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Is your firm ready for ongoing lease compliance?

Companies need to shift gears to focus on the implications of new lease accounting rules, writes **Tammy Whitehouse**.

Accounting Standards Codification Topic 842 on leases requires companies to elevate virtually all of their leases out of footnotes and on to the face of the balance sheet, a change that began Jan. 1, 2019, for calendar-year public companies. That means first-quarter filings will begin reflecting the new accounting rules, grossing up balance sheets for the first time with what are expected to be trillions of dollars in new assets and liabilities.

"There's still some scrambling going on," says James Barker, senior consultation partner at Deloitte, especially with respect to determining the incremental borrowing rate that should be applied. "We are still getting questions in that area."

The standard requires companies to use a rate implicit in a lease contract as the discount rate for calculating the lease liability, but it leaves companies to determine exactly what that rate should be. That has led to a great deal of research and questions about how to determine the appropriate rate.

Beyond determining that rate, most companies have gathered their lease data and worked out how they will reflect leases for the first time, although they may still face additional work throughout 2019 to refine their processes before their first year-end reporting, says Barker. "Many of them are going to work out the kinks over the course of the year, and they've got some time to improve as they go through the year of adoption before they are audited for the first time," he says.

Some are also still raising questions about how to handle sale-lease back transactions and build-to-suit transactions, says Anastasia Economos, a partner at EY. The accounting for such transactions is different under ASC 842 than under historic rules, so companies are still working to get that right upon adoption. And then there are disclosures, says Economos. "There are still a lot of systems challenges out there in terms of functionality and disclosures," she says.

One of the ongoing accounting implications companies will face as they move past their first-quarter reporting is an impairment analysis of the new assets now moving on to the balance sheet. Companies are required under ASC 360 to regularly assess the value of the long-lived assets on their balance sheet and determine if any of them are "impaired," or have diminished in value and therefore should be marked down.

The impairment analysis compares the carrying value, or the value on the balance sheet, for an asset to the undiscounted future cash flows associated with the asset, plus the eventual recovery amount on disposal of the asset. If the carrying amount is greater than the expected cash flows and recovery amount, then the asset is considered impaired and must be marked down.

The new leasing standard under ASC 842 doesn't change the longstanding impairment requirements for long-lived assets under ASC 360, says Scott Muir, a partner at KPMG. Instead, it exposes new assets to the impairment rules by requiring companies to put new assets on the balance sheet.

"My impression is that most of the companies for whom this will be a relatively significant matter—meaning they have significant right-of-use assets they are adding to the balance sheet—are aware and are having discussions about this," says Muir.

Significance will vary, depending on how many such new assets will be added to the balance sheet, and therefore subject to the impairment analysis. "Impairment testing is definitely one of the bigger issues companies will face," says Angela Newell, national assurance partner at BDO USA. "I'm not sure companies have fully internalized this issue yet. We've seen a lot of companies that have not had the time or have not taken the time to implement a system that will help them manage the accounting moving forward."

Firms that have dealt with any significant number of capital leases under old accounting rules are likely to be quite familiar with the process, as capital leases already appear on the balance sheet and are subject to impairment testing. Leasehold improvements have also been subject to impairment analysis, whether the lease itself was on or off the balance sheet.

Companies in the retail sector are probably more familiar with the impairment analysis, says Newell. "Not every store they open turns out to be a winner," she says. "That's life for those industries. In other industries, where impairments may not be a fact of life, this may be a little bit of a sleeper issue."

In fact, some companies may even be facing the impairment issue in their first period of reporting if they are adding leases to the balance sheet that already show signs of impairment, says Barker. "There are some situations, although rare, where companies might have to take impairments when they adopt the new guidance," he says.

Some refer to those as "hidden impairments," says Economos. "Did you have an impairment? Does it still exist? Did it exist prior to the effective date, and does it exist afterward?" It's important to identify those issues at adoption, she says, because the effects can flow through equity at adoption rather than through earnings.

Beyond the impairment analysis, companies will also need to assure they are monitoring their lease obligations in light of new guidance in ASC 842 for ongoing compliance, says Sheri Wyatt, a partner at PwC. That includes, for example, considering the term of the lease in light of business decisions that might suggest the company plans to exercise a renewal even if it hasn't already done so.

"The new standard requires an evaluation of whether the facts and circumstances have changed that could result in a change in lease term," says Wyatt. If, for example, a company performs a significant leasehold improvement before exercising a renewal option, that's a good indicator that the company will likely extend the lease.

Companies generally applied the necessary focus to get the opening balance sheet adjustments required to adopt the standard, but that kind of analysis will need to continue in subsequent periods to assure lease obligations are reflected appropriately, says Wyatt. "That's going to require good communication with the accounting and the business people who are working closely with the asset," she says. ■

FASB finalizes lease edits

Tammy Whitehouse examines= minor edits the Financial Accounting Standard Board has made to lease rules after the effective Jan. 1 implemenation date.

As companies have started to reflect new lease accounting rules, the Financial Accounting Standards Board has approved some minor edits intended to assure a smooth transition to the major new standard.

FASB issued Accounting Standards Update No. 2019-01 to address small changes to Accounting Standards Codification Topic 842 on leases, which brings virtually all lease-related assets and liabilities on to corporate balance sheets this year. ASU 842 took effect for calendar-year public companies on Jan. 1, 2019, so they will begin reflecting the new guidance in their first-quarter filings.

ASU 2019-01 makes changes to ASU 842 to address three separate issues that have come to the board's attention as it answers questions from companies preparing to implement the new rules. One issue focuses on determining the fair value of underlying assets by lessors when they are not manufacturers or dealers.

Historic lease accounting guidance provided an exception for lessors that are are not manufacturers or dealers from determining the fair value of leased property, permitting them to recognize those assets at cost, net of any volume, or trade discounts that may apply. ASU 842 did not provide this exception, prompting affected lessors to appeal to the board to reinstate the exception. ASU 2019-01 reinstates the exception, although it indicates fair value under ASC 820 will apply if any significant lapse of time has occurred between acquiring the asset and commencing the lease.

A second issue addressed in the codification update focuses on presentation in the cash flow statement for sales-type and direct financing leases. The new guidance says lessors that are also depository or lending entities under the scope of ASC 942 on financial services should present all principal payments received under leases within investing activities in the cash flow statement.

Finally, the new guidance addresses transition disclosures under ASC 250, which focuses on accounting changes and error corrections. The board says the guidance clarifies its original intent to explicitly exempt both lessees and lessors from having to provide certain interim disclosures in the fiscal year in which the entity adopts the new lease accounting standard. FASB says companies should adopt the updates in tandem with the adoption of ASC 842. ■

Companies tie loose ends on leasing

While some have completed their work around the new lease accounting standard, others remain in the weeds. **Tammy Whitehouse** reports.

With a final heave-ho to get leases on to corporate balance sheets, public companies generally are expected to be ready for year-end reporting but still face some added work to prepare for the ongoing accounting.

"People are pretty fatigued," says Sheri Wyatt, a partner at PwC. "It was a big lift for different reasons, but people are starting to feel like they are approaching the finish line."

Some companies have substantially completed their implementation work around Accounting Standards Codification Topic 842, says Wyatt. "Those may be the exception rather than the rule," she says. "Most had a big push at year-end so they could provide robust disclosures around what the effect on the financial statements is going to be."

ASC 842 is the standard that took effect Jan. 1 for calendar-year public companies requiring virtually all lease-related assets and liabilities to be added to corporate balance sheets. Finalized by the Financial Accounting Standards Board in early 2016, ASC 842 provided for a long lead time so it would follow an even bigger change in revenue recognition that took effect a year earlier.

Under Staff Accounting Bulletin No. 74, the Securities and Exchange Commission requires companies to provide investors with advance notice of how a company's financial statements will be affected by pending new accounting pronouncements. The SEC has generally indicated it expected increasing detail, even quantitative detail, as companies approached the effective date.

"We're generally seeing most companies are in good shape to make their year-end SAB 74 disclosures and their opening transition adjustment," says Scott Muir, a partner at KPMG. "We'd generally expect companies to be able to provide some relevant quantitative information in their SAB 74 disclosures about the effects of the new standard."

Most companies have put their information technology systems into place and have tested them at least at a high level, Muir says, but many will have some work to do in subsequent periods to make their controls and processes sustainable on a go-forward basis. "Many companies will have a longer tail in terms of getting their ongoing processes and controls in place," he says.

After inventorying their existing leases, abstracting the necessary data, and performing the necessary calculations to implement the standard, companies also need to work out how they will continue to comply in future periods. They need controls and processes, for example, to capture new leases and modifications to existing leases to continue the accounting into subsequent periods.

"We expect companies will continue to work to develop those processes and controls for some period of time, even after they've adopted the new standard," says Muir.

While experts say companies generally are ready at year-end, that doesn't mean all companies have crossed the finish line. Sean Torr, managing director in risk and financial advisory at Deloitte, says many companies are still dealing with "curveball scenarios," like how to account for a lease that has unusual payment streams.

"By and large, companies know where they need to get to, but now they just are getting data sanitized and normalized into the system and making sure the system is working the way it's intended to work," Torr says. "The level of anxiety around technology aspects is high across the board."

James Barker, senior consultation partner for lease accounting at Deloitte, says he still sees a lot of companies testing their systems, which is likely to raise eyebrows among auditors. "To me, it's very notable that companies are still doing user acceptance testing for a standard that's already effective," he says.

Barker said he expected companies still testing systems late into the fourth quarter might have switched to manual processes as a bridge to compliance on the effective date. "We're finding many companies haven't pulled the plug yet," he says, a fact he finds surprising. "It's not the best to adopt a standard using a system you haven't quite finished testing yet. It's not a great starting point when you talk to your auditors."

Barker says he also sees companies doing a lot of work to double-check, even triple-check, that they've captured their entire population of leases. "They are getting ready to demonstrate to auditors that their list is complete and accurate," he says.

That has included some 11th-hour work on embedded leases, or lease obligations that might be contained in other contracts, like service agreements, says Wyatt. "Some companies haven't addressed the full uncertainty yet," she says. "Some additional work is still under way centering on whether the analysis is complete."

Companies are also double-checking their abstraction of lease data from lease contracts, assuring they've gathered all the right data and have entered it accurately into their lease accounting system, says Barker. "There's a big effort to make sure that's finished but also accurate," he says.

To some extent, some companies are also working on what discount rate they will use to measure and book their lease liabilities. The standard generally requires companies to use a rate that reflects their cost to borrow, but it does not prescribe a method for determining the rate. "The discount rate continues to be one of the top themes we have seen in terms of questions," says Barker.

Thomas Faineteau, national assurance partner at BDO USA, has heard the questions, and they often surround how to apply the guidance to difficult situations, he says. A long-term lease of land, for example, might have a term of 50 years, making it difficult or impossible to observe a rate in the market with a similar duration. "It's important for people to discuss things like this among themselves, other companies, and with the accounting firms, so the guidance is applied consistently by everyone," he says.

Companies have also struggled with identifying appropriate discount rates in entities that involve subsidiaries, especially overseas. "If a lease is entered into by a subsidiary say in the U.K., do I need to get individual discount rates for each of my subsidiaries, or do I look to the overall parent borrowing rate?" asks Wyatt. "That has generated a lot of questions, and there are differences in views."

Preparers also are considering the impairment analysis that must occur after new assets are added to the balance sheet under ASC 360. The impairment or markdown analysis that must occur for fixed assets is not new, but the application of it to a larger population of leased assets will be new. "It didn't apply to operating leases historically because operating leases were off balance sheet," says Barker.

Some companies are even dealing with questions about whether certain leases should be marked down at transition, said Barker. Lease liabilities are calculated based on the present value of remaining lease payments, but that equation can produce a number that is bigger than the fair value of the asset, he says. "We think there are circumstances where there should be impairment testing at the date of adoption," he says. ■

ProLease

7 FAQ'S:
IMPLEMENTING THE NEW LEASE ACCOUNTING STANDARD

It has been nine years since FASB and IASB released their first exposure draft on the new lease accounting standard, and three years since they finalized the new standard. Throughout this time, software providers, accounting advisors and end-user corporations have been working tirelessly in preparation for this massive change in accounting for leases.

We have now reached the finish line, or starting line depending on how you look at it, with many public companies having completed their initial software implementation and transition on January 1, 2019. Over the past two years, we have worked with hundreds of companies on their software implementations to support compliance. These companies have posed countless questions regarding the guidance, but some stand out as recurring themes. The intention of this whitepaper is to provide a detailed response to these common questions.

We have enlisted our technical accounting team at ProLease to gather this list of questions and provide thoughtful, detailed responses. As always, our interpretation should not replace discussions with your auditor who should guide you in making any final determinations.

Without further ado, here are the top 7 lease accounting implementation questions asked by ProLease customers over the past year:

1 | HOW DO WE BREAK OUT LEASE AND NON-LEASE COMPONENTS OF A LEASE?

Understanding the difference between a Lease Component versus Non-Lease Component versus other Provisions may seem straightforward on the surface, but many companies have discovered through implementation that these components do not always appear so black-and-white in practice. So, how do we break out the service portion of rent?

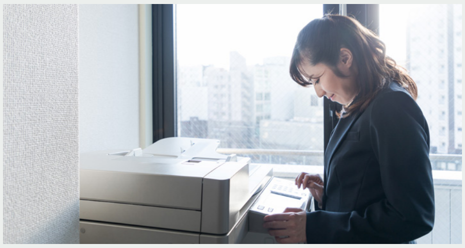
Once a contractual arrangement is determined to meet the definition of a lease, the total consideration to be paid by the lessee in the contract (as defined) would be allocated to the *Lease Components* and *Non-Lease Components* based upon relative standalone prices for these components. None of the consideration is allocated to *Other Provisions*.

LEASE COMPONENTS

A leased asset can only be PP&E (Property, Plant & Equipment). Examples include, but are not limited to buildings, office space, vehicles and office equipment. Each PP&E asset would be considered a separate Lease Component only if both of the following criteria are met. If these criteria are not met for an individual asset, then the assets will be combined until the criteria is met, and the combined asset would represent the Lease Component.

A. 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

B. The right of use is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract.



NON-LEASE COMPONENTS

Many contracts that contain a lease also include the provision for other goods or services. Examples include maintenance of equipment, operating the equipment, and providing common area maintenance for an office building. Since these elements are not PP&E, they cannot be considered a Lease Component, but since they still transfer a good or service to the lessee they are considered to be a Non-Lease Component of the contract.

OTHER PROVISIONS

Other provisions that do not transfer a good or service to the lessee is neither a Lease Component or a Non-Lease Component. Examples include (a) A lessee's reimbursement or payment of a lessor's cost such as property taxes and insurance, (b) Administrative tasks to set up the contract or initiate the lease.

2 HOW DO WE KNOW WHICH EXPENSE ITEMS IN A LEASE SHOULD BE CAPITALIZED?

As a general rule, only the amounts allocated to the **Lease Components** (as described in Q1) would be capitalized. However, the amounts allocated to the **Non-Lease Components** (as described in Q1) would also be capitalized if the practical expedient were elected to not separate the Lease and Non-Lease Components.

The treatment of **Other Provisions** (e.g. property taxes and insurance) depends in large part as to whether the lease is a gross or net lease. In a gross lease the fixed lease payment may be intended to cover the lessor's cost for property taxes and insurance, but the lessee has no separate obligation outside of the fixed lease payment to pay for property taxes and insurance. In this instance the property taxes and insurance effectively become part of the Lease Component (i.e. assuming the practical expedient is elected to not separate Lease and Non-Lease Components). On the other hand, in a net lease the lessee will, in addition to the fixed lease payment, reimburse the lessor (or pay a 3rd party directly) the actual costs associated with property taxes and insurance. In this instance the property taxes and insurance would be considered a **Variable Lease Payment** that would be expensed as incurred.

A Variable Lease Payment is defined as a payment made by a lessee to a lessor for the right to use an underlying asset that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time. Examples include, but are not limited to, lease payments that are based upon an index or rate (e.g. CPI or an interest rate) and lease payments that are based upon usage or performance (e.g. machine hours or sales). As a general rule Variable Lease Payments that are not considered to be an In-Substance Fixed Payment (as defined) are expensed as incurred or when accruable.

Following are instances when a Variable Lease Payment would be capitalized:

At lease commencement, Variable Lease Payments that depend on an index or a rate are included in the lease payments and are hence capitalized using the index or rate at the lease commencement date. However, the entity should not attempt to forecast future changes in the index or rate.

Subsequent to lease commencement a FASB company would remeasure the ROU Asset and Lease Liability for changes in an index/rate only if the lease had to be remeasured for other reasons. However, an IASB company would remeasure the ROU Asset and Lease Liability each time an index/rate change resulted in a change to a lease payment.

3 HOW DO WE PROPERLY ACCOUNT FOR PREPAID RENT?

A Prepaid expense is generally defined as an amount paid in advance to secure the use of assets or the receipt of services at a future date. As it relates to lease accounting, Prepaid Rent represents rent paid in a month that pertains to future month(s) rent. Under the new lease accounting standards, rent paid early is excluded from the measurement of the Lease Liability but is included in the measurement of the ROU Asset. How to measure rents paid just before month-end is a company by-company-decision.

4 HOW ARE DEFERRED RENT BALANCES IN AN EXISTING OPERATING LEASE HANDLED AT TRANSITION WHEN EMPLOYING A "PROSPECTIVE" TRANSITION APPROACH?

When an existing operating lease is being transitioned, all balances on the books as of the company's effective date must be derecognized with the offset being an adjustment to the opening ROU Asset balance. Your lease accounting software solution should provide a mechanism for achieving this result.

The balances to be derecognized include the following:

FASB

- Unamortized Prepaid Rent
- Accrued Lease Liability, difference between S/L & cash rent
- Unamortized Lessor Allowance
- Unamortized Initial Direct Cost
- Exit Cost Liability, per ASC-420
- Intangible Lease Asset or Liability acquired in conjunction with a business combination

IASB (assuming practical expedient to exclude IDC is elected)

- Unamortized Prepaid Rent
- Accrued Lease Liability, difference between S/L & cash rent
- Unamortized Lessor Allowance
- Onerous Lease Liability, per IAS-37
- Intangible Lease Asset or Liability acquired in conjunction with a business combination

5 WHEN, WHY, AND HOW DO WE UPDATE OR REASSESS A LEASE UNDER THE NEW GUIDANCE?

Under the previous guidance, lease standards were handled in a "set-it & forget-it" process. The new lease standards have created the concept of ongoing assessment. After lease commencement, lessees must monitor leases for certain changes. A lessee must update the capitalized lease in the following circumstances:

A. The lease is modified and that modification is not accounted for as a separate lease (i.e. does not grant an additional right of use). Examples include, but are not limited to, a change in the scheduled base rent or a change in the lease term that is not the result of an option within the lease.

B. There is a change in the lease term (e.g. reasonably certain assessment of exercising a renewal or termination option) or whether the lessee is reasonably certain to exercise a purchase option. *This reassessment must be precipitated by a significant/specific event or change in circumstances (as defined).*

C. There is a change in the amount probable of being owed by the lessee under a Residual Value Guarantee.

D. A contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments now meet the definition of lease payments. For example, upon attaining a specified number of cumulative copies, a printer lease whose lease payments were variable based upon a per copy charge now changes to a straight fixed lease payment.

E. There is a change in future lease payments resulting from a change in an index or rate used to determine those payments, for IFRS-16 only. An ASC-842 capitalized lease would be updated for a change in an index or rate only if that lease had to also be updated for one of the other reasons.

Notes: *Items A and B also require that the discount rate and lease classification (ASC-842) be reassessed and updated, as appropriate. Item A also requires the lease to be reassessed to determine if it still meets the definition of a lease.*

6 HOW DO WE CORRECT A JOURNAL ENTRY ERROR/OMISSION THAT WAS DISCOVERED IN THE CURRENT MONTH BUT APPLIES TO A PRIOR MONTH THAT HAS ALREADY BEEN CLOSED?

An accounting error is the result of mathematical mistakes, mistakes in the application of an accounting standard, oversight or misuse of the facts, or a change from an unacceptable to an acceptable accounting principle. Within lease accounting, a couple examples of accounting errors include, but are not limited to: a) capitalizing certain costs, such as a variable lease cost, that are not eligible to be capitalized, and b) discovery that a lease had commenced in a prior month but was not recorded in that prior month.

ASC-250, *Accounting Changes and Error Correction and IAS-8, Accounting Policies, Changes in Accounting Estimates and Errors* govern the accounting for error corrections for FASB and IASB, respectively. If based upon the required analyses of these standards it is concluded that the error was immaterial to prior periods and correcting the impact of the error all within the current period (i.e. period that the error is discovered) would also be immaterial, then the cumulative correcting adjustment for the effect of that error would generally be recorded in that current period.

7 HOW SHOULD WE SET UP OUR TEAM TO MAINTAIN LEASE ACCOUNTING DATA POST IMPLEMENTATION?

The new standards will impact many departments throughout your company, including, but not limited to: Real Estate, IT, Accounting, Financial Reporting, Treasury, Procurement, Tax, & Internal Audit. Since so many groups in a company are impacted, it is important to establish a cross functional lease accounting team to make sure everyone is on the same page. It is also critical that your lease accounting software solution include role-based security and access levels to facilitate the interaction between departments. Working together as a team in one integrated system will eliminate duplication of work efforts and help ensure accuracy in your reporting.

ABOUT PROLEASE

Founded in 1992, ProLease is a leading SaaS provider of integrated Lease Administration and Lease Accounting software, supporting Real Estate and Equipment leases. Over the past eight years, ProLease has developed comprehensive functionality for its customers to comply with the new FASB / IASB lease accounting standards ASC-842 / IFRS 16. Today, ProLease has over 700 active customers globally, including many Fortune 500 corporations.

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Mind controls, disclosures on leases, Big Four advises

The Big Four accounting firms have stepped up to help companies with their first-quarter reporting, now that lease accounting implementation is set. **TammyWhitehouse** has more.

As the window closes on lease accounting implementation and companies face their first quarter of reporting under massive new guidance, Big Four firms are offering some last-minute pointers about controls and disclosures.

Under Accounting Standards Codification Topic 842, public companies are required to bring virtually all lease-related assets and liabilities out of footnotes and onto the face of financial statements with their first-quarter reports in 2019. That means calendar-year companies that will close the books on March 31 will report leases on the balance sheet for the first time in their next 10-Qs.

EY is advising companies to focus on making sure they have controls in place to appropriately account for leases not only upon adoption of the new

"It may be challenging for entities to manage separate processes and controls over their entire lease portfolio—one for leases that existed at adoption and another for new leases and those that are modified or reassessed after adoption."

EY

accounting but also going forward. The Financial Accounting Standards Board permitted a simplification that allows companies to account for their existing leases only on a go-forward basis, without restating historic periods. That means the day-one accounting for existing leases will differ from the accounting for new leases or lease modifications in subsequent periods.

"The prospective accounting model for the new leases standard is different from its transition provisions for existing leases," EY reminds companies. "It may be challenging for entities to manage separate processes and controls over their entire lease portfolio—one for leases that existed at adoption and another for new leases and those that are modified or reassessed after adoption."

EY says it expects companies to evolve their controls and processes throughout the year of adoption. Many companies have implemented lease accounting systems with some measure of manual processes to achieve compliance by the effective date. "If a company implements a new system or modifies an existing one after the effective date, management will need to consider additional processes and controls necessary to address the risks resulting from those IT system changes," EY says.

PwC is reminding companies to take a careful look at their disclosures under the new standard to assure they are compliant. "The disclosures under the new lease standard are more extensive than under the prior guidance," PwC says in an alert to clients.

The Securities and Exchange Commission requires companies to provide both annual and interim disclosures for each interim reporting period in the initial year of adoption of a new accounting standard, PwC says. That means "calendar-year public business entities will need to include all annual and interim lease disclosures starting with their March 31, 2019, quarterly filing," the firm says.

However, companies do not need to provide the interim or annual disclosures required by the changes in the accounting principles standard during the year of transition to ASC 842, PwC says. "The transition guidance in the new leases standard explicitly removes the requirement to provide the annual disclosures required by the standard on changes in accounting principles," PwC says. FASB recently issued guidance in ASU 2019-01 that clarified the interim disclosures related to changes in accounting principles also are not required during transition. "This is consistent with the transition guidance provided in the new revenue standard," PwC says.

PwC says it also has heard questions regarding whether lessees must carry forward disclosures regarding five-year minimum lease expense from their most recent annual filings into interim and annual filings going forward. The firm says the standard requires companies adopting on the effective date to provide disclosures required under the legacy guidance for all previous periods. For calendar-year companies, "this means they will need to include the five-year minimum lease disclosures from their 2018 10K in each of their 2019 quarterly and annual filings," PwC says. That's in addition to the five-year minimum lease disclosures required under the new standard moving into 2019. ■