PRACTICAL TIPS FOR IMPLEMENTING THE NEW LEASE ACCOUNTING STANDARD

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1. Overview of Accounting Changes

2. Practical Tips
1. OVERVIEW OF ACCOUNTING CHANGES
<table>
<thead>
<tr>
<th>LESSEES</th>
<th>LESSORS</th>
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</thead>
<tbody>
<tr>
<td>Most leases on balance sheet</td>
<td>Similar to ASC 840</td>
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<tr>
<td>Two types:</td>
<td>Three types:</td>
</tr>
<tr>
<td>• Finance</td>
<td>• Operating</td>
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<tr>
<td>• Operating</td>
<td>• Direct finance</td>
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<tr>
<td>Recognize a right to use asset and lease liability</td>
<td>• Sales-type</td>
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<tr>
<td>Income statement recognition pattern will depend on lease type</td>
<td>Initial selling profit deferred if lessor does not transfer control</td>
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<td></td>
<td>Leveraged lease model is eliminated</td>
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ASC 842 and IFRS 16 not converged
SCOPE & DEFINITION

Scope applies to all leases except those related to:

- Intangible assets
- Natural resources
- Biological assets
- Inventory
- Assets under construction

A lease is defined as a contract that conveys the right to use an asset for a period of time in exchange for consideration.
SHORT TERM LEASES

- Accounting policy election
- Similar to current operating leases
- Term of twelve months or less, determined consistent with other leases
  - Lease term would include periods covered by renewal options that are reasonably certain to be exercised
  - Also would include periods covered by termination options that a lessee is reasonably certain NOT to exercise
IDENTIFYING A LEASE

Lease Contracts involve:

- An identified asset
  - Explicitly or implicitly specified and physically distinct
  - Supplier has no substantive substitution right (lacks practical ability to substitute or would not economically benefit from substituting)

- Right to control use during lease term
  - Decision making authority over the use of the asset
  - Ability to obtain substantially all economic benefits from the use of the asset
SEPARATING LEASE & NON-LEASE COMPONENTS

- Separating lease from non-lease components – based on relative standalone price of components (lessee).

**Example:** Copier and a service agreement

**Practical Expedient** – accounting policy election to account for entire contract as a lease (*MAY BE available to both lessee and lessor)

**NOTE:** Activities/costs that do not transfer a good or service are NOT components of a contract and receive no allocation of the consideration.
Rights to Use Multiple Assets. Assets are separate leases if:

- Lessee can benefit from the use of the asset on its own
- The underlying asset is neither dependent on, nor highly interrelated with, the other assets

Example: Warehouse and a parking lot
LEASE TERM

Determined at the lease commencement date and based on the noncancelable term of the lease, together with the following:

- **Noncancelable term**
- **Option to renew** (reasonably certain TO exercise)
- **Period after optional termination** (reasonably certain NOT to exercise)
- **Option to extend** (only if controlled by lessor)

Lease term determination should remain mostly unchanged from current GAAP.

Reasonably Certain = Reasonably Assured
## CALCULATING THE LEASE LIABILITY

The present value of unpaid lease payments, measured at the commencement date

**Discount rate**
- Implicit rate in the lease
- Incremental borrowing rate
- Risk-free rate (non-PBEs)

### INCLUDE
- Fixed lease payments, less any lease incentives
- Variable lease payments that depend on an index or a rate
- In-substance fixed lease payments structured as variable payments

### LESS
- Lessor-provided incentives
- The exercise price of a purchase option if the lessee is reasonably certain to exercise that purchase option
- Payments for penalties for terminating a lease (if term reflects termination option exercise)
- Amounts expected to be payable under residual value guarantees ("probable")
## LESSEES

- Required to remeasure lease payments in certain circumstances
  - Lease term or purchase option reassessment
  - Resolution of contingencies
  - Change in amounts probable of being paid under Residual Value Guarantee (RVG)
- Variable lease payments based on rate or index would need to be remeasured
- Updated discount rate and classification
- Adjust Right of Use (ROU) asset until reduced to zero, then P&L

## LESSORS

- Not permitted to reassess lease term, variable rent or discount rate
- Reassess only on modification (ex: extending lease term) – use updated assumptions at date of modification
LEASE CLASSIFICATION (LESSEE)

- Does ownership of the lease transfer to the lessee by the end of the lease term?
  - No

  - Is the lessee reasonably certain to exercise an option to purchase the underlying asset?
    - No

    - Is the lease term for a major part of the remaining economic life of the underlying asset?
      - No

      - Is the present value of the lease payments and residual value guarantees equal to substantially all of the fair value of the asset?
        - No

        - Operating Lease (unless specialized in nature)

  - Yes

  - Finance Lease

N/A if commencement date is at or near end of economic life
LESGOR ACCOUNTING

Lessor accounting is mostly unchanged from current GAAP, except:

- Definition of initial direct costs
- Alignment with ASC606 (new rev rec guidance), especially for sale/leasebacks
- No differentiation between leases of real estate and other assets
LESSOR MODEL

**LEASE CLASSIFICATION**

- Direct Financing and Sales-Type Leases (no longer necessary for title to transfer or Bargain purchase)
- Operating Leases
- Similar to current requirements

**PROFITS**

- Upfront profit recognized in which the lessee obtains control of the underlying asset (sales-type)
- Upfront profit is deferred in which the lessee does NOT obtain control of the underlying asset (direct financing)
Companies with calendar year-ends will need to adopt on or before January 1, 2019, while U.S. private companies are allowed a year deferral.

Optional practical expedients – all or nothing:
- Identifying leases
- Lease classification
- Initial direct costs

Use of hindsight (lease renewals and purchase options)

Easements

Retrospective Transition (*FASB finalizing option for cumulative effect at date of adoption)
2. TEN PRACTICAL TIPS
1. HAVE A PLAN & STICK TO IT, REASSESS AS NECESSARY

**Assessment**
- Stakeholder alignment on objectives
- Identify and scope lease agreements
- Sample lease agreement review
- Disclosure and transition evaluation
- Gap analysis

**Design**
- Draft accounting policies
- Transition method and disclosure analysis
- Draft business requirements for software selection
- Finalize data requirements
- Develop data gathering approach and initiate data collection process

**Implementation**
- Application development and build out
- Data import into application
- Integration tests and UAT signoff
- Updated procedures and controls
- Cumulative adjustment calculation

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PROJECT MANAGEMENT | TRAINING & CHANGE MANAGEMENT | CROSS-FUNCTIONAL COORDINATION
2. GATHER THE RIGHT STAKEHOLDERS

Accounting & Finance
- Financial statements
- Governance
- Tax, FP&A and internal audit

HR
- Policies and procedures
- Organizational design

Assets & Facilities
- Equipment
- Buildings
- Lease contract management & administration

Procurement & Sourcing
- Acquisition of new leases

Sales & Marketing
- Negotiations
- Close processes

IT
- Systems
- Data and integrations

Real Estate
- Lessees/lessors

Legal
- Lease review and approval
### 3. DATA GATHERING WILL TAKE MORE TIME THAN YOU THINK

<table>
<thead>
<tr>
<th>FIRST STEP</th>
<th>SECOND STEP</th>
<th>THIRD STEP</th>
<th>FOURTH STEP</th>
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<tbody>
<tr>
<td>Identify Sources</td>
<td>Determine Requirements</td>
<td>Data Abstraction</td>
<td>Iterative Review</td>
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<tr>
<td>Determine all sources of information relative to lease portfolio</td>
<td>Assess data of existing sources against ASC 842 requirements</td>
<td>Data gaps in current source systems may require additional info from lease arrangements</td>
<td>Review and validate accuracy of data set</td>
</tr>
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</table>
3. DATA GATHERING WILL TAKE MORE TIME THAN YOU THINK – CON’T

CHALLENGES:
- Completeness
- Amendments/Modifications
- Location/form
- Language
- Accuracy of data in systems
- Most cost-effective way to abstract (AI?)

- Structured vs unstructured
- Not all data comes from the contract
- Which fields are necessary (prioritize)
- Scoping – embedded leases
- Materiality
4. DEFINE YOUR REQUIREMENTS BEFORE SELECTING SOFTWARE

- Lessor/Lessee
- Equipment vs. Real Estate
- Accounting (ASC 842/ IFRS 16) vs. life cycle management
- Subledger / single source of truth
- Size of portfolio and cost (licensing and implementation)
- Cloud vs on-prem
- Integration with other systems (ERP and legacy)
- Vendor presence and stability
- Potential independence concerns
- Detail level
- Upload capability
- Potential ROI

Participation of all stakeholders

Define transaction use cases to evaluate systems
5. YOUR PROJECT MAY COST MORE AND TAKE LONGER THAN YOU EXPECT

- Allow time for negotiating contracts (software, service providers)
- Auditor response time or change in position
- Documents off-site or in storage
- Number of leases often underestimated
- Numerous assets per lease
- Try to get budget approval for the whole project
- Don’t skimp on project and change management – dedicated resources are best
- Unforeseen staff issues
- Data gathering & policy decisions – determination of incremental borrowing rate
6. THIS COULD GET POLITICAL

- Many stakeholders involved in the leasing process (cross-organizational)
- Executive support is critical for allocations of internal and external resources
- Ensure you know who makes the ultimate decision on policy issues, software and advisor selection, and process/roles
- Change management through communication and training
7. YOU MIGHT FIND ERRORS

- Evaluation of materiality (qualitative too – other regulatory?)
- Discussion with auditors
- Could affect practical expedient election on transition
8. CHOOSE POLICY & IMPLEMENTATION DECISIONS CAREFULLY

- Accounting policy will be different for US GAAP vs IFRS – try to minimize differences where possible
- Materiality
- Implementation date
- Portfolio approach
- Practical expedients: Short-terms leases, separation of lease/non-lease, use of hindsight, package of transition expedients
- Software implementation decisions:
  - Integration with AP (load embedded leases? Payment timing? Reconciling)
  - One or more software solutions, or more than one instance
  - Immaterial?
  - Short-term leases
9. CONSIDER OTHER IMPACTS

- EBITDA
- Debt covenants
- Executive compensation
- Statutory/tax
10. OPERATIONALIZE FOR DAY 2

- Clearly define process and responsibilities for ownership
- Introduce control without crippling the business (Center of Excellence)
- Consider lease/buy strategy
- Continue automation journey
- Outsourcing?
Thank you

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