DID PUBLIC COMPANIES GET IT RIGHT? LESSONS LEARNED FROM IMPLEMENTING ASC 842

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Today’s presenters

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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

Many public companies underestimated both the complexity of ASC 842 and the as well as the time and resources required to implement the standard
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 dates

• ASC 842 is effective for annual periods beginning after:
  – Dec. 15, 2018 for public business entities
  – Dec. 15, 2019 for all other entities

• Companies may make an election to restate or not restate comparable financial statements when first adopting the standard

The majority of public companies elected to not restate comparable financial statements upon implementation of ASC 842
“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

Advantages

• Reduced costs and level of effort due to not having to reassess expired and existing leases and unamortized initial direct costs as of Jan. 1, 2019

• Minimal differences between US GAAP and IFRS if the IFRS modified approach and the practical expedients are elected.

Disadvantages

• Increased right of use (ROU) 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)

• Requires that current lease accounting to be correct (i.e., does not grandfather errors)

Nearly all public companies elected to utilize the package of practical expedients
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 ROU 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 ROU 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

- 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 extend the lease
- Lessees do not reassess lease term for existing leases in transition unless electing the hindsight expedient
- Lessee can elect not to capitalize leases with total terms of 12 months or less
Lease term – Public company lessons

• Very few public companies elected to use the hindsight expedient

• Nearly all public companies elected not to record lease assets and liabilities for leases with total terms of 12 months or less
  – 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.

• All companies must define what constitutes “triggering events” resulting in reassessment of the lease term following adoption of ASC 842
• 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 residual value guarantee (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)”

• Lessees should follow ASC 840 policies for minimum rental payments disclosures when determining whether:
  – Fixed executory costs should be included minimum rental payments
  – Minimum rental payments should include increases resulting from changes in CPI

• Lessees can generally elect to combine lease and non lease components in transition if electing to do so post effective date as well
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.
- Few public companies historically performed robust embedded leases analyses under ASC 840.
- Does not imply that historical financial statements were incorrect; if an arrangement did contain a lease under ASC 842, lease would frequently been classified as an operating lease, and accounted for similar to service arrangements.
- Completing a robust embedded lease analysis is typically a key component of the ASC 842 implementation process.
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 – Public company lessons

- The process of separating lease and nonlease components can be complicated and the technical requirements are often not intuitive.
- Many lease accounting systems are not designed to account for lease and nonlease components without significant manual effort required to be performed “outside” of the system.
- Due to complexities of separately lease and nonlease components, many public companies elected not to separate for most asset classes.
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 (cont.)

- Implicit rates are generally not considered to be “readily determinable to a lessee”
- Incremental borrowing rate is specific to each lease and must consider lease, collateral, other economic factors, e.g., currency
- Private companies may elect to use a risk-free rate
- The discount rate had a direct impact as to what lessee record on their balance sheets under ASC 842; public companies frequently performed robust analyses to determine rates for each lease and/or group of leases, if applicable
- Even if using a risk-free rate, private companies must ensure rates consider term, collateral, currency, etc.
Lease classification - Lessees

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 ROU 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 ROU 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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| • The lease meets any one of the lessee classification criteria | • 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  
• It is probable that the lessor will collect the lease payments plus any amounts necessary to satisfy a residual value guarantee | • The lease does not meet sales-type or direct financing classification criteria |
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.

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.
Why do I need technology to support ASC 842?

Lease Lifecycle

Centralization
- Document management
- Lease workflow
- Storage of abstracted data in relational database
- Workflow management

Calculations
- Lease Liability
- ROU Asset
- Expense, interest, amortization
- Impairment
- Variable and/or Step up Rents
- Exercising options
- Journal Entry
- A/P Export

Reporting
- Lease Schedule
- FASB Disclosures
- Ad-Hoc, operational reporting
- Reminders on Options

While many public companies focused on ASC842 compliance, benefits can be obtained from technology – decrease of administrative burden, centralized document repository, insight into leasing decisions.
Why do I need technology to support ASC 842? (cont.)

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 US
Many public companies underestimated the time required to assess and develop a strategy prior to software selection and all of the accounting decisions needed to configure the system and abstract the leases.
Implementation methodology overview

**Implementation Management**

- **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
  - 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**
THANK YOU FOR YOUR TIME AND ATTENTION