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INDEX

JOURNAL OF ACCOUNTANCY ARTICLES

JOURNAL OF ACCOUNTANCY®

NEWS / FINANCIAL REPORTING

Pandemic Alters Lease Accounting Landscape

By Stephen G. Austin, CPA; Joel C. Colbourn, CPA; Ane Ohm, CPA; and Don Mitchell

April 16, 2020

In addition to causing enormous disruption to health, safety, and the economy across the globe, the coronavirus pandemic has significantly altered the landscape for CPAs related to the lease accounting standard.

The changes include a potential effective date delay of FASB's new lease accounting standard for certain entities, including private companies; a monumental increase in the number of lease modifications requested by lessees and granted by lessors; and the need for disclosures related to a company's lease accounting decisions in the new environment.

Here's a closer look at lease accounting amid the coronavirus pandemic.

FASB'S DELAY PROPOSAL

In recognition of the business disruptions caused by the new standard, FASB has voted to issue a proposal that would delay by one year the effective dates of its lease accounting standard for certain entities. If approved, the delay to FASB ASC Topic 842, Leases, would apply to private companies, not-for-profits, and not-for-profit entities that FASB calls public not-for-profits, which have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or an over-the-counter market and that have not yet issued financial statements.

The soon-to-be-proposed delay for private companies and private not-for-profits would make the standard effective for private companies and private not-for-profits for fiscal years starting after Dec. 15, 2021. The effective date for public not-for-profits would be fiscal years starting after Dec. 15, 2019.

LEASE CONCESSIONS

Shelter-in-place, stay-at-home, social distancing, self-quarantine, and other directives have caused significant disruptions to business operations, with many businesses and industries being effectively shut down. This has resulted in record levels of layoffs and unemployment claims, with a potential record number of bankruptcy filings expected over the next few months.

The federal government has taken several actions to provide relief from the devastating economic impact, including enacting the Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136, which provides assistance to small businesses (under 500 employees) through U.S. Small Business Administration loans primarily to support payroll costs for affected businesses. While these loans are for a limited period (up to eight weeks), some or all of the loan may be forgiven.

Despite this government aid, it is anticipated that a significant number of lessees will be looking to negotiate short- or long-term lease concessions or other relief from lessors. On April 10, the FASB staff issued a Q&A on Topic 842 and Topic 840 accounting for lease concessions related to the effects of the COVID-19 pandemic.

One topic addressed by the FASB staff is the existing guidance requiring an analysis of whether changed lease agreements provide enforceable rights and obligations for lease concessions. An absence of enforceable rights and obligations can result in lease modification accounting, where the right-of-use asset and lease liability are remeasured using an updated discount rate and the lease classification as either a finance or an operating lease is reassessed.

The FASB staff concedes that existing guidance did not contemplate the speed and volume of modifications resulting from a major global public health crisis. The FASB staff also acknowledged that absent further interpretative guidance, appropriately analyzing lease modification requirements on the large volume of leases impacted could be costly and complex for both lessees and lessors.

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A further complication in determining whether lease concessions are consistent with contract terms rather than a contract modification are the programs implemented or encouraged by governments that permit or require changes to either party's contractual obligations during the period impacted by the COVID-19 pandemic.

The underlying premise of remeasuring a lease is that the economics of the lease are affected for the remainder of the lease term. The FASB staff understands the view that recognizing lease concessions related to the effects of the COVID-19 pandemic over the remainder of the lease term may not reflect the economics of those concessions.

ANOTHER ELECTION TO CONSIDER

FASB's staff Q&A provided guidance that it would be acceptable to make an election to account for lease concessions related to the effects of the COVID-19 pandemic as though the lease agreement provides enforceable rights and obligations for lease concessions not requiring lease modification treatment even though the existing agreements do not include such provisions. In making this election, an entity will not need to evaluate whether each applicable lease contains the enforceable rights provisions.

Noted examples include deferred rental payments from three to six months, most initiating in April 2020. Deferred rents are then to be paid back in addition to base rents mandated in the lease agreements, starting in 2021, amortized over a reasonable period. A key point as stated by FASB is that the tenant must be "affected by the economic disruptions caused by the COVID-19 pandemic" and not use the opportunity to take advantage of the general circumstances.

The FASB staff is clear that this guidance can be applied only if lease concessions do not result in a substantial increase in the rights of the lessor or obligations of the lessee. There is an expectation of exercising reasonable judgment in determining that the total payments of a modified lease contract will be substantially the same as or less than the original contract.

When concessions result in the deferral of payments with no substantive changes to contract consideration, the FASB staff indicated that there may be several ways to account for the deferral. With no method identified as preferable, two possible alternatives were presented:

- Deferred payments are accrued, with lessors continuing to recognize income and lessees continuing to recognize expenses; or
- The deferred payments would be accounted for as variable lease payments.

A company's lease accounting software should be able to handle either alternative presented.

Regardless of the method used to account for a lease concession related to the effects of the COVID-19 pandemic, there should be appropriate disclosures about material concessions granted (lessors) or received (lessees) and the related accounting treatment used, so financial statement users can understand the financial impact of lease concessions related to the COVID-19 pandemic.

Should the lease concessions granted result in substantial changes to consideration, treating the changes as a lease modification would be appropriate. The lease liability and right-of-use asset would be remeasured with an updated discount rate, and the lease term may change with an updated evaluation of the "reasonably certain" criteria for extension or early termination options. These changes could result in determination of a different lease classification. There may also be right-of-use asset impairment considerations that could require appropriate attention.

JOURNAL OF ACCOUNTANCY®

FEATURE / AUDITING

Lease Accounting Standard Requires New Auditor Judgments

New processes and controls will be evaluated by internal and external auditors.

By Stephen G. Austin, CPA; Joel C. Colbourn, CPA; Phillip Doolittle; and Doug Renner

March 1, 2020

Public companies' required implementation of FASB's new lease accounting standard in 2019 means that financial statement auditors need to be prepared to make new judgments.

Although the private company implementation date for the standard hasn't yet arrived, auditors of both public companies and private companies that prepare financial statements in accordance with GAAP will eventually need to determine whether adequate work has been performed to ensure a reasonable opening entry upon implementation. As part of understanding the entity's processes and controls, auditors also will have to assess whether their clients or companies (in the case of internal auditors) have adequate go-forward processes in place to ensure that upon execution of a contract, a determination is made as to whether that contract is, or contains, a lease.

The new standard (FASB ASC Topic 842, Leases) calls for recognition of lease liabilities and right-of-use assets for lease arrangements previously identified as operating leases and capital leases (which are now called finance leases). This means that on the first day of a new fiscal year, the entity will have to prepare accounting entries to record this recognition. The auditor needs to understand how the client determined the entry balances recorded through this opening entry.

Most companies will adopt the package of three practical expedients by which the leases identified and recorded in the prior year will carry forward as the foundation for the opening entry. This assumes the previous accounting was handled correctly — perhaps a precarious assumption. The new accounting standard does not grandfather in accounting errors. Rather, they need to have been corrected under the old guidance before moving forward.

There are a couple of other key policy decisions with potentially significant consequences. First, there is the accounting policy election to not apply the lease liability and right-of-use asset recognition requirements to leases with initial terms of 12 months or less.

The second key accounting policy election is whether to separate lease and nonlease components, which is done by designating applicability of the election to specific asset types. For many asset types this election can eliminate what might otherwise be an administrative nightmare. For example, it may not be meaningful to financial statement readers if the service component of a copier lease was separated as a nonlease component and excluded from the calculation of the lease liability and right-of-use asset. On the other hand, a large security guard service contract that includes a low-dollar-value golf cart could result in a larger-than-expected lease liability and right-of-use asset balance if this election was applied. Materiality might indicate that it is not appropriate to apply this policy election to asset types where it just does not make sense.

While leasing arrangements generally address a continuing business need, business seldom actually happens as envisioned. The entity needs to be aware of the developments because the entity is responsible for the reassessment, remeasurement, or impairment adjustments. The auditor needs to understand the entity's process for identifying developments, and the auditor needs to obtain evidence about the adjustments.

IDENTIFICATION CHALLENGES

One of the biggest challenges of implementing Topic 842 is ensuring the identification of all contracts where there is an identified asset being provided. This is significant not only for the preparation of the opening lease accounting entry, but also to ensure accurate recording of new or updated lease arrangements throughout the year. This is a critical "completeness test" that auditors need to perform.

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Some key considerations the entity needs to perform in determining the completeness of the lease accounting information include:

- Identifying persons or roles with the authority to execute contracts that are or may contain a lease.
- Asking interested parties to identify leases and other arrangements where identified assets are provided on a continuing basis. Interested parties include supply chain, real estate, operations, distribution, fleet, IT, accounting and finance, legal, treasury, and others.
- Identifying vendors and types of vendors that may represent a higher risk of including contracts that are or may contain a lease.
- Reviewing internal processes for authorizing recurring monthly payments, some of which may include rentals.
- Analyzing entries to rent expense.
- Ensuring adequate training and involvement of stakeholders.
- Reviewing prior footnote disclosure support schedules for completeness and accuracy.
- The auditor's role includes assessing the reasonableness of the entity's critical "completeness" determination and the related processes and controls that have been established.

Defining the lease term is an issue that never received adequate attention in Topic 840. Under the previous guidance in Topic 840, lease extension options determined to be "reasonably assured" should have been included in the minimum future rental payments footnote disclosure. In practice, the disclosure often covered only the period to the next extension option since it did not actually affect any financial statement balances. There is greater importance under the new lease standard because the correctly defined lease term determines the measurement of a balance sheet asset and liability. Note that the "reasonably certain" standard under the new guidance in Topic 842 approximates the previous "reasonably assured" standard but provides more guidance on when lease extension options should be included in the lease liability.

Determining the appropriate discount rate to use has been an area of confusion and concern. The rate stated or implicit in the lease should be used when determinable. If not determinable, the secured borrowing rate for a similar amount and term should be used. This may involve developing rates to be used based on quotes and rate sheets from lenders and financial institutions. There should be a defined process with appropriate review and approval, and regular updates. The risk-free rate can be designated the discount rate for an organization that is not a public business entity, but that can result in larger finance lease classifications and liabilities than might otherwise be expected.

MATERIALITY APPROACH

While Topic 842 does not provide specific materiality guidance, many organizations have established a minimum asset size that mirrors their fixed asset capitalization policy below which lease accounting calculations to determine the lease liability and right-of-use asset will not be performed. The materiality approach should embrace the objectives of the new standard while providing results meaningful to the readers of the financial statements.

From an internal audit perspective, Topic 842 presents a very real challenge in the preparation of clear documentation, policies, internal controls, and processes surrounding these complex changes. Typically, management of lease agreements is based in a decentralized office within the company, outside of the accounting office. Bringing cohesion and clarity from a controls and process perspective between the two departments can be the job of the internal auditor to address and bring them into compliance.

A strong working group from both of these areas now becomes necessary for successful knowledge transfer and the appropriate data gathering, especially when it comes to real estate leases that may have been in place and amended over multiple years and embedded leases. The success of the internal auditor in this case begins with data mining the information correctly upon the initial implementation, which will require strong collaboration and clarity from all parties.

Many organizations have looked to outside service providers to perform the needed lease accounting calculations, provide the required accounting entries, and generate the necessary disclosures. Similar to other outside systems used in the

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accounting process, the auditor should obtain and carefully review the provider's System and Organization Controls 2 type 2 report to assess the level of effort that may be required to have confidence with the information being provided. There should be clearly authorized processes to establish system users, authorize updates to lease records, and generate and approve accounting entries and disclosures provided by the system.

Creating policies for the go-forward review/renewal and treatment of future leases, as well as review of contracts that may have a potential embedded lease component within them, is now a reality for enterprises and will need to be captured through newly created control processes and then continually followed up on by the internal auditor. Only through strong collaboration, clear policies, and consistent review will the company be assured that it is adhering to this new standard and faithfully representing the amounts on its financials.

Similar to other accounting changes in the past, implementation of Topic 842 will likely be a learn, analyze, and refine process until the desired result becomes another recurring accounting activity. The list of interesting first-time audit issues is a long one, and practitioners need to be prepared for these issues as they audit financial statements of public companies now and those of private companies in the future.

JOURNAL OF ACCOUNTANCY®

NEWS / FINANCIAL REPORTING

Hidden in Plain Sight: Accounting for Embedded Leases

By Stephen G. Austin, CPA; Joel C. Colbourn, CPA; and Kristen Gibbons

September 19, 2019

FASB's new lease accounting standard is having a significant effect on a broad range of balance sheets for all types of entities, with some companies reporting financial obligations of billions of dollars.

In addition to requiring large sums to be placed on balance sheets, the new standard is causing difficulties for preparers as they struggle to locate and extract data from their many lease contracts so they can comply with the new rules. But this is not the only difficulty preparers are facing.

Under the new standard as codified in FASB ASC Topic 842, Leases, contracts that are not clearly identified or labeled as leases may be "arrangements that contain a lease." For example, a lease may exist when equipment is provided by a vendor in connection with the purchase of consumables or the delivery of a service. Discovery and deeper evaluation of these arrangements where leases may be hidden in plain sight has been a significant challenge for many preparers.

FASB's previous lease accounting standard, Topic 840, also required evaluation of these arrangements, although some may say that this analysis was not considered as thoroughly as it is now that the lease liability belongs on the balance sheet under Topic 842. Often under Topic 840, the many "service contracts" that met the "arrangements that contain a lease" criteria were classified as some type of operating expense other than rent expense.

The correction of this accounting is probably a classification issue in the income and expense statement. However, embedded lease commitment obligations missing from the lease commitment footnotes of GAAP financial statements are perhaps more significant.

Topic 842 is now very clear about the identification and criteria for an embedded lease. A contract contains a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. This includes the right to obtain substantially all of the economic benefits from the asset.

How should you deal with this challenge in your enterprise?

First, there should be a good presentation of the rules and application of Topic 842 to all stakeholders. This includes not just the finance and accounting departments but also supply chain, purchasing, operations, and information technology.

Second, create an environment of prescreening and evaluation of embedded leases identified with the contracting personnel in your enterprise and develop a quality-control program with your finance/accounting people who are Topic 842-savvy.

Third, recognize that the quantifying of embedded leases is not as simple as for real estate leases. The valuation exercise can be challenging. Some of the more significant considerations for the valuation of these leases are:

- Evaluation of all significant service contracts that may contain an identified asset.
- Determination of the portion of purchase commitments or service fees that would apply to the lease lability.
- Assessment of the financial consequences if required purchase levels for consumables are not attained.
- One of the more interesting aspects of these types of leases is the inclusion of nonlease components such as maintenance and taxes.

Under Topic 842, there is a practical expedient (that becomes an accounting policy) that provides for the combination of

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lease and nonlease components such that the measurement of nonlease costs is not carved out but included in the lease liability.

While this will increase the Topic 842 lease liability, depending on the magnitude and duration of these embedded leases, the adoption of such a policy by asset category may be well worth the efficiency in accounting for these leases.

One of the industries in the United States that seems to have more than its fair share of embedded leases is health care and hospital systems.

Why is that?

When you look at all the equipment in a hospital room or a surgical center to serve a patient, it is readily apparent that many technologies and disposables are needed to provide care, ranging from infusion pumps to testing equipment.

Many of these related service contracts have an identified asset in the arrangement but are often buried in the “razor/razor blade” type of contracts of the suppliers of such important health care support systems. Similar to past days when sellers of grooming products would give away razors in anticipation of future razor blade sales, medical suppliers are providing “no-cost” medical equipment when accompanied by the customer’s commitment to purchase related consumable products.

One of the best ways to identify embedded leases in those types of environments is to complete an analysis of all material service contracts, coupled with asking questions and/or holding small group brainstorming meetings with supply chain (procurement), IT, and related stakeholders.

Going forward, after Topic 842 has been implemented, controls or processes should be put in place to identify embedded leases at contract initiation. Determining what the cost of services would be if the asset was owned would help when valuing an embedded asset.

Although this process may be a challenge both in implementation and future identification, the additional transparency regarding lease arrangements can provide useful information to users of financial statements and to organizations as they consider whether their processes are effective and optimized.

JOURNAL OF ACCOUNTANCY®

FEATURE / FINANCIAL REPORTING

Lease Accounting: A Private Company Perspective

Organizations implementing the new standard can expect a complex transition and a substantial financial statement impact.

By Stephen G. Austin, CPA; Michael G. Fraunces, J.D.; and Alisia Scudder, CPA

July 1, 2019

By now, most public companies in the United States have adopted the new lease accounting standards as required on January 1, 2019. Companies with noncalendar fiscal year ends will adopt the new standards sometime over the next few months.

Moving the measurements of operating leases from the footnotes of GAAP financial statements under FASB ASC Topic 840, Leases, to the balance sheet as assets and liabilities under Topic 842, Leases, has not been a simple task for corporate America. Now, private companies and most not-for-profit organizations face the same task. Entities with more than a handful of leases may be in for a surprise as to the time and expense required to address the complexity of the transition and analyze the related accounting rules that must be considered. They may also be surprised with the effect on financial statements and, perhaps, loan covenants due to potential significant changes in debt and related ratios.

Here are some of the lessons learned from act one with the public companies:

GATHERING DOCUMENTS IS A CHORE

In many cases, document management systems for operating leases have been less than ideal and certainly not well organized to be "Topic 842-friendly." In our work assisting a Fortune 100 company in its compliance with Topic 842, a major challenge was locating and organizing all the relevant documents for making the assessment. Our work included assessing, on the company's behalf, thousands of its agreements to determine whether they constitute leases under the new standard. The relevant documents include not just the initial agreement, but all amendments, exhibits, addenda, supplements, and enhancements thereto plus the amendments to each exhibit, addendum, supplement, and enhancement. As a threshold matter, you and your outside auditors must have confidence that you have captured the universe of documents to be evaluated under Topic 842. Do not underestimate this challenge.

Lesson Learned: Start early by taking inventory of all critical documents needed for properly analyzing and accounting for documents that may be "leases" under Topic 842. You need to thoroughly think through what constitutes a lease under the new guidelines. Start broad in what should be considered for analysis. At a minimum, these documents must include the initial agreement plus all amendments, exhibits, addenda, supplements, and enhancements as well as nonlease arrangements such as parking charges and initial direct costs like brokers' fees.

THE STANDARD IS LENGTHY

The guidance surrounding Topic 842 is extensive and includes hundreds of pages of mandated GAAP from FASB (and the IASB for non-U.S. GAAP), including FASB developments issued last summer called "Targeted Improvements."

Lesson Learned: Spend time understanding the guidance. Everyone needs to allocate sufficient time to this task to learn the new rules and get appropriate training. It is also important to understand how the guidance specifically applies to each company. For example, due to the complicated nature of the leases of a Fortune 50 company we worked with, identifying an "identified asset" necessary for concluding that an arrangement is a "lease" under Topic 842 proved more difficult than initially expected. In one case, a 150-page document had a line buried in an exhibit stating that the other party to the agreement was providing two dedicated strands of fiber to the lessee, making the arrangement a "lease" under Topic 842. In another case, the arrangement had a "lease component" under Topic 842 even though virtually all the equipment being used to deliver the service was owned and controlled by the other party to the agreement because a single rack in an

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equipment room was being provided to the lessee for its equipment. Another example of the complexity of the analysis is an agreement that allowed a property owner to move the lessee's equipment to a new location at will, but this right did not disqualify the arrangement as a "lease" under Topic 842 because the practical reality underlying the right was not "substantive" due to the prohibitive expense of moving the lessee's equipment and the practical reality that such rights were rarely, if ever, exercised. Using and analyzing the implementation guidance and illustrations provided in Topic 842 can be helpful in applying the new standard to a company's specific documents.

PRACTICAL EXPEDIENTS CAN BE HELPFUL

FASB issued a package of "practical expedients" in July 2018 that many public companies embraced once they began thinking about the challenges involved in restating prior-period financials.

Lesson Learned: The "package of three" provides a type of "hall pass" as to lease classification, reevaluation of embedded leases, and reassessment of initial direct costs for existing leases.

The practical expedients allow the company to use the prior accounting for leases (e.g., Topic 840 accounting) such that they do not have to determine whether the lease is a finance or operating lease, or capture and account for initial direct costs, such as legal fees incurred in the past associated with the original lease negotiations and drafting leases.

Implementing this package can help reduce the large amount of time and analysis required to adopt and implement Topic 842.

2-STAGE TRANSITION IS NECESSARY

It is critical to bifurcate the lease accounting transition process for implementing the project between pre-practical expedients applications and post-practical expedients applications and to understand what each portion of the project means to the company or organization.

Lesson Learned: Depending on the remaining terms of a company's existing leases and the renewal dates occurring after the fiscal year ending after Dec. 31, 2019, full implementation of Topic 842 could take years due to the various analyses required to take place for existing, amended, renewed, and new leases.

LEASE ARRANGEMENTS MAY BE HIDDEN IN OTHER CONTRACTS

Embedded leases — contracts that contain a lease — constitute the "mystery" portion of the new lease accounting. While companies have often accounted for many arrangements as service agreements with no balance sheet liability, companies now must assess and identify those arrangements that meet the criteria for a "lease" under Topic 842.

Lesson Learned: Start this process early and engage your accounts payable and supply chain departments to help you through that process. Develop new or updated systems and controls to identify any embedded leases at the commencement of all new contracts or arrangements.

EVALUATE CAREFULLY THE LEASE ACCOUNTING SOFTWARE CHOICES

While many lease administration software solutions have added modules to address the actual recording of the lease liability and right-of-use (ROU) asset, other software solutions have been developed within the last two years by accountants solely for Topic 842. If you have a large number of documents to assess under Topic 842, consider using machine-learning or artificial intelligence software specifically designed to abstract legal documents. This technology, while still in its infancy, can substantially speed the Topic 842 analysis and reduce overall costs.

Lesson Learned: Test-drive these software solutions to see how well they work with your team and interface with your current accounting software. Also, be sure to obtain the software solutions' most recent System and Organization Controls (SOC) reports and read them carefully to ensure that the IT security and accounting algorithms are properly designed and are effective. Experience has shown that because these solutions are relatively new, many bugs are still being worked out.

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AUDITORS' INVOLVEMENT CAN HELP

Reach out early to your independent accounting firm and discuss your implementation plan for Topic 842. Well over 3,000 pages of guidance are already available in the public domain that were published by regional and national accounting firms for the purpose of helping companies successfully implement, and auditors effectively audit, Topic 842.

Lesson Learned: Look at any published guidance from the large independent accounting firms' internal technical groups. Discuss the timing of the auditing process with your independent auditors to ensure that there is time for remediation if needed.

COMPANIES WILL NEED TO IMPLEMENT OR MODIFY INTERNAL ACCOUNTING CONTROLS

Develop key controls surrounding the implementation process, lease document retention/organization, and internal quality control of the input of leases into the lease accounting software. Alternatively, for companies not using software solutions, consider a checklist of key areas to be addressed.

Lesson Learned: Since this concept is new to most accountants, companies should develop a robust quality-control program. To aid in having a clear audit trail of the new or modified internal control procedures, companies should clearly document the steps required to properly perform these controls, clearly communicate these updates and procedures to all involved individuals, and maintain proper evidence of review and approval of key control performance. Licensing software specifically developed for Topic 842 in combination with specialists with expertise both in Topic 842 and the legal terms of your documents can substantially reduce your risk of noncompliance.

DEBT COVENANTS MAY BE AFFECTED

Reach out to your lending institutions and discuss the pro forma effect on debt covenants and the need to modify existing debt arrangements or proactively address the new covenants needed in a post-Topic 842 world.

Lesson Learned: The lease liability may have a material impact not only on debt covenants, but also on bonus arrangements or EBITDA-sensitive earnouts that may need to be amended. The significant effects that the lease liability can have on these factors may cause an increased risk of fraud due to added pressures of maintaining the appearance of healthy debt ratios or positive earnouts. Companies should address this risk when making modifications to their control environments.

TIME AND COSTS MAY BE SUBSTANTIAL

Many companies, especially those with over 100 leases (real estate, equipment, embedded) in their portfolio, have had to engage consultants to help in both the accounting and the project management needed for accurate implementation of Topic 842.

Lesson Learned: Many public companies have noted that the actual time and fees are well in excess of their original budgets.

MASS MIGRATION TO THE BALANCE SHEET

Lease accounting is becoming a specialty area that requires the ongoing maintenance of the appropriate amounts in monthly, quarterly, and annual financial statements as the world, in compliance with Topic 842, and its counterpart IFRS 16, *Leases*, moves significant amounts of off-balance-sheet liabilities into their new home on the balance sheet.

JOURNAL OF ACCOUNTANCY®

NEWS / FINANCIAL REPORTING

Practical Considerations for Lease Accounting

By Stephen Austin, CPA

November 21, 2017

On the heels of a transformative and challenging revenue recognition standard, FASB's new lease accounting standard presents a potential tsunami of changes to the financial statements of public and private companies.

In February 2016, FASB issued new lease accounting guidance in Accounting Standards Update (ASU) No. 2016-02, *Leases* (Topic 842). This new guidance was initiated as a joint project with the International Accounting Standards Board to simplify lease accounting and improve the quality and comparability of financial information for users. The IASB also issued guidance in IFRS 16 during January 2016.

This new guidance eliminates the historical concept of off-balance-sheet treatment for "operating leases" for lessees for the vast majority of lease contracts. Under ASU No. 2016-02 (Topic 842) and IFRS 16, at inception, a lessee is required to classify all leases with a term of more than one year as either finance or operating leases, with both classifications resulting in the recognition of a defined "right of-use" asset and a lease liability on the balance sheet.

These lease accounting changes are substantial and will require in many cases a significant investment of time and effort. These practical considerations can help entities as they implement the new standard:

- A defined strategy and timeline will help an organization comply with the standard in time to meet the implementation deadline. Good project management and planning is paramount.
- More time and effort will be required than most companies anticipate. This is partly because many leases are drafted in varying forms, since there is no industry standard. Most lease documents are dictated by the landlords or equipment lessors. Additionally, large companies are constantly leasing, renewing, and exiting current leases, so an accurate leased property inventory is critical.
- Real-estate-related leases are typically more complicated than equipment leases and may require real estate leasing expertise to implement and maintain.
- Various sales tax and local taxes need to be addressed. Organizations should keep their tax experts involved throughout implementation.
- Entities will need to identify all expenses that will be considered initial direct costs so they know what needs to be tracked.
- Global entities often have leases involving a variety of foreign currencies, creating another challenge for implementation. For leases denominated in a foreign currency in which the entity has multiple leases, the remeasurement exchange rate for the each of these right-of-use assets may be difficult to determine due to the need to use the exchange rate at the commencement of each lease. Preparers will need to trace the exchange rate back to the rate used at the time of lease commencement.
- Measurement metrics depend on the country of origin. Acceptable definitions for square footage measurements also vary from market to market. Depending on the market, square footage measurements may be defined based on space that is useable, rentable, rentable with a loss factor, rentable with a core factor, rentable based on drip line, or rentable based on ANSI-BOMA standards. For U.S.-based companies, preparers will need to convert the metric system to the imperial system to facilitate consistency and comparability throughout their leased property portfolio.
- Lease payments need to be analyzed and accounted for based on the goods and services they secure. For example, it is fairly simple to account for a lease that covers rent while the tenant is responsible for all maintenance, tax, insurance, and utilities. When those extras are included in the lease payment, the lease liability and right-of-use asset will increase.

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Parking costs and allocations will need to be considered. Many times, parking costs are factored into the base rent, which does not allow for expensing them separately. As part of the base rent, parking costs increase the lease liability.

- Security deposits will continue to be accounted for as other assets.
- In leases with biannual (twice yearly) payment increases, lessors and lessees may wish to agree to switch to annual leases for ease of accounting. Where biannual increases exist, the lessees will need to remeasure twice a year instead of once. While this doesn't directly affect the lease accounting, it will affect the comparability of leases and related economies.
- Renewal options and their related structure, including relocation rights and termination rights, can have a profound effect on the balance sheet liability. For example, if a tenant has a five-year lease that it is reasonably certain the tenant will renew for an additional five years below fair market value, this would be considered a 10-year lease under the new standard.
- If upon initial capitalization of a lease it is determined that it is not reasonably certain that the entity will exercise the option to renew the lease, the entity will not include the renewal term in the capitalized term. However, if upon reassessment in a subsequent reporting period it is determined that it is reasonably certain that the entity will exercise its option to renew the lease, the entity will include the computation of the renewal period for the asset and liability at that time.