

ASC 842 Technical Basics and Implementation Considerations

A deeper look into ASC 842 adoption

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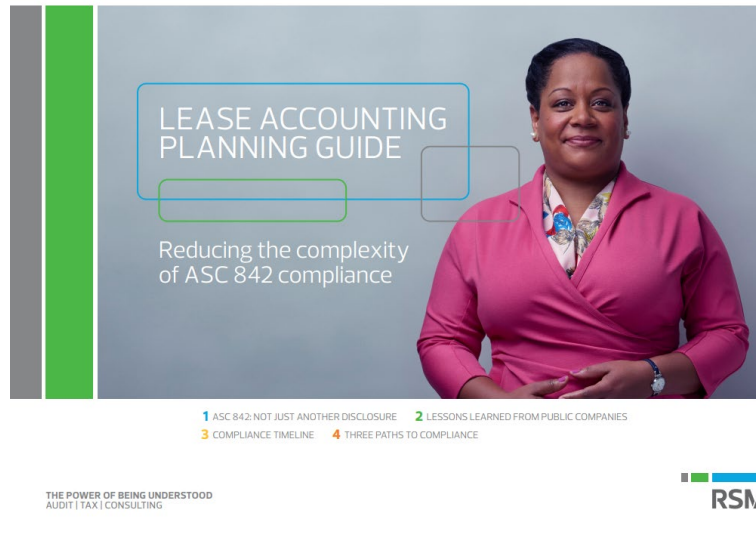
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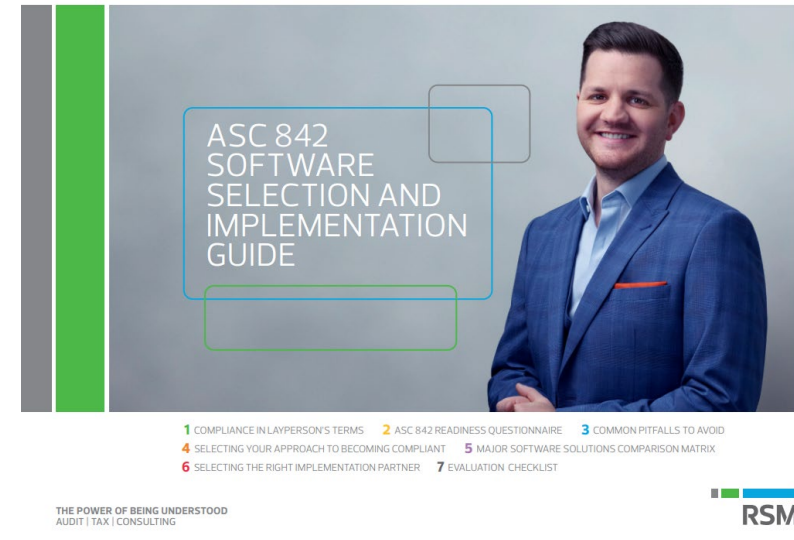
Helpful insights on ASC 842 from RSM

You will find a link to both of these e-books in the **RESOURCES** section to the right of your screen.

Lease Accounting planning guide




ASC 842 software selection guide



Agenda

1	Overview of the New Lease Accounting Standard (ASC 842)	5 mins.
2	Key Accounting Considerations	25 mins.
3	Implementation Planning	10 mins.
4	Materiality Considerations	10 mins.
5	Completeness of the Lease Portfolio	15 mins.
6	Lease Abstraction	10 mins.
7	Other Considerations	15 mins.

Objectives



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

01

Explain critical concepts underlying the new lease accounting standard

02

Discuss the key lease data points that will impact the accounting under the new lease accounting standard

03

Discuss key elements of an ASC 842 implementation plan

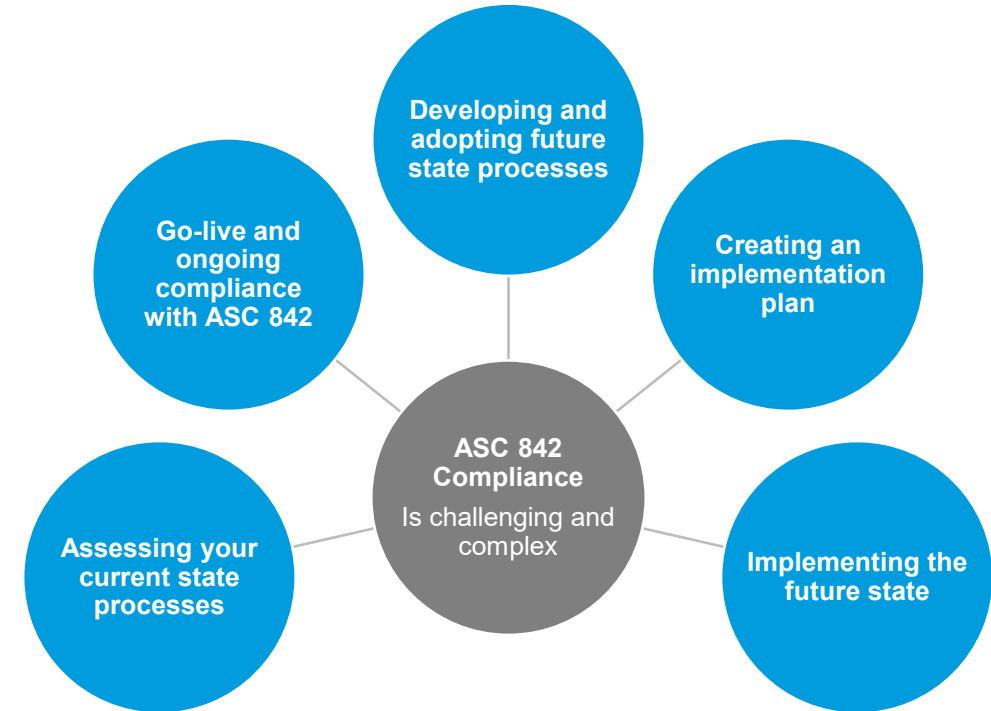
04

Define documentation to support an effective adoption and your assertions over accuracy and completeness of your lease population

OVERVIEW OF THE NEW LEASE ACCOUNTING STANDARD (ASC 842)

ASC 842 – The big picture

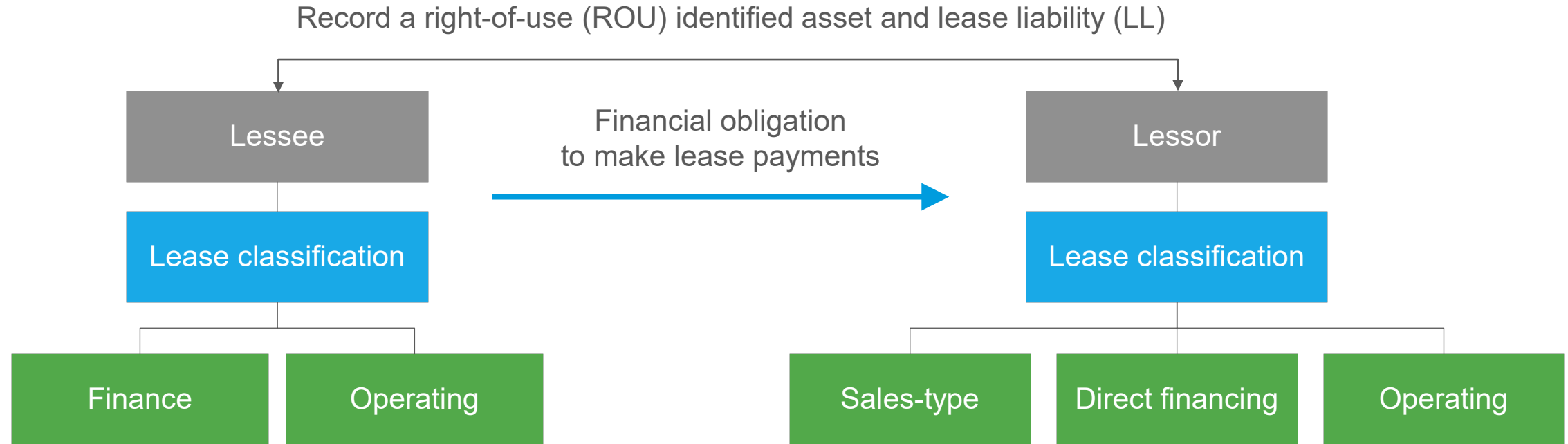
- Long-term leases (operating and finance) will be recorded on the balance sheet
- 2021 reporting requirement considerations
 - Disclose status of impact assessment
 - Disclose assessed impact
- Existing leases and service contracts are being assessed
- Processes, internal control and system changes will be required
- Lease characterization for federal income tax purposes has not changed
- Potential impact on debt covenants needs to be assessed



Some are calling ASC 842...

“the biggest accounting change ever.”

Lease model under ASC 842



- Recognize right-of-use (ROU) assets and lease liabilities for most leases
- Pattern of expense recognition is similar to legacy GAAP

- Similar to legacy GAAP with some changes
- Leveraged lease accounting eliminated prospectively

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

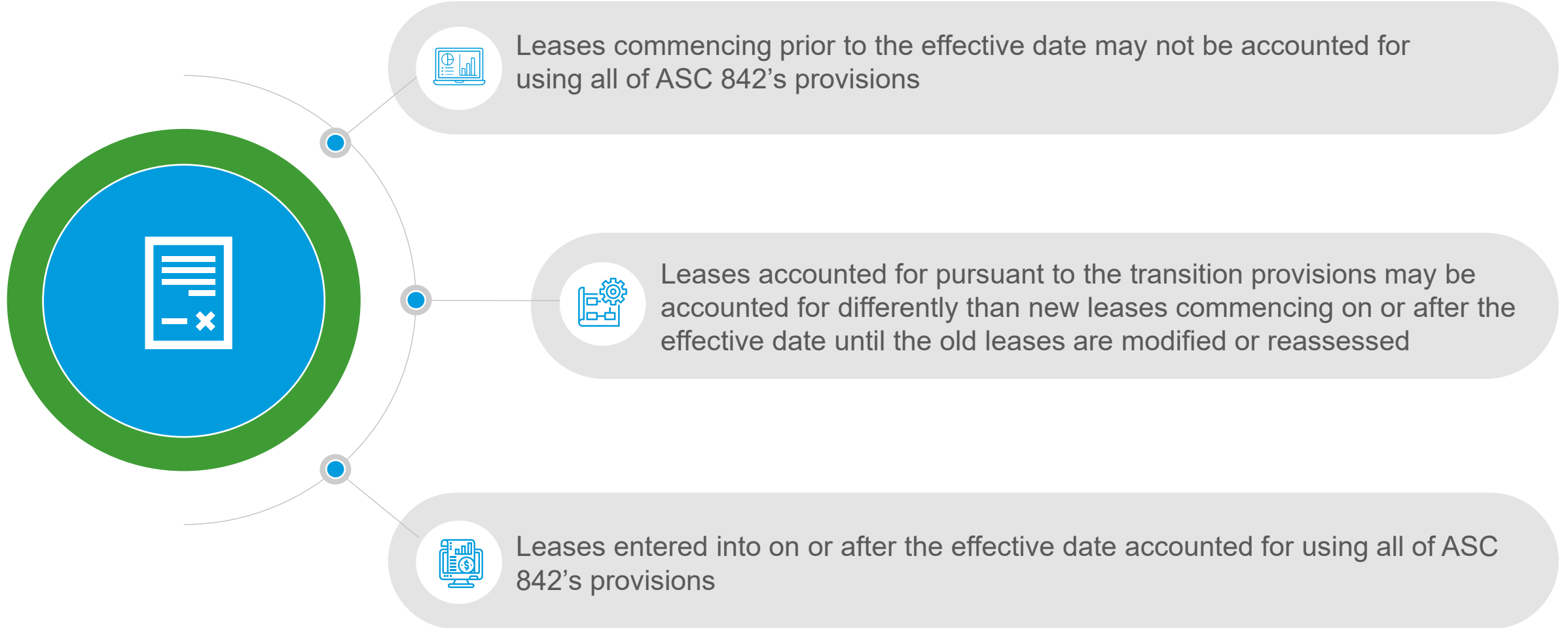
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- software
- leases of inventory
- assets under construction
- intangible assets
- biological assets
- leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources

Standard does not apply to

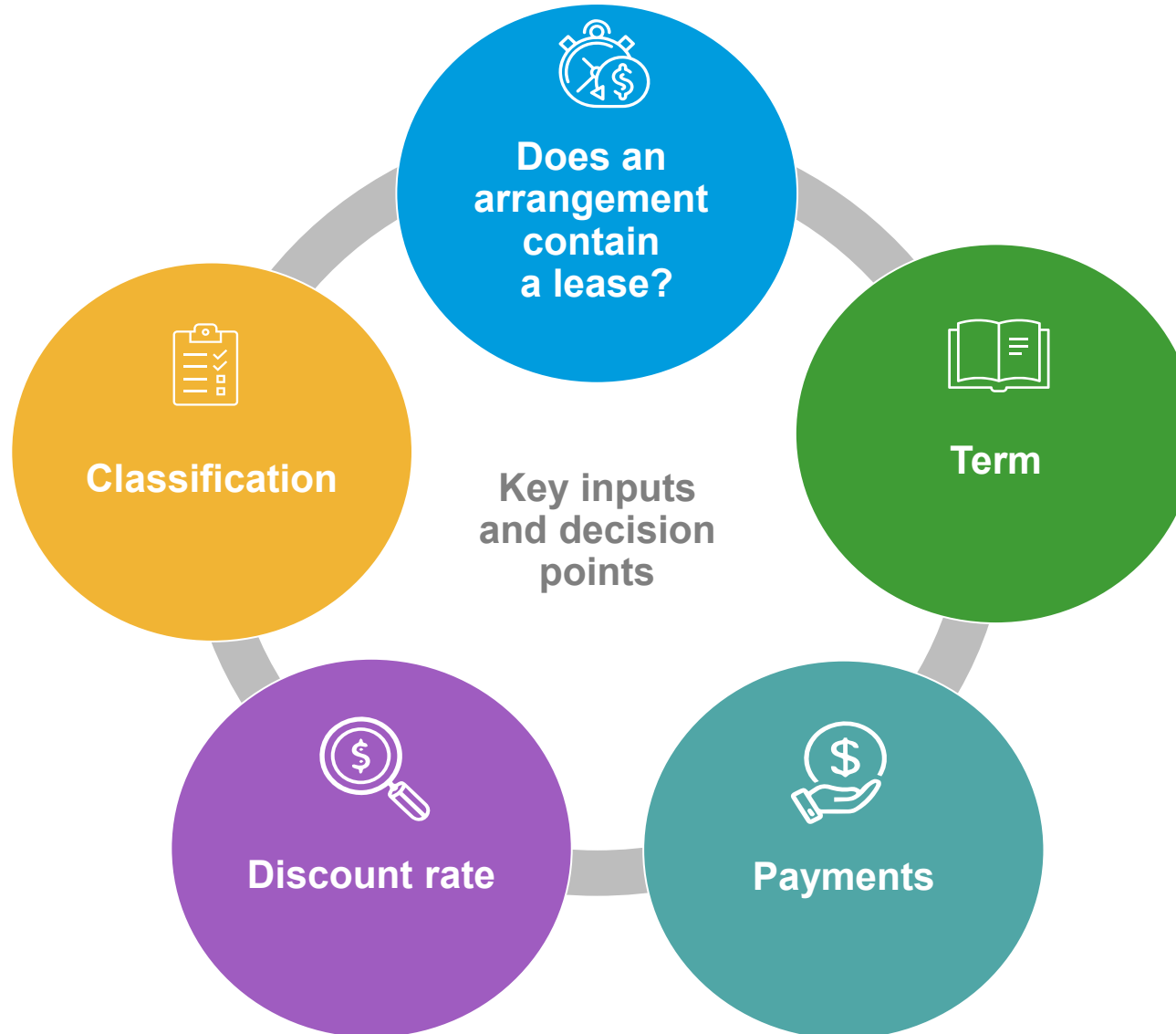
KEY ACCOUNTING CONSIDERATIONS

Leases commencing prior to effective date



Primary considerations

Materiality



Materiality

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:



The amount of the initial measurement of the lease liability



Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received



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, 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 for the initial measurement of the lease liability and adjusted for existing amounts related to:
 - Prepaid or accrued lease payments
 - Lease incentives
 - Unamortized initial direct costs
 - ASC 420 “cease-use” liabilities
 - Favorable or unfavorable lease intangibles
- For leases classified as capital leases under ASC 840 and finance leases under 842, a lessee carries forward prior 840 accounting

**Does the Company account
for/track these items?**

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 initial direct costs, 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)⁴
- Impairment of right-of-use assets is evaluated and accounted for using the guidance in ASC 360-10-35

Lease term



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

**Reasonably certain” has the same meaning as
“reasonably assured” in ASC 840**

Lease term – Determining “reasonably certain”

Factors that may support “reasonably certain”

- Option period payments below market rates,
- The lessee constructed significant leasehold improvements that will still have economic value
- The lessee would incur significant costs as a result of exercising an option to terminate the lease. These costs could relate to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee’s operations, etc.
- The underlying asset is critical to the lessee’s operations and cannot be readily replaced and/or substituted.
- The location of the leased asset is of strategic importance to the lessee

Factors that may not support “reasonably certain”

- Option period payments above market rates or reset to fair market value,
- The lessee constructed significant leasehold improvements that will still have economic value
- There is a significant period of time before option can be exercised
- Other similar types of leased assets are readily available in the market place
- Leased asset does not have strategic value to lessee



Lease payments

Lease payments should be consistent with the lease term



Fixed
(including in-substance fixed)
payments, less any
lease incentives paid
or payable to lessee)



Variable payments
based on an index
or rate



Exercise price of a
purchase option*



Payments for
penalties for
terminating lease**



Amounts it is
probable will owe
under residual
value guarantees
(lessees only)***

* Including only if reasonably certain of exercise

** Include only if the lease term reflects the lessee exercising an option to terminate the lease

*** Maximum amount of any RVG is included for purposes of lease classification

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 – Lease and non-lease components

Contracts may contain separate lease and non-lease components

- Maintenance provided by the landlord is considered a non-lease component



Lessees allocate fixed consideration in a contract to lease and non-lease 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 non-lease component(s) as a single lease component



Discount rate

The discount rate for the lease is the “rate implicit in the lease”

- Generally, lessees do not consider the implicit rate to be readily determinable
- If rate implicit in the lease cannot be readily determined, lessees use their incremental borrowing rate

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”

Incremental borrowing rate is specific to each lease and must consider:

- Lease term
- Collateral
- Other economic factors (e.g., currency)

Non-public companies may elect to use a risk-free rate

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 reasonably 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

Embedded leases

- Certain arrangements that are not structured as leases may contain **embedded leases**.
- Examples of types of contracts that often may contain embedded leases include:



IT and office equipment



Miscellaneous equipment



Advertising



Cell towers/
antennas

- If a contract contains a lease, it does not automatically indicate that the entire contract is a lease (i.e., it may also contain non-lease components).

Embedded leases



**A contract
contains a lease if:**

01

PPE is explicitly or implicitly identified

02

**The contract conveys to the customer/less
the ability to controls the use of the PPE**

Facts and circumstances

Embedded leases (continued)

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 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



Coffee machines

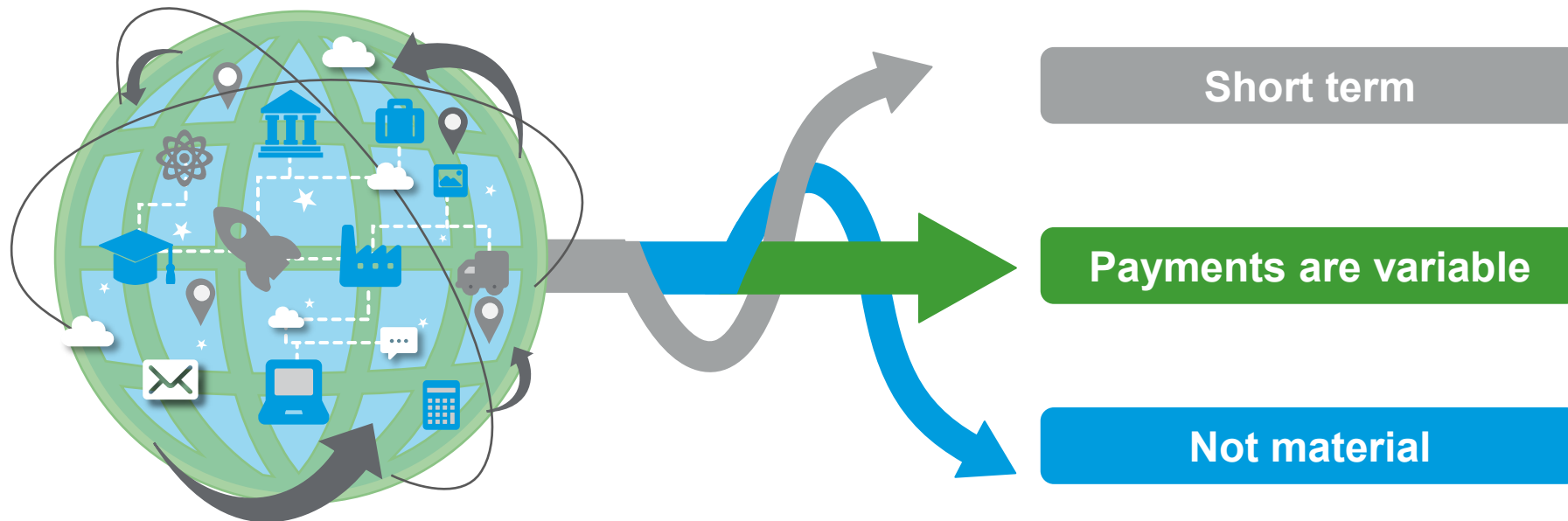


Billboards

Embedded leases: Key point

The only wrong response to your auditor's inquiry regarding embedded leases is...

“we have no embedded leases.”



Case study



Assess



Plan



Implement



Execute

Commencement date	January 1, 2021
Term	36 months
Rent	<ul style="list-style-type: none">• 10,000/monthly, paid monthly in advance• Annual 5% escalation (as of January 1)• No rent for first 4 months
Discount rate	4.5%
Classification	Operating (ASC 840/842)
ASC 842 transition date	January 1, 2022
Deferred rent balance (ASC 840) at December 31, 2021*	\$32,767

**Deferred Rent under ASC 840 = difference between expense recognized and cash paid*

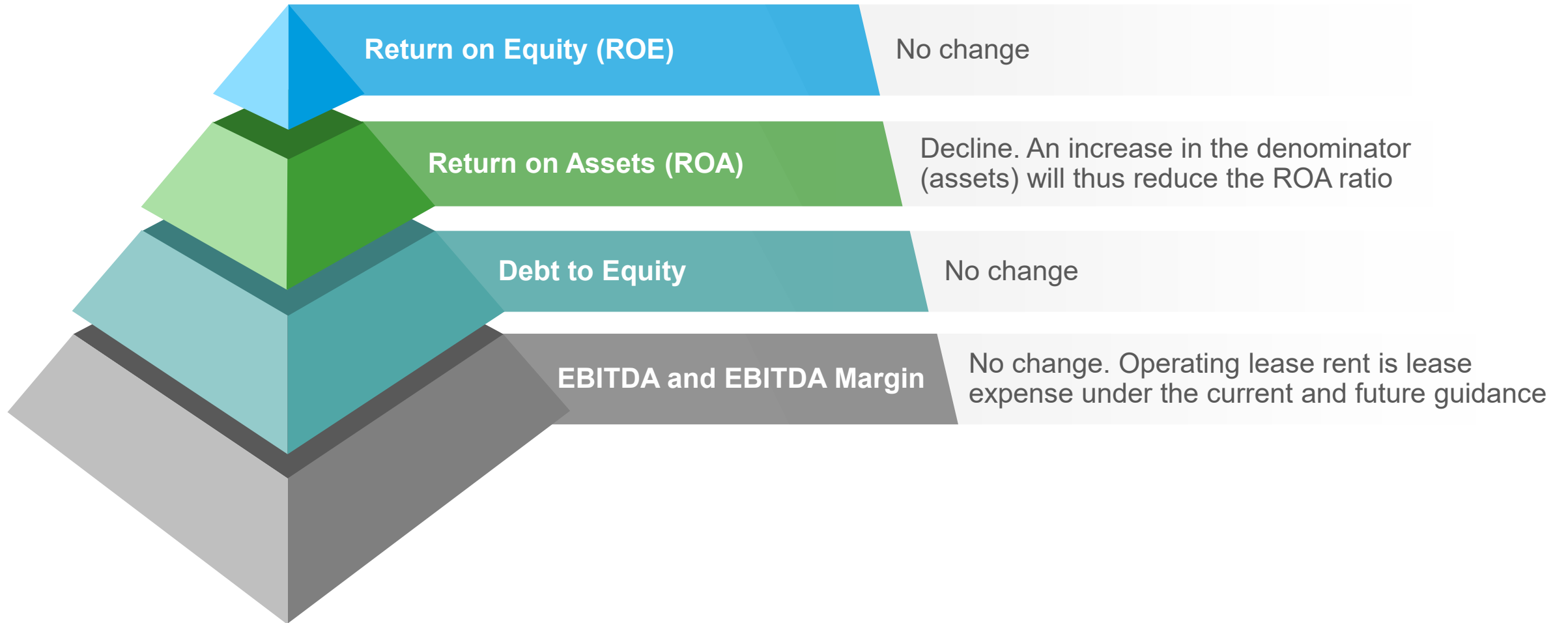
Lessee example – ASC 840 operating lease

	Debit	Credit
Lease commencement	NA	NA
<i>There are no journal entries upon lease commencements; however, other items, such as lease incentives, prepaid rent, etc. may be required to be recorded upon lease commencement if applicable.</i>		
Subsequent measurement – Month 1		
Lease expense	\$9,397	
Cash		\$0
Deferred rent		\$9,397
<i>To record lease expense and deferred rent. Deferred rent is equal to the difference between lease expense and cash paid. As expense is greater than cash, the deferred rent balance increases.</i>		
Subsequent measurement – Month 5		
Lease expense	\$9,397	
Cash		\$10,000
Deferred rent	\$603	
<i>To record lease expense and deferred rent. Deferred rent is equal to the difference between lease expense and cash paid. As expense is less than cash, the deferred rent balance decreases.</i>		

Lessee example – Operating lease upon transition to ASC 842

	Debit	Credit
Initial measurement		
ROU asset	\$214,598	
Lease liability		\$247,365
Deferred rent	\$32,767	
<i>To initially recognize the ROU asset, lease liability, and derecognize deferred rent liability</i>		
Subsequent measurement – January 2022		
Lease expense	\$9,397	
ROU asset		\$8,509
Cash		10,500
Lease liability	\$9,612	
<i>To record straight-line lease expense, cash paid, amortization of ROU asset and amortization of lease liability</i>		

Impact on key ratios



IMPLEMENTATION PLANNING

Overview of key activities



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

MATERIALITY CONSIDERATIONS

Materiality: Capitalization threshold

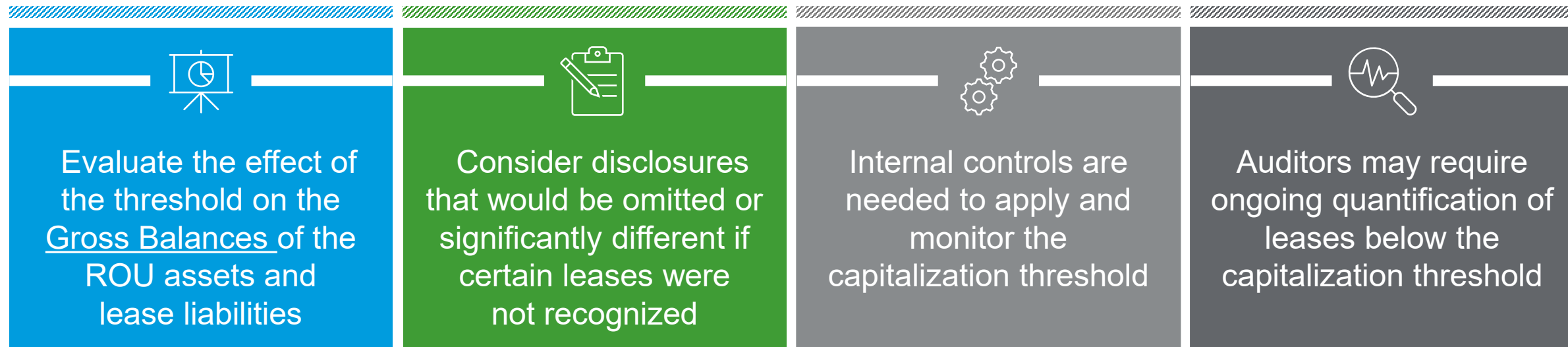
“In addition to accounting for some leases at a portfolio level, entities will likely be able to adopt **reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized**, which should reduce the costs of applying the guidance. An entity’s practice in this regard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

Source: Basis for Conclusions 122

**Financial Accounting
Standards Board**

Materiality: Capitalization threshold (continued)

Considerations when establishing a capitalization policy and 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 (continued)

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



Materiality for implementation procedures

Materiality for executing implementation procedures 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



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



COMPLETENESS OF THE LEASE PORTFOLIO (INCLUDING EMBEDDED LEASES)

Overview

- Operating leases are moving onto the balance sheet, resulting in increased risk of the under statement 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



Begin with your prior year future minimum lease payment footnote disclosures under ASC 840. The details supporting these operating and capital leases footnote disclosures is typically the starting point to establish your master lease inventory

Establish a central repository to capture all leases in one, central location

Reconcile your leases population to your rent expense

Review of general ledger details for higher risk general ledger accounts. This approach is easier to implement but presents a lower level of precision in support of the completeness assertions

Review of vendor spends and evaluate a sample of vendors against your lease inventory to identify potential leases not capture elsewhere

Completeness: Conventional leases (continued)



Inquiries and/or formal surveys of identified departments which routinely utilize leased assets, enter into lease transactions and/or house 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 (continued)



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

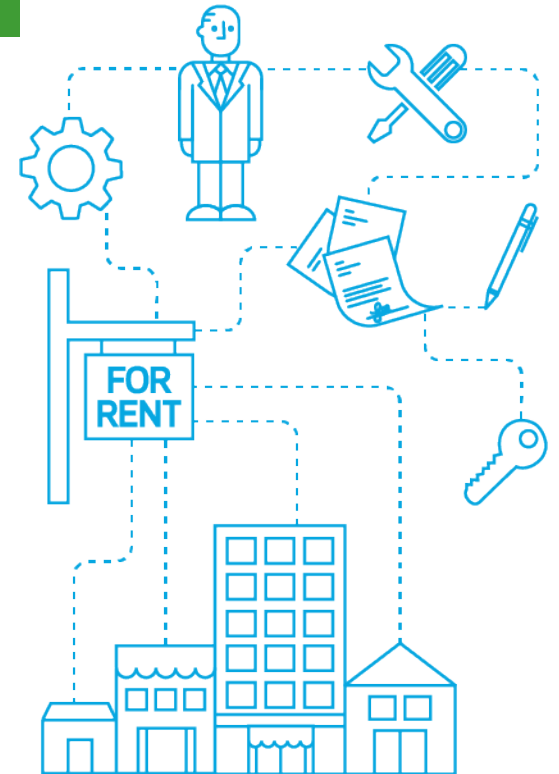
Completeness: Embedded leases

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 (continued)



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



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



Payments are fixed (not variable)



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

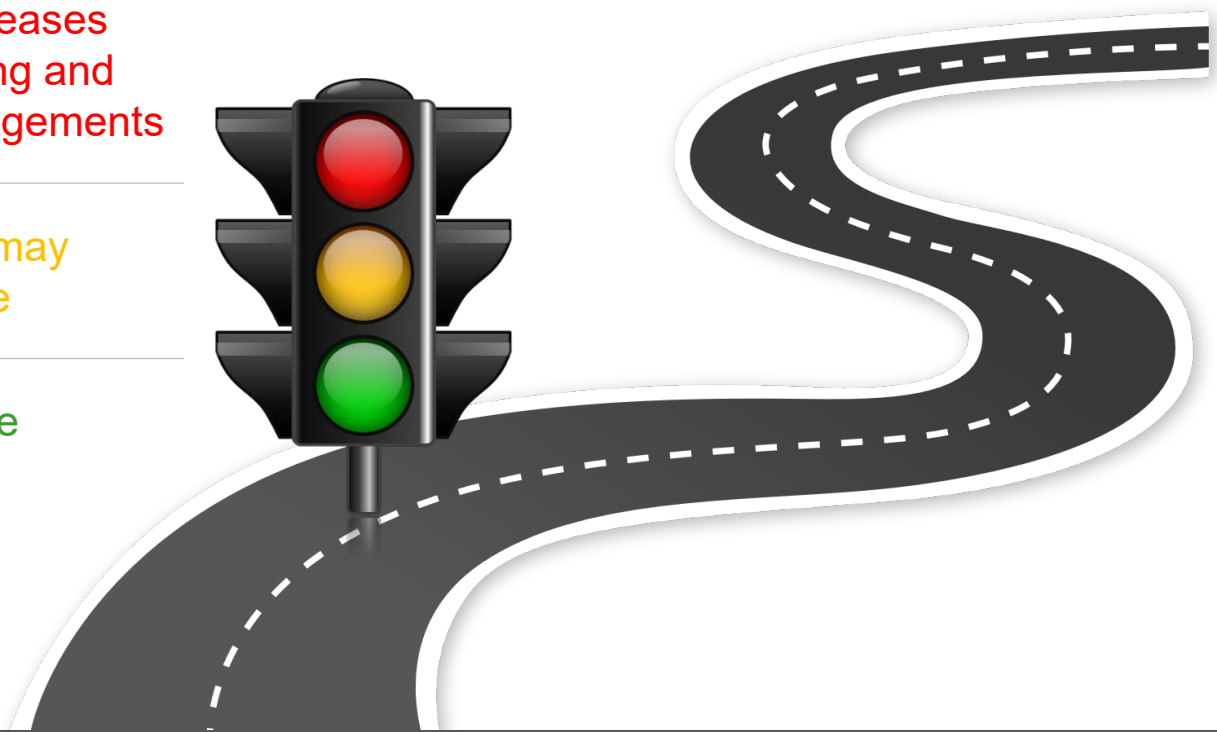
Embedded leases: Risk assessment (continued)

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

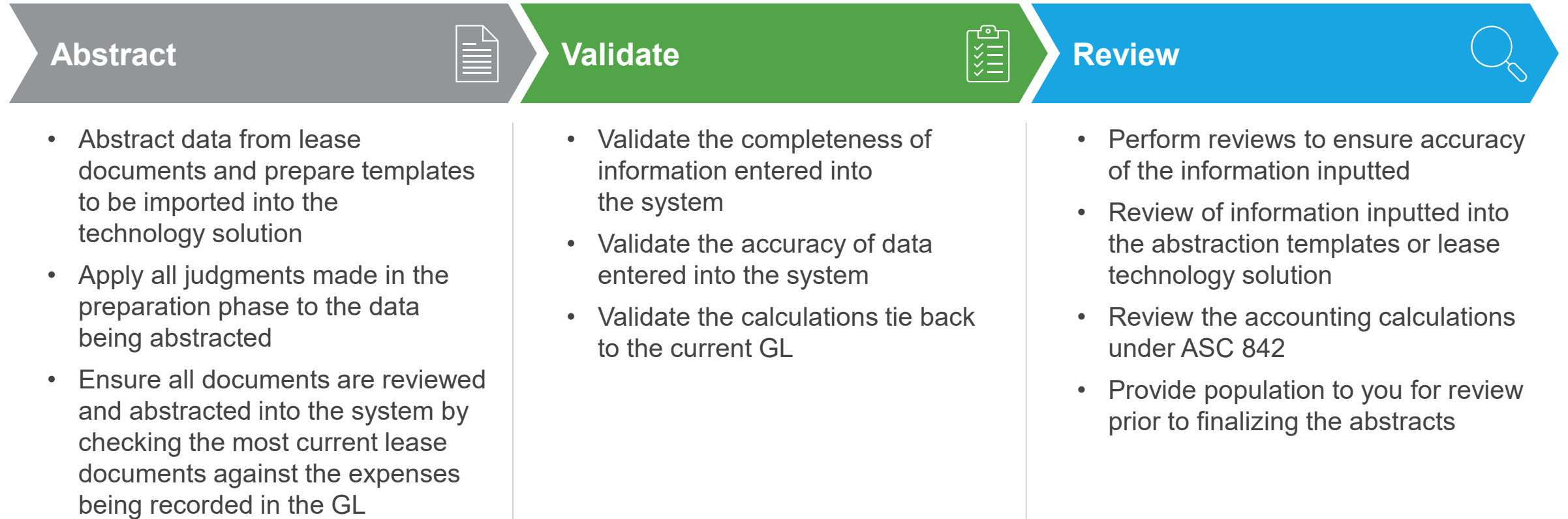
Insurance, payroll costs, taxes, legal are expense categories where the inherent risk for embedded leases is very low. Typically, no reason to look at vendors in these categories



LEASE ABSTRACTION

Data abstraction and review

Below provides an overview of a typical abstraction process



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: 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

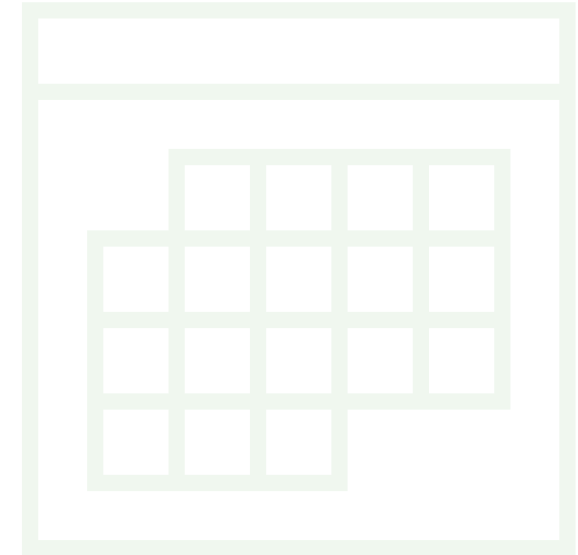


ASC 842 abstraction lessons learned: Scheduling



- 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



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
-



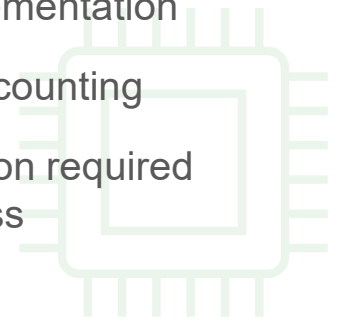
Foreign language leases typically require more time for all lease types and may require third party foreign language abstractors

OTHER CONSIDERATIONS

Technology software – why not just use Excel?

- Software solutions are affordable and effectively tailored to the specific complexities of the new lease accounting standard
- We generally recommend clients with 5 or more leases to purchase lease accounting software. The value of automated disclosure content alone makes this worthwhile for most clients, let alone the enhanced ability to handle any changes to the lease portfolio down the road

- Software eases initial implementation
- Supports ongoing lease accounting
- Provides auditors information required throughout the audit process



Challenges with Excel

➤ Prone to error with integrity of formulas

➤ Difficulty in aggregating lease data for journal entries and rollforwards

➤ Fx translation issues

➤ Parallel reporting (e.g., ASC 842 and IFRS 16)

➤ Miss key terms (e.g., renewal options, termination options)

➤ Lack of audit trail

➤ Difficulty in performing lease modifications

➤ Expanding lease population presents challenges with formulas and compiling data

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**



Polling question #6

Assume a lessee did not historically account for operating lease expense on a straightline basis. Lessee's ASC 842 system calculates what deferred should have been and adjust the ROU asset accordingly. Which statement is accurate?

- A. This is appropriate because ASC 842 requires adjusting deferred rent against the ROU asset
- B. Adjusting the ROU asset for deferred rent not previously recorded will cause lease expense to be understated
- C. Lessee should consider adjusting historical accounting to account for lease expense on a straightline basis
- D. B and C

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

Financial reporting and disclosures

The new standard requires disclosure of qualitative information about the lease portfolio, and many requirements are new (presented in bold) that did not previously exist under ASC 840:

➤ Nature of leases:

- General description
- Terms and conditions of variable lease payments
- Existence, terms and conditions of extension or termination options, residual value guarantees (lessee disclosure), and lessee purchase options (lessor disclosure)
- Restrictions/covenants imposed by leases
- Related party leases

➤ Significant judgments and assumptions used in lease accounting, including:

- The determination of whether a contract contains a lease
- The allocation of consideration in a contract between lease and non-lease components (or whether the practical expedient has been applied)
- The determination of the discount rate for the lease

➤ Whether an accounting policy election was made for the short-term lease exemption

➤ Information about leases that have not yet commenced, but that create significant rights and obligations

➤ Lease transactions between related parties

➤ Terms and conditions of sale-leaseback transactions

Financial reporting and disclosures (continued)

The following example illustrates how a lessee may meet the quantitative disclosure requirements in paragraph 842-20-50-4.

	Year Ending December 31	
	20X2	20X1
Lease cost	\$ XXX	\$ XXX
Finance lease cost:	XXX	XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	\$ XXX	\$ XXX
Other information		
(Gains) and losses on sale and leaseback transactions, net	\$ (XXX)	\$ XXX
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term — finance leases	XX years	XX years
Weighted-average remaining lease term — operating leases	XX years	XX years
Weighted-average discount rate — finance leases	X.X %	X.X %
Weighted-average discount rate — operating leases	X.X %	X.X %



QUESTIONS AND ANSWERS

THANK YOU FOR
YOUR TIME AND
ATTENTION

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