & Technology Strategy**
  - Define requirements
  - Evaluate vendors
  - Select vendor
  - Define implementation scope, timeline and budget

#### Implementation Management

- **Business Process & System Design**
  - Detailed system design
  - Templates and tools
  - Stakeholder impact (tax, treasury)

- **Lease Abstraction & System Config**
  - Configure software
  - Abstract leasing data
  - Feedback from external auditors

- **System Testing and Validation**
  - Testing plan
  - Execution of test plan
  - Validation of lease calculations
  - Issue tracking

- **Deployment, Training and User Adoption**
  - Training for accounting users
  - Training for procurement users
  - Internal controls

#### Project Management, Communication and Change Enablement
Implementation methodology overview

**Initiation**
- Finalize scope & objectives
- Identify key business owners & define roles
- Develop detailed project plans
- Educate project team Software
- Evaluate outsourcing vs insourcing

**Analysis & Design**
- Conduct design workshops to review business processes, updates and 842 requirements
- Develop system design document
- Aggregate lease data
- Design ERP integration

**Development**
- Configure Application
- Develop lease abstraction plan
- Abstract and migrate all leases
- Design data migration
- Develop future state process design
- Develop test plan

**Refinement & Testing**
- Conduct Core User Training
- Validate lease import and calculations with First Midwest
- Manage testing and resolve issues
- Prepare training materials

**Training & Deployment**
- Develop Cutover plan
- Cutover from Test environment to Production environment
- Conduct End User Training
- Post Go-Live support

**Project Management, Communications & Change Enablement**
Lessons learned

• This is not just an accounting project – **identify and engage** all key stakeholders, both internal and external

• Getting the **right data** is key to success and potentially the biggest challenge

• Both **real estate and equipment leases** are often significant for healthcare companies

• Healthcare companies will frequently have a significant amount of **embedded leases**, which often were not previously identified

• **Practical expedients** decisions impact data & abstraction requirements

• **Intercompany** arrangements may result in lease accounting requirements for business units

• **Companies should not underestimate the time and resources required!**
THANK YOU FOR YOUR TIME AND ATTENTION