

THE KNOWLEDGE GROUP

Live CLE/CPE Webinar Invitation

THE ROAD TO LEASE ACCOUNTING IMPLEMENTATION:

Practical Tips and Strategies to Ensure You're Compliant



Thursday,
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3:00 pm - 4:00 pm (ET)

PRESENTING SPEAKERS



Stephen G. Austin, CPA, MBA

*Firm Managing Partner
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Alison R. Weinberg-Fahey

*Associate & Director
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AGENDA

Introduction of Presenters

Introduction to Lease Accounting

Leases Overview

Key Decisions and Implementation Issues

Lessons Learned from Public Company Implementations

Current Developments and Opportunities

Closing Thoughts

Q&A

PRESENTING SPEAKERS



Stephen G. Austin, CPA, MBA

Firm Managing Partner
Swenson Advisors, LLP



Steve is a Certified Public Accountant in the states of California and Georgia. Steve manages audit, SEC, Sarbanes-Oxley, and business and lease accounting consulting engagements with a focus on technology, manufacturing, service, real estate, social media, and non-profit organizations. He is the author of the book *Rise of the New Ethics Class*. Steve speaks worldwide on governance, Sarbanes-Oxley, and IFRS matters and writes articles published by the AICPA. Prior to joining Swenson Advisors, Steve held Partner positions with McGladrey & Pullen, LLP and Price Waterhouse, LLP. Steve earned a BS in Accounting and Finance from Bob Jones University and an MBA from the University of Georgia, Terry College of Business. Steve serves on numerous community boards and audit committees including Summit Ministries, Family Heritage Foundation, Brandman University and InSoCal CONNECT.

PRESENTING SPEAKERS



Alison R. Weinberg-Fahey

Associate & Director
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Alison is a real estate attorney at Manatt, Phelps & Phillips, LLP and a director at Manatt Real Estate Advisors, Inc., located in the firm's Los Angeles office. She focuses her practice on commercial real estate transactions, including acquisitions and dispositions, development, joint ventures, construction, secured loans, and workouts. She also advises and represents property owners, developers, tenants, lenders and investors in retail, office, hospitality, hospital system/medical center, aviation and multifamily projects. As a broker and director, Alison represents clients in listings and acquiring properties, and in an advisory capacity including with respect to brokerage rules and regulations.

Prior to becoming an attorney, Alison was a CPA and worked as an auditor at a Big 4 accounting firm in New York City on a team for AIG Financial Products in Wilton, Connecticut during the 2008 financial crisis.

INTRODUCTION TO LEASE ACCOUNTING

- **Accounting Standards:**
 - ASC 842 (FASB - U.S. GAAP)
 - IFRS 16 (International)
 - GASB 87 (Government)
- **Balance sheet recognition of right-of-use (ROU) assets and lease liabilities**
- **Decrease in reported working capital**
- **Financial ratio changes may impact debt compliance and other financial covenants/requirements**
- **Required Implementation:**
 - Public companies for fiscal years beginning after 12/15/2018
 - Private companies for fiscal years beginning after 12/15/2021 (COVID-19 delay)

LEASES OVERVIEW

WHAT IS A LEASE?

A **LEASE** is a contract that conveys the “right to use” an underlying asset for a period of time in exchange for consideration

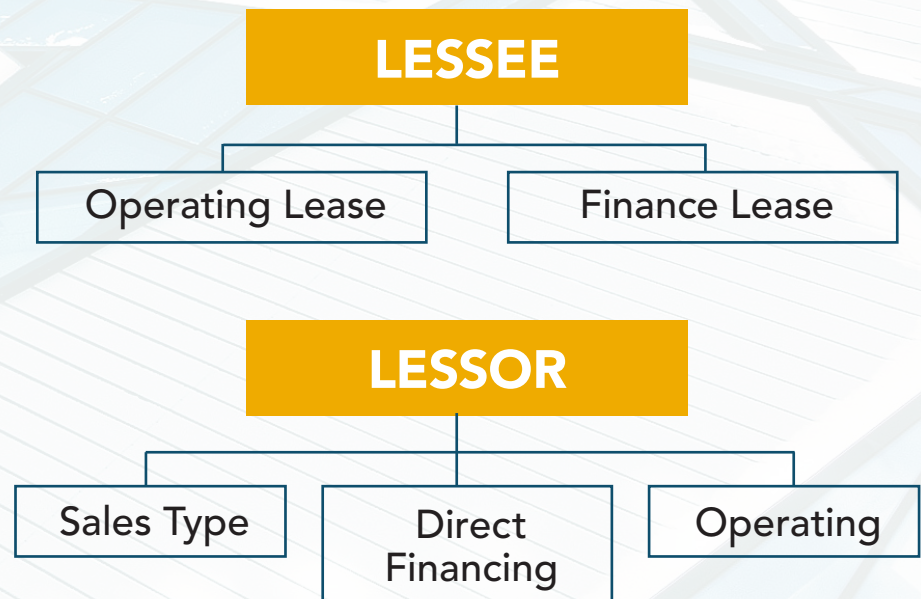
A CONTRACT IS (OR CONTAINS) A LEASE IF:

- A. The use of an identified asset is explicitly or implicitly specified (842-10-15-3)
- B. The customer controls the use of the identified asset for a period of time (842-10-15-4).

CONTROL means that the customer has the right to:

- Direct the use of the identified assets, and
- Obtain substantially all of the economic benefits during the lease term from directing the use of the identified asset

TYPES OF LEASES



LEASES OVERVIEW – LEASE CLASSIFICATION

FINANCE LEASE

When **ANY** of the following criteria are met at lease commencement (842-10-25-2):

1. The lease transfers ownership of the underlying asset
2. The lessee is reasonably certain to exercise an option to purchase the asset
3. The lease term is for the major part of the remaining economic life of the asset (generally 75% or more)
4. The present value of the sum of the lease payments equals or exceeds substantially all of the fair value of the underlying asset (generally 90% or more)
5. **NEW** – 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

OPERATING LEASE

When a lease does not meet any of the criteria above.

LEASES OVERVIEW – EMBEDDED LEASES

ARRANGEMENTS THAT MEET THE DEFINITION OF A LEASE

- **Service or supply contracts with identified assets being provided that meet the definition of a lease**
- **Identification of assets and lease determination often difficult**
- **Inventory is excluded**
- **Valuations are challenging**



LEASES OVERVIEW – LEASE ACCOUNTING STAKEHOLDERS



LEASES OVERVIEW – KEY ACCOUNTING CONCEPTS

- **Recognizing ROU asset and lease liability**
 - Present value of fixed future payments for lease components
 - ROU asset adjustment for balance sheet amounts at implementation date (i.e., deferred rent)
 - Possible ROU asset adjustment for reimbursed improvements
- **Lease commencement vs. payment commencement**
 - For ASC 842 accounting, lease commencement is when the property is available for use by the lessee
 - Payment commencement affects the timing of payments only

KEY DECISIONS AND IMPLEMENTATION ISSUES

- **Assess current status of lease accounting practices (ASC 840)**
 - Current accounting practices
 - Identifying lease arrangements
 - Accounting for leases (capital and operating)
 - Reviewing/authorizing/approving changes to leases
 - Reviewing/authorizing/recording lease payments
 - Updates for lease changes – maturity, extension, termination
 - Physical inventory of leased assets
 - Financial statement reporting and disclosures

KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

- Profile of leases portfolio
 - Lease classification – capital (now finance) vs. operating
 - Types of leases
 - Real estate leases
 - Equipment leases
 - IT leases
 - Fleet leases
 - Embedded leases
- Accounting policy elections:
 - Transition methods
 - Apply prospectively – as of the beginning of the period of adoption, or
 - Apply retrospectively – as the earliest period presented in the financial statements with cumulative effect recognized in equity
 - Reassessment practical expedient “package of 3” (existence of lease, lease classification, initial direct costs)
 - Exclude short-term leases (12 months or less)
 - Do not use hindsight

KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

- **Election to not separate non-lease components (and treat as one combined lease component)**
 - ROU asset and lease liability amounts determined using both lease and non-lease components
 - Need to separate between fixed and variable payments
 - Election can be made by asset type
- **Determining lease term for accounting purposes**
 - Generally stated lease term
 - May reflect exercise of renewal/extension option(s) if “reasonably certain”
 - May reflect exercise of early termination option if “reasonably certain” after consideration of penalties
 - Lease term may be redetermined
 - “Reasonably certain” considered high threshold
 - “Reasonably certain” corresponds to “reasonably assured” under ASC 840

KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

- **Determining discount rate:**

- **Rate implicit in the lease**

- **Defined as follows:**

The rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used.

- **Rate known only by lessor – some information known only by lessor**
 - **Should be used if known or determinable, or if disclosed by lessor with sufficient information to determine reasonableness**

KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

- Incremental borrowing rate

- Defined as follows:

The rate of interest that a 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.

- Used if rate implicit in the lease is not available
- Rate reflects secured borrowing for the same term
- Determination often involves treasury organization
- Based on market rates
- Identified process should be updated regularly to reflect market or credit changes
- Auditors should assess and concur with the process

KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

- Risk-free rate

- Can elect if organization is not a Public Business Entity
- Must be applied to all leases
- Based on U.S. Treasury securities – rates published daily on the U.S. Treasury Department and Federal Reserve websites
- Results in higher ROU asset and lease liability balances



KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

- **Determining lease payments used in calculating lease liability and ROU asset amounts**
 - Only fixed payments known at commencement date are used
 - Fixed rent increases (i.e., 2% per year) included in fixed payments
 - Index-based (i.e., CPI changes) increases not included in fixed payments as amount not known at the commencement date (however, the current rent amount as of implementation date used for the opening accounting entry)
 - Future amounts of variable rent are not known as of the commencement date and are not included unless there is an identified minimum amount
 - No rent amounts are included for rent holiday periods

KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

- **Leasehold/tenant improvements**

- Accounting treatment depends on the intent of the parties and the wording of the agreement
- In general, accounting driven by who pays and who benefits (landlord or tenant)
- For tenant, amount paid could be prepaid rent/adjust to ROU asset, capitalized leasehold improvements, or pass-through receivable for costs to be reimbursed by lessor

- **Existing balances on the Balance Sheet as of implementation date**

- Deferred rent and prepaid rent recorded as adjustments to ROU asset
- Deposit balances remain until refund at maturity
- Leasehold improvements remain and continue to be depreciated

KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

- **Amendments to the lease and remeasurements for accounting purposes**
 - Exercise of renewal/extension option determined to be “reasonably certain” is not an amendment
 - Exercise of renewal/extension not previously determined to be “reasonably certain” results in amendment with remeasurement at current discount rate
 - Generally, amendment results in lease modification with remeasurement of remaining lease payments at current discount rate
 - Current FASB proposal to not require remeasurement for decrease in asset (space rented) with no change to other terms
 - If adding space under an existing lease that might be considered a stand-alone arrangement, treat as separate arrangement without remeasurement of existing lease
 - Termination can result in P&L recognition for difference between asset and liability balances

KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

- **Selection of lease accounting software solution**
 - Find one that has a proven track record...there are plenty of reviews now
 - Find one that is developed by CPAs...and provides good support
 - LeaseCrunch® has been a popular one that meets these criteria
- **Audit considerations**
 - Audit involvement in implementation planning with continuing dialog
 - Early review key policy and implementation decisions
 - Feedback on implementation progress and findings including completeness
 - Interim testing of processes and information residing in technology solution
 - Review and assessment of processes and controls implemented
 - Testing of year-end balances and disclosures

KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

- **Financial statement presentation and disclosures**

- **Financial statements:**

- **Balance sheet** – Separately present finance lease and operating lease ROU assets and lease liabilities (current and noncurrent); either the asset side or liability side may be combined
 - **Income statement** – Finance lease amortization and lease interest expense do not need to be separately identified; operating lease expense does not need to be separately identified in income from continuing operations



KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

- Disclosures:

- General description of leases and leasing activity, policies, assumptions and judgments, and determination of discount rates.
- Other information including a maturity analysis by lease classification as follows:

FASB ASC 842 Footnote

Lease expense

Finance lease expense		
Amortization of ROU assets		
Interest on lease liabilities		
Operating lease expense		
Short-term lease expense		
Variable lease expense		
Sublease income		
Total		

KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

Other Information

(Gains) losses on sale-leaseback transactions, net		
Cash paid for amounts included in the measurement of lease liabilities		
Operating cash flows from finance leases (i.e. interest)		
Financing cash flows from finance leases (i.e. principal portion)		
Operating cash flows from operating leases		
ROU assets obtained in exchange for new finance lease liabilities		
ROU assets obtained in exchange for new operating lease liabilities		
Weighted-average remaining lease term in years for finance leases		
Weighted-average remaining lease term in years for operating leases		
Weighted-average discount rate for finance lease		
Weighted-average discount rate for operating leases		

KEY DECISIONS AND IMPLEMENTATION ISSUES CONT.

Maturity Analysis	Finance	Operating
2021-12		
2022-12		
2023-12		
2024-12		
2024-12		
2025-12		
Thereafter		
Total undiscounted cash flows		
Less: present value discount		
Total lease liabilities		

LESSONS LEARNED FROM PUBLIC COMPANY IMPLEMENTATIONS

- **Best completed with a Senior Management/Executive sponsor**
- **Don't make assumptions about what is happening – find out for sure, and then confirm/verify**
- **More complex than initially envisioned; takes longer than initially envisioned**
- **More stakeholders involved than initially envisioned**
- **Make sure you have the right team and have budgeted sufficient resources to do it right**
- **Most companies made the following ASC 842 elections:**
 - **Apply prospectively – no restatement...a more practical approach**
 - **Used reassessment "package of 3" practical expedients – existing leases are the starting point**
 - **No hindsight – no need to start over**
 - **Large majority elected to “not separate” lease and non-lease components for one or more asset types**
- **Obtaining and analyzing data is the key; technology solution is not the driver**

LESSONS LEARNED FROM PUBLIC COMPANY IMPLEMENTATIONS CONT.

- **Process changes needed to establish appropriate controls**
 - Identifying leases, contracts that may include a lease, and updates/ amendments with timely communication to the lease accounting team
 - Collaboration and discussions with the legal and brokerage teams who negotiate the lease language and terms
 - Reviewing and approving lease abstract documentation and recording in the lease accounting system
 - Reviewing the information from the lease accounting system, reconciling to other ledger activities (such as payments), and recording monthly activity
 - Reviewing activity related to preparation of financial statements and disclosures

CURRENT DEVELOPMENTS AND OPPORTUNITIES

- **Pandemic-related changes to lease arrangements/contracts**
 - Accounting for rent deferrals/forgiveness
 - Amendments/modifications to lease arrangements/contracts
 - Rationalization of future facilities requirements – impact of remote work capabilities
 - Lease impairment considerations for business model changes
 - With plan to reduce rental space there may be an Asset Retirement Obligation ("ARO") requiring recognition

CURRENT DEVELOPMENTS AND OPPORTUNITIES CONT.

- **Sale and leaseback transactions**

- Can provide working capital for other strategic business purposes
- If “successful for accounting purposes”, can result in gain recognition if the following are met:
 - Must meet the transfer of control requirements of ASC 606
 - Leaseback must be classified as an operating lease
 - No repurchase option unless for fair value at the time and there are other “substantially the same” assets available (excludes real estate)
- Treated as a financing if “not successful for accounting purposes”

- **Following successful implementation, establish the “vision for the future” including appropriate processes and controls**

CLOSING THOUGHTS

- **Provide enough time (we have seen that it takes at least 9 – 12 months) and resources (including budget for technical assistance, project team, technology solution, system implementation, continuing requirements) and remain flexible**
- **Enlist the support of professionals and assemble a team with the needed talent and experience**
- **Manage the project, monitor progress, and see through to completion**
- **Assess lessons learned for establishment of post-implementation compliance processes and controls**
- **Recognize the benefits and take advantage of integrating your teams and collaborating to achieve better long-term results across your organization**



Q&A

CONTACT US WHEN WE CAN HELP.



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