



Dot the i's and cross the t's

A deeper look into ASC 842 adoption

September 28, 2021

Your instructors



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Agenda

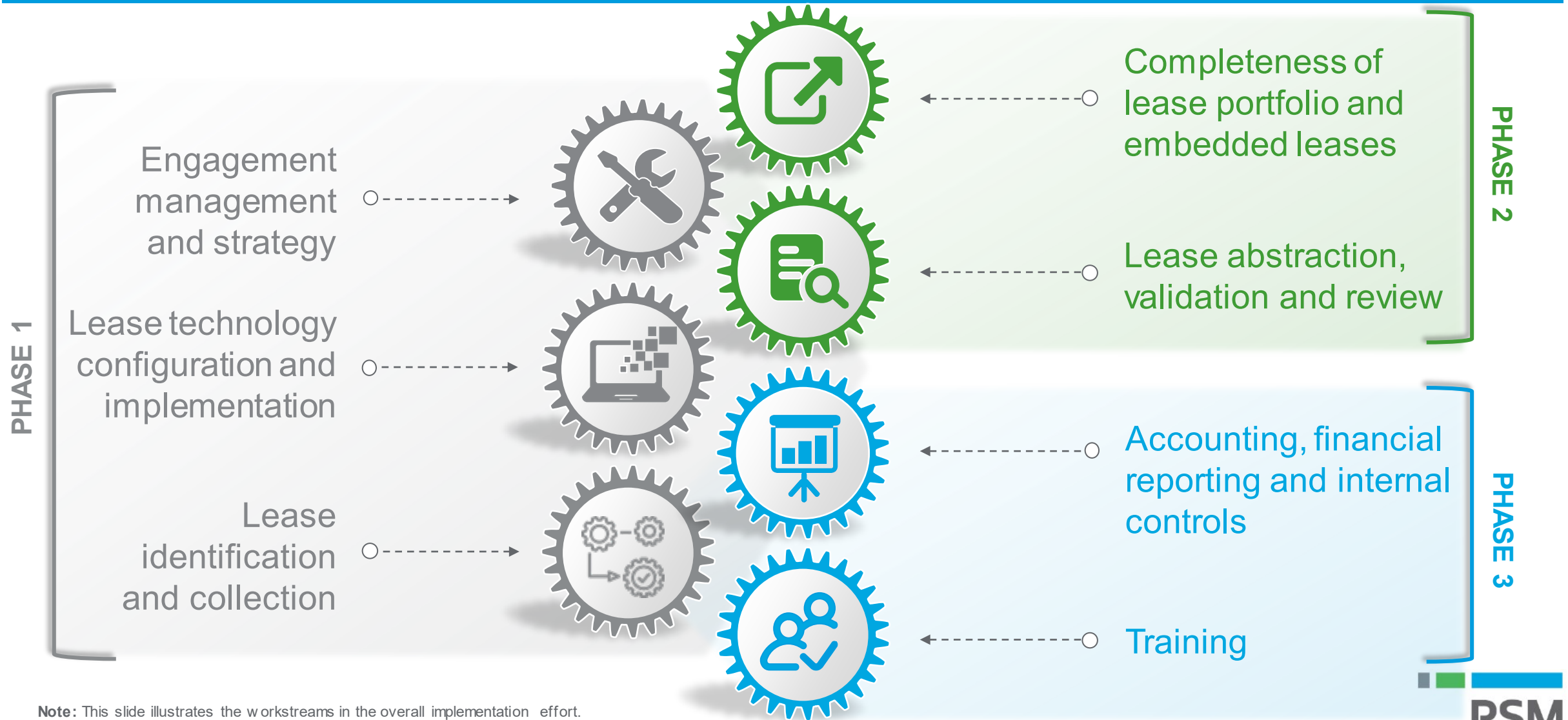
Topic	Minutes
Introductions and overview	5
Materiality considerations	15
Completeness of your lease portfolio	15
Lease abstraction	15
Q&A	10

Objectives

By the end of this course, you will be able to:

- 1 Identify and speak about new areas that will potentially impact your adoption
- 2 Discuss key elements of a written ASC 842 adoption plan
- 3 Define documentation to support an effective adoption and your assertions over accuracy and completeness of your lease population
- 4 Explain abstraction tricks and traps

Overview of key activities



Note: This slide illustrates the workstreams in the overall implementation effort.



MATERIALITY CONSIDERATIONS

Materiality: Capitalization threshold

“In addition to accounting for some leases at a portfolio level, entities will likely be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, which should reduce the costs of applying the guidance. An entity’s practice in this regard may be consistent with many entities’ accounting policies in other areas of GAAP (for example, in capitalizing purchases of property, plant, and equipment).”



**Financial
Accounting
Standards
Board**

Source: Basis for Conclusions 122

Materiality: Capitalization threshold (cont.)

Considerations when establishing a capitalization policy and threshold:

Evaluate the effect of the threshold on the Gross Balances of the ROU assets and lease liabilities

Consider disclosures that would be omitted or significantly different if certain leases were not recognized

Internal controls are needed to apply and monitor the capitalization threshold

Auditors may require ongoing quantification of leases below the capitalization threshold

Inappropriate to evaluate the effect of non-recognition on a 'net' basis [i.e., considering only the net effect on the balance sheet (ROU asset minus lease liability)]

Materiality: ASC 842 implementation procedures

Companies should apply materiality to multiple aspects in an ASC 842 implementation project.

Common scenarios include:

1

Determining the scope of implementation procedures

2

Evaluating a portfolio of leased assets that exceed the Company's capitalization threshold in aggregate

- *In most cases, the criteria for the portfolio practical expedient is not met*

3

Assessing errors under ASC 840 identified in the implementation of ASC 842

Materiality: ASC 842 implementation procedures (cont.)

Materiality can be used to design implementation procedures – it may not be reasonable or practical to review every possible contract or analyze every G/L account for potential service arrangements and leases

Procedural materialities can be established for:

- Recurring vendor payment analysis: assessment of recurring payments **above** a calculated procedural materiality threshold
- Service arrangement reviews: review of arrangements with a total contractual spend **above** a calculated procedural materiality threshold
- Exclusion of specific asset classes: exclude asset classes **below** a calculated procedural materiality

PROCEDURAL MATERIALITIES



QUALITATIVE CONSIDERATIONS

Qualitative considerations must be factored into the materiality calculation, such as:

- Primary financial statement users
- Debt covenants
- Classified vs. unclassified balance sheet
- Stand-alone reporting requirements for a subsidiary

Materiality: Intentionally excluding a portfolio of leased assets

- When evaluating a lease portfolio, a company may assert it is not efficient or cost effective to include all identified leases in the scope of ASC 842 accounting
 - Companies may have a fleet of equipment or vehicles that exceed the capitalization threshold in aggregate
 - For example: a copier fleet containing **500 assets** leased under a MSA has a **ROU asset and lease liability of \$100,000** in aggregate; **capitalization threshold is \$15,000**
 - Vendor reports may not be available with all required data in a format that can be easily uploaded directly into a lease accounting system, and manual abstraction would be a significant manual effort
 - The addition of 500 assets causes “lease bloat” in a lease accounting system
 - Some lease accounting systems charge based on number of records in the system
- Management may perform a quantitative and qualitative analysis of the fleet **compared to total assets and total liabilities to assess** the materiality of the omission of the fleet from ASC 842
 - Must consider whether the fleet is expected to grow and could become material in future years

Threshold: A walk through of a hypothetical calculation

	Estimated 12/31/22		
Current assets	\$ 20,000,000		
Other assets	90,000,000		
Total Assets	\$ 110,000,000		
Current liabilities	\$ 18,000,000	X%	\$XXX,XXX
Long-term liabilities	79,000,000	X%	\$XXX,XXX
Total Liabilities	\$ 97,000,000	X%	\$XXX,XXX
Smaller of the calculated amounts	\$ XXX,XXX		
Adjust downward for potential unidentified risks		XX%	Adjusted based on risk assessment
Aggregation threshold	\$ XXX,XXX		
Conversion to individual transactions		X'	Adjusted based on risk assessment
Potential Calculated Threshold	\$ XX,XXX		Recognition/Capitalization Threshold
Clearly Deminimus Threshold	\$1,000		

*Must demonstrate
individual threshold
will not result in the
aggregation of
immaterial items to
a material amount*



COMPLETENESS OF THE LEASE PORTFOLIO

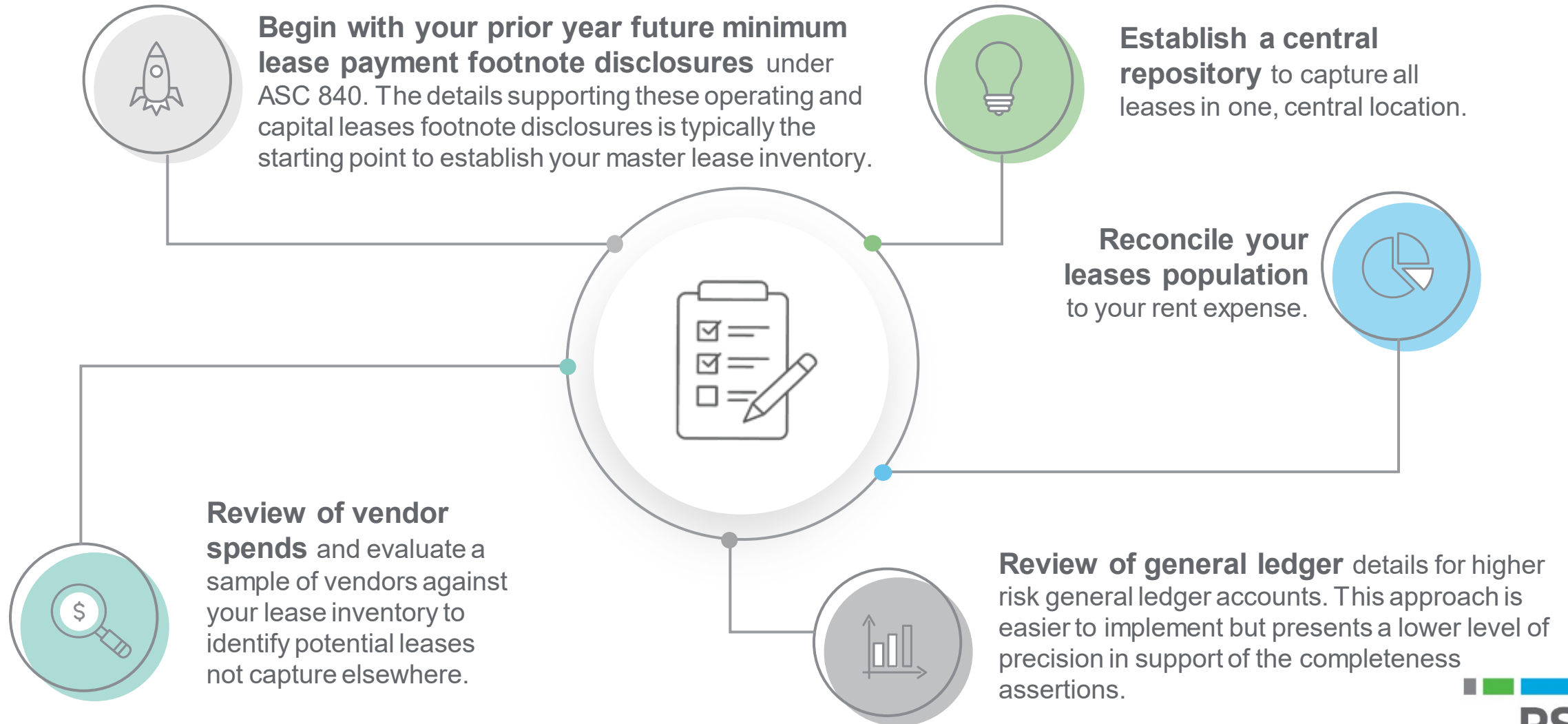
Overview

- Operating leases are moving onto the balance sheet, resulting in increased risk of the understatement of liabilities and assets which previously did not exist under ASC 840.
- Expect your auditors to request you to support (provide evidence) the completeness of your lease population.
- The requests typically require you to address two different types of leases which potential could be missed:
 - Conventional leases, legal form lease
 - Embedded leases, contracts which are service arrangement or other contracts, which meet the definition of a lease or contain a lease embedded within the contract.



**Under ASC 840, little focus was placed on embedded leases.
This will change under ASC 842.**

Completeness: Conventional leases



Completeness: Conventional leases (cont.)

- **Inquiries and/or formal surveys** of identified departments which routinely utilize leased assets, enter into lease transactions and/or lease agreements. These departments typically consist of:
 - **Corporate IT**, will be responsible for leased computer and telephone equipment
 - **General and Administration**, will be responsible for leased copiers, cars, remote office locations, break room equipment
 - **Legal** departments will review leases and maintain lists of executed leases
 - **Procurement**, if a standalone procurement group exists, they will typically source lease transactions
 - **Tax** departments will oversee preparation of personal property returns which typically requires reporting leased assets

Do not forget to document your inquiries and compare the results to your master lease listing.

Completeness: Conventional leases (cont.)

- Analyze vendor payments (AP records) to identify and review **recurring vendor payments** of same and similar amounts.
 - Should cover AP vouchers over a nine-to-twelve-month period prior to adoption date
 - Should consider similar amounts within +/- 5%
 - Your materiality thresholds should incorporate a threshold for selecting identified transaction to evaluate
- **Certification of lease listing by key stakeholder.** Distribute department listing of leases to department or division heads for their review and certification of completeness and accuracy.
- Typically, all the above steps are **not** needed to support your conventional lease completeness assertion. Often, satisfactorily performing a combination of three or more of these steps can support a conclusion that the risk of a material error resulting from an unidentified conventional lease has been reduced to an acceptable low level.



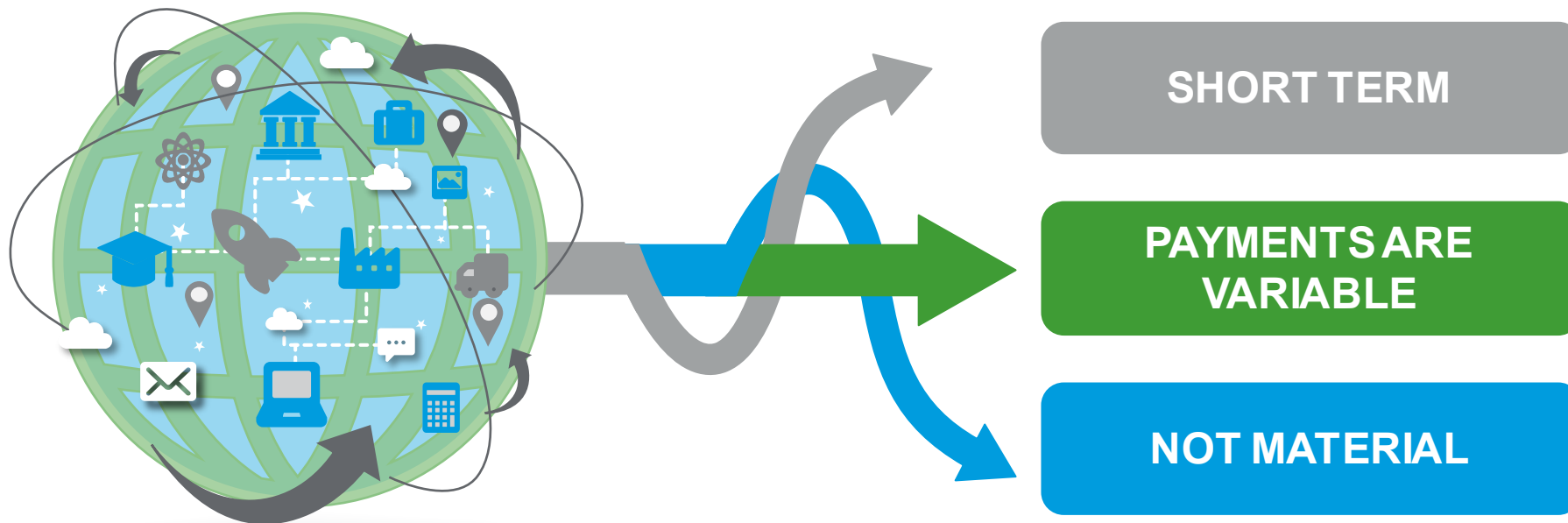
COMPLETENESS OF THE LEASE PORTFOLIO: EMBEDDED LEASES

Embedded leases

- Companies often did not assess and document 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 ASC 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; therefore, any historic impact is often only related to classification or disclosure

Embedded leases: Key point

The only wrong response to your auditor's inquiry regarding embedded leases is...
"we have no embedded leases." 🙈



Scope and definition of a lease

LEASE: A contract or part of a contract that conveys the right to control the use of identified property, plant or equipment (identified asset) for a period of time in exchange for consideration

Standard applies to

- leases of:
- property
 - plant
 - equipment



- software
- leases of inventory
- assets under construction
- intangible assets
- biological assets, including timber
- leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources

Standard does not apply to

Definition of a lease under ASC 840 vs. ASC 842 is different

December 31, 2021

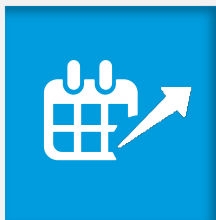
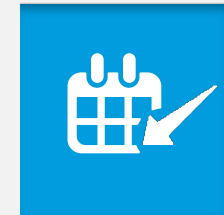
Pre adoption through December 31, 2021	Post adoption – January 1, 2022
Use ASC 840 framework	Use ASC 842 framework
Is there an identified asset? Explicitly or implicitly specified?	Is there an identified asset? Explicitly or implicitly specified?
<i>Substantive substitution rights and practical ability to exercise that right</i>	<i>Substantive substitution rights and supplier would not benefit from substituting the asset</i>
Do you have right to control the asset?	Do you have right to control the asset?
1. Right or ability to operate the asset (or direct others) AND obtaining/controlling more than a minor amount of the output? or	1. Decision-making authority over the use of the asset; and
2. Right or ability to control the asset AND obtaining/controlling more than a minor amount of the output? or	2. Ability to obtain substantially all economic benefits from use of the asset
3. Obtain substantially all of the output and price/unit is not contractually fixed/unit or equal to current market price/unit?	

Embedded leases ASC 840 vs ASC 842

REMINDER!

Electing to not reassess leases under ASC 842 may yield fewer embedded leases

Contracts entered into prior to adoption (e.g., December 31, 2021 and before) would be evaluated under the ASC 840 framework.



ASC 842 framework would be utilized to evaluate contracts post adoption (e.g., January 1, 2022)

Embedded lease examples: General operations

- Some common examples of embedded leases found in overall business operations:

- Advertising space on billboards or buildings
- Equipment rental for special event services
- Food and vending services/machines
- Secure shredding services
- Mail machines (postage)
- Copiers (toner and paper supplies)
- Catering equipment
- Small equipment (water coolers, coffee machines, etc.)
- Third party owned security equipment
- Contract manufacturing



Shredding Bins



Colocation Data Sites



Billboards



Completeness: Embedded leases

Your adoption plan should include:

- steps specifically focused on the identification of material embedded (non-legal form) leases. ***These steps are similar to the steps performed to support your completeness assertion for conventional leases.***
- Stakeholder training in embedded leases.

Embedded leases is not a well understood concept by your stakeholders. To demonstrate to your auditors the effectiveness of your inquiries, surveys, certifications and all other procedures detailed, ***you first should ensure your stakeholders know what to look for.***

When stakeholder training for embedded leases is not performed, auditors have asserted reviews, inquiries and surveys for embedded leases may not effective.



Completeness: Embedded leases (cont.)



The procedures are similar to those for completeness procedures for conventional leases

Embedded leases: Risk assessment

Higher inherent risk for embedded leases exists in service or supply contracts, where the supplier/vendor:

Utilizes material property, plant or equipment in providing their services

Your materiality thresholds should incorporate a threshold for evaluating contracts for embedded leases



Contract is for a long-term period (greater than one year)



Payments are fixed (not variable)

Embedded leases: Risk assessment (cont.)

Review total vendor spends and/or expense categories to eliminate vendors/suppliers where risk of a material embedded lease is low. Focus on areas where risks are not inherently low.



Arrangements which can be of higher risk for material embedded leases include contract manufacturing, subcontract arrangements, shipping and transportation contracts, IT service contracts and co-location arrangements.

Expense categories where the inherent risk for embedded leases may not be low depends on the nature of the services you are purchase.

Insurance, payroll costs, taxes, legal are expense categories where the inherent risk for embedded leases is very low. Typically, no reason to look at vendors in these categories.



LEASE ABSTRACTION

Data abstraction and review

Below provides an overview of a typical abstraction process.

ABSTRACT

- Abstract data from lease documents and prepare templates to be imported into the technology solution
- Apply all judgments made in the preparation phase to the data being abstracted
- Ensure all documents are reviewed and abstracted into the system by checking the most current lease documents against the expenses being recorded in the GL

VALIDATE

- Validate the completeness of information entered into the system
- Validate the accuracy of data entered into the system
- Validate the calculations tie back to the current GL

REVIEW

- Perform reviews to ensure accuracy of the information inputted
- Review of information inputted into the abstraction templates or lease technology solution
- Review the accounting calculations under ASC 842
- Provide population to you for review prior to finalizing the abstracts

ASC 842 abstraction lessons learned: Organization

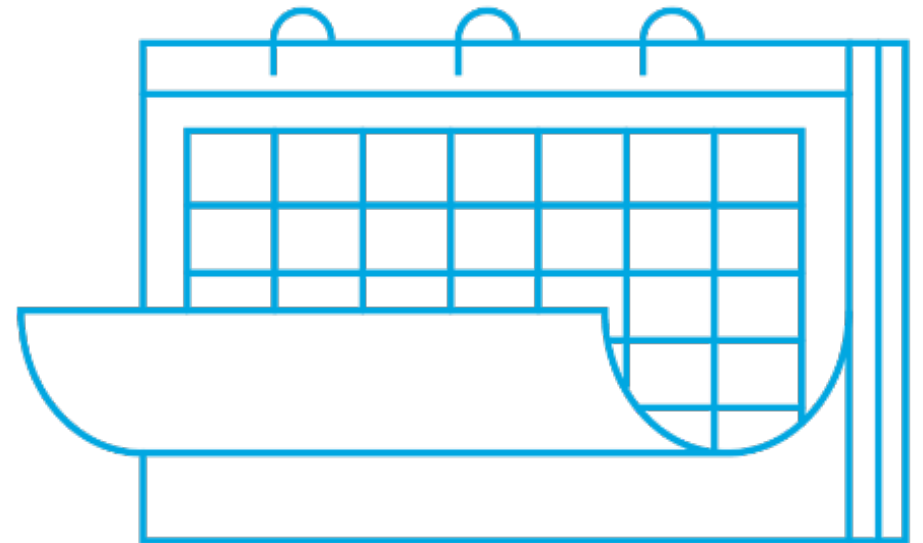
- Lease index and abstraction tracker
- Lease document labeling
- SharePoint site to collect, organize and share lease agreements
- Abstraction question tracker
- Supplemental trackers *may* be needed to identify:
 - Asset Retirement Obligations (AROs)
 - Tenant Improvement Allowances (TIAs)
 - Indexed lease rent
 - Immaterial lease components
 - Deferred rent and tenant allowance balances
 - ASC 805 balances
 - Restructuring liabilities



ASC 842 abstraction lessons learned: Scheduling

- Don't expect a clean stop at the end of the abstraction
 - Questions linger on – plan and schedule for it
 - Estimate 5+ hours/week to resolve ongoing questions
- Consistency of resources is key
- Training of resources needs to occur before abstraction commences
 - Technical topics under ASC 842
 - Specific abstraction fields and blanket assumptions
 - Lease software/template navigation

Plan for sufficient time for quality control reviews



Data collection – abstraction

Key information that will be needed to apply accounting for leases under ASC 842 includes:

- Lease commencement date
- Lease expiration date
- Renewal option(s)
 - Lease payment terms
 - Lease incentives related to renewal
 - Option exercise evaluation
- Termination option(s)
 - Option date
 - Payment amount
 - Option exercise evaluation
- Purchase option(s)
 - Option date
 - Payment amount
 - Option exercise evaluation

- Lease payments
 - Fixed payments excluding consideration allocated to non-lease components
 - Free rent or rent credit
 - Variable payment – based on index
 - Variable payment – based on performance or usage
 - Payment frequency
- Lease classification (fair value and economic life of leased asset)
- Initial direct costs
- Lease incentives
- Residual value guarantee
- Discount rate
- Prepaid/accrued lease-related balance

ASC 842 abstraction lessons learned: Budgeting

- Real estate: 3 - 4 hours for initial abstraction of lease
- Equipment: Dependent upon nature of population
 - Mass download and upload of fleet vehicle data could be a few hours for several hundred leases
 - Individual lease agreement abstractions could range from 0.5 - 3 hours depending on complexity
- Must factor in:
 - Multiple QC reviews, QC 1 is typically 100% of population, QC 2 is 10-20% of population
 - Analytical QC over data prior to import
 - Project management time
- Foreign language leases typically require more time for all lease types and may require third party foreign language abstractors





OTHER CONSIDERATIONS

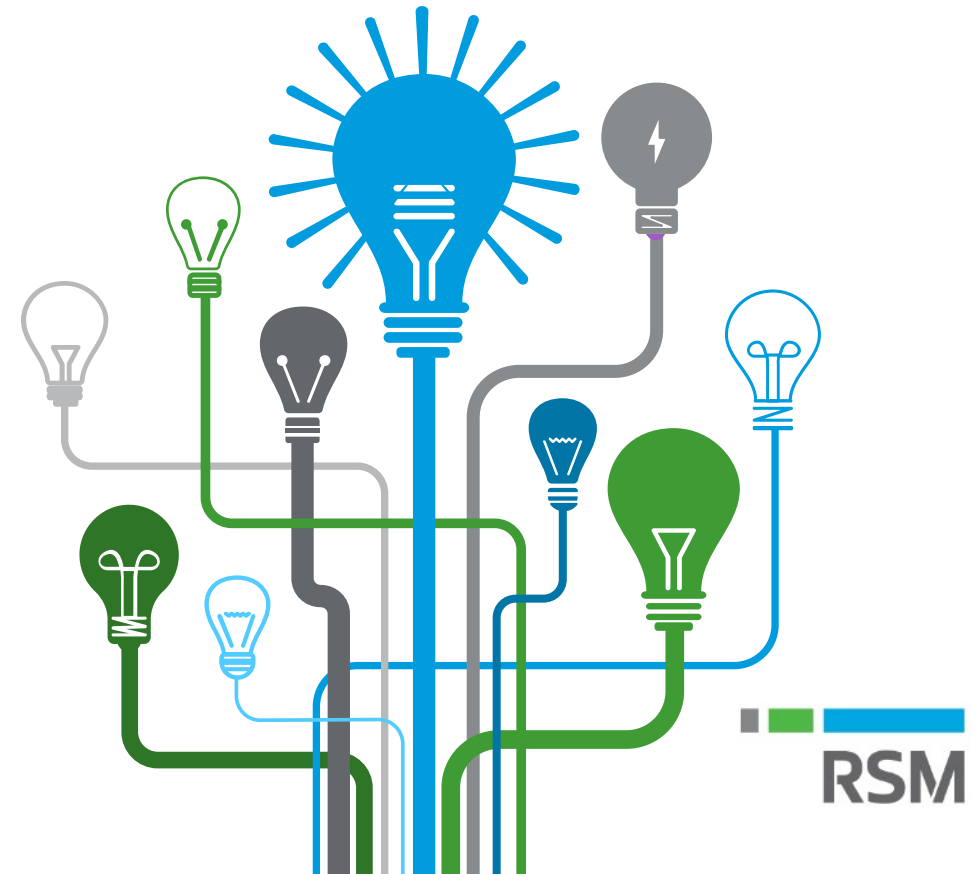
Assessing errors

- During the ASC 842 implementation effort, companies often identify errors in ASC 840 accounting. These frequently relate to (but are not limited to):
 - Accounting (or not accounting) for deferred rent or lease incentives
 - Leases omitted from the future minimum commitments disclosure
 - Changes resulting from lease amendments not reflected in the future minimum commitments disclosure
 - Improper classification of operating vs. capital leases
- Management may apply a materiality framework to determine whether to correct the error upon transition to ASC 842 or “pass” on the error correction.
- **Specifically address your consideration for the identification of historical errors which may be identified through your implementation procedures. If you did not identify historical errors, state such within your adoption memo.**



Disclosure requirements relating to transition adjustments

- Nature and reason for change in accounting principle
- Method used for applying change
- Cumulative effect of change on opening balance sheet
- If practical expedients are used, disclose which are used and the effect of applying each of the expedients
- If not using a lease system, assembling the quantitative ASC 842 disclosure can be time consuming



QUESTIONS AND ANSWERS

THANK YOU FOR
YOUR TIME AND
ATTENTION



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