ASC 842 Lease Standard – Practical Implementation Considerations

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Learning Objectives

- Identify the key elements and general step-by-step process for implementing the new lease standard ASC 842
- Recognize leading practices and practical implementation tips based on "lessons learned" from other entities' implementations
- Identify how to apply real-world example scenarios to assist in your assessment of what constitutes a lease

Overview of Lease Standards

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Overview - Definition of a Lease

A lease is a contract, or part of a contract, that conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

Lease is present in a contract if the contract includes both:

An identified asset

- Is explicitly or implicitly specified
- Supplier has no practical ability to substitute or would not economically benefit from substituting

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Right to control use of the asset during the term

- Decision-making authority over the use of the asset
- The ability to obtain substantially all economic benefits from the use of the asset

Polling Question #1

What is your level of familiarity with the new leasing standards?

a) Knowledgeable – Have completed lease implementation(s).

b) Somewhat knowledgeable - Have read basic training slides, presentations, etc.

c) Not very knowledgeable - Aware of the new standard but no detailed knowledge.

d) What? There is a new lease standard?

Implementation Tips and Strategies

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Program Agenda

- Three Key Elements of an Implementation
  - Identify Explicit Lease Contracts
  - Software/Subsidiary Ledger
  - Embedded Lease Assessment

- Other Considerations
  - Discount Rates
  - Process Changes
  - Areas of Impact
  - Why Start Now?

Lease Implementation

Implementation - Three Key Elements

- Identify Explicit Lease Contracts
- Software/Subsidiary Ledger
- Embedded Lease Assessment

Polling Question #2

Have you gathered all of your explicit lease contracts?

a) Yes

b) No

Explicit Leases – Determine Full Population

- Review prior lease disclosure support
- Obtain the full population of lease contracts related to disclosure support
- Analyze current year GL accounts related to Lease Expense or Rent Expense
- Cross reference expense transactions with vendor listing
- Obtain the full population of contracts with vendors that serve as lessors

Explicit Leases – Practical Advice

- Categorize the following:
  - Short Term Leases (12 months or less)
  - Real Estate Leases
  - Non-Real Estate Leases
  - Lessee/Lessor contracts

- Review lease contracts to identify follow-up requirements
  - Delivery Dates
  - Occupancy Dates

Polling Question #3

Have you thought about implementing a lease accounting subledger tool?

a) Yes

b) No

Lease Accounting Sub Ledger Solution

- Consider the benefits of using lease accounting software (be cautious with Microsoft Excel, it may likely not be optimal given the size, nature and complexity of the lease portfolio)
- Determine whether current ERP platform offers lease accounting sub ledger
- Consider various cloud-based lease accounting software packages that are available
- Review software demos from several vendors, assess available tools, and determine the best solution for the circumstances

Lease Accounting Sub Ledger: Implementation Tips

- The sub ledger will need to be configured to generate journal entries at the desired level of detail within the accounting ledger structure (top-side, department/division level, etc.)
- After configuration, a small test sample of records should be entered to validate the output based on the configuration and calculations (journal entries and other reports)
- Perform manual calculations on a sample of records and compare against sub ledger output

Polling Question #3

Have you thought about updating your chart of accounts to include new accounts needed for ASC 842 compliance?

a) Yes

b) No

Lease Accounting Sub Ledger Implementation Tips cont'd

- Review chart of accounts to identify all lease related accounts that will be required
  - Right of Use Asset – Operating (Intangible Assets)
  - Right of Use Asset – Finance (Intangible Assets)
  - Short Term Lease Liability – Operating
  - Short Term Lease Liability – Finance
  - Long Term Lease Liability – Operating
  - Long Term Lease Liability – Finance
  - Short Term Lease Expense
  - Variable Lease Expense
  - Operating Lease Expense
  - Interest Expense – Finance Lease
  - Amortization Expense – Finance Lease
  - Lease Clearing Account (Balance Sheet)

Polling Question #4

Have you thought about updating your accounts payable process to accommodate ASC 842 compliance?

a) Yes

b) No

Lease Accounting Sub Ledger Implementation Tips cont'd

- Review current accounts payable process related to lease payments
- Review current journal entries recorded for lease expense (i.e., deferred rent, etc.)
- Map expected revised process for recording all lease related entries (coordinate current processes with the requirement to record entries generated by the sub ledger)
- All balances related to deferred rent, unamortized tenant improvement allowances, etc. should be gathered and tied to specific lease contracts in preparation for adoption entry (under ASC 842, those balances are rolled into the ROU asset balance)

Lease Accounting Sub Ledger Implementation Tips cont'd

- All balances related to deferred rent, unamortized tenant improvement allowances, etc. should be gathered and tied to specific lease contracts in preparation for adoption entry
- ASC 842 requires deferred rent and unamortized tenant improvement allowances to be rolled into the ROU asset balance
- If deferred rent and unamortized tenant improvement allowances have not been accounted for properly under legacy accounting guidance through the adoption date, an adjustment should be recorded to retained earnings to reflect a true-up of the rent expense that should have been accumulated in prior periods

Polling Question #5

Have you worked through an assessment of your vendor contracts to assess for potential embedded leases?

a) Yes

b) No

Embedded Leases - Concept

- Embedded leases may potentially exist in vendor arrangements where the supplier or service provider employs tangible property in the delivery of the supply or the provision of the service.
- Assessment is required to determine whether tangible property would be considered a leased asset in compliance with the standard (an identified asset used solely for the customer's benefit and is controlled by the customer, etc.).

Embedded Leases – Examples

- IT Service Contract for which the IT Service Provider dedicates specific hardware (i.e., a specific server) to house the customer's applications and data.
- Cafeteria service contract may include refrigeration units to be installed on-site to be used in storage of perishable items.
- Supply contract for gas or chemicals – As part of the vendor arrangement, the vendor will install a tank on the premises of their customer to facilitate bulk storage. That tank may, in many cases, be considered an embedded leased asset, based on the guidance.
- Water coolers and dispensers that are provided by a water supply company.
- Vending machines or soda fountains that are provided by the suppliers of sodas/snacks.

Embedded Leases - Assessment

- The embedded lease assessment requires consideration of all purchase activity from the entire list of vendors
- The population should be categorized as either casual vendors (PO only), or contract vendors
- The contract vendor population should be assessed for the following characteristics:
  - Minimum spending requirement (absent a minimum spending requirement, there would be no amount that could be allocated to fixed base rent, thus no capitalizable balance could be developed)
  - Tangible property used to satisfy the contract

Embedded Leases – Assessment, Cont'd

- After identifying contract vendors that use tangible property which also have a minimum spending requirement, the fact pattern related to the tangible property should be evaluated utilizing the concepts in the appropriate standard to reach a conclusion as to whether an embedded lease asset requires capitalization
- If the conclusion is that an embedded leased asset exists and requires capitalization, the fixed minimum spending requirement should be allocated between the embedded leased asset and the related service or supply
- That allocated fixed minimum spend is treated as our fixed base rent and used to calculate the right of use asset and related lease liability

Polling Question #6

Which Item is NOT One of the Three Elements of a Lease Implementation?

a) Identify Explicit Leases

b) Determine Sub Ledger/Lease Software

c) Embedded Lease Assessment

d) Material Right

Other Considerations

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Other Considerations

Discount rate

- Lessees
  - Interest rate charged by lessor, which may be an implicit rate (when determinable)
  - The lessee’s incremental borrowing rate
- Lessors – rate it charges the lessee
- Discount rates should only be reassessed in the following instances:
  - Lessee - Upon a change in the lease term or a change in determination as to whether the lessee is reasonably certain to exercise a purchase option.
  - Lessor - Upon a change in lease term or a change in interest rate charged to the lessee.

Other Considerations, cont'd

Discount rate

- For lessees, to determine the incremental borrowing rate, a practical solution is to contact your primary source of financing (i.e., a lender)
- Bankers are aware of the new lease standard and are generally receptive to providing guidance with their understanding of the lessee financial position and industry (subject to certain bank disclaimers)
- The FASB allows private entities to use a risk-free rate in lieu of an incremental borrowing rate

Process Changes

The new processes have to be documented

- Because of the absence of a uniform way of processing leases, most organizations haven't followed consistent processes for requisitioning or monitoring leased property or equipment

Strong internal controls have to be in place

- All leases will become part of financial statements, which will require a different level of scrutiny
  - Scrutiny of the tracking of accounting treatment
  - Scrutiny of the processes surrounding lease management and lease lifecycles

- Need to rethink the way the organization handles lease terminations, lease bookings, and lease negotiations (communications between Operations and Accounting)

Process change will likely create opportunities for cost savings


SUMMARY

Areas of Impact

- Current business activities (vendor management, lease management and centralization)
- Current financial and accounting policies (e.g., capex – approval process & signature authority, accrued liabilities)
- Contract negotiations
- Budgeting and governmental fund accounting
- Financial/IT systems –future software/ application needs & processes
- Internal controls
- Key metrics

Why Our Clients Should Start Now

- A complete list of Lease/Service and Supply contracts – can be difficult and time consuming to compile
- A software solution to perform complex computations – can take many months to be implemented
- Time/Staffing – Limited resources can create delays

Lease Examples

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ASC 842-10-55-52: Example 2 Concession Space

- A coffee company (Customer) enters into a contract with an airport operator (Supplier) to use space in the airport to sell its goods for a three-year period. The contract states the amount of space and that the space may be located at any one of several boarding areas within the airport. Supplier has the right to change the location of the space allocated to Customer at any time during the period of use. There are minimal costs to Supplier associated with changing the space for the Customer. Customer uses a kiosk (that it owns) that can be moved easily to sell its goods. There are many areas in the airport that are available and that would meet the specifications for the space in the contract.

Answer to Example 2 Concession Space

- ASC 842-10-55-53: The contract does not contain a lease.
- ASC 842-10-55-54: Although the amount of space Customer uses is specified in the contract, there is no identified asset. Customer controls its own kiosk. However, the contract is for space in the airport, and this space can change at the discretion of Supplier. Supplier has the substantive right to substitute the space Customer uses because:
  - Supplier has the practical ability to change the space used by Customer throughout the period of use. There are many areas in the airport that meet the specifications for the space in the contract, and Supplier has the right to change the location of the space to other space that meets the specifications at any time without Customer's approval.
  - Supplier would benefit economically from substituting the space. There would be minimal cost associated with changing the space used by Customer because the kiosk can be moved easily. Supplier benefits from substituting the space in the airport because substitution allows Supplier to make the most effective use of the space at boarding areas in the airport to meet changing circumstances.

ASC 842-10-55-55: Example 3 Fiber-Optic Cable

- Customer enters into a 15-year contract with a utilities company (Supplier) for the right to use 3 specified, physically distinct dark fibers within a larger cable connecting Hong Kong to Tokyo. Customer makes the decisions about the use of the fibers by connecting each end of the fibers to its electronic equipment (for example, Customer "lights" the fibers and decides what data and how much data those fibers will transport). If the fibers are damaged, Supplier is responsible for the repairs and maintenance. Supplier owns extra fibers but can substitute those for Customer's fibers only for reasons of repairs, maintenance, or malfunction (and is obliged to substitute the fibers in these cases).

Answer to Example 3: Fiber-Optic Cable

- ASC 842-10-55-56: The contract contains a lease of dark fibers. Customer has the right to use the 3 dark fibers for 15 years.
- ASC 842-10-55-57: There are three identified dark fibers. The fibers are explicitly specified in the contract and are physically distinct from other fibers within the cable. Supplier cannot substitute the fibers other than for reasons of repairs, maintenance, or malfunction.
- ASC 842-10-55-58: Customer has the right to control the use of the fibers throughout the 15-year period of use because:
  - Customer has the right to obtain substantially all of the economic benefits from use of the fibers over the 15-year period of use. Customer has exclusive use of the fibers throughout the period of use.
  - Customer has the right to direct the use of the fibers. Customer makes the relevant decisions about how and for what purpose the fibers are used by deciding when and whether to light the fibers and when and how much output the fibers will produce (that is, what data and how much data those fibers will transport). Customer has the right to change these decisions during the 15-year period of use.
  - ASC 842-10-55-57: There are three identified dark fibers. The fibers are explicitly specified in the contract and are physically distinct from other fibers within the cable. Supplier cannot substitute the fibers other than for reasons of repairs, maintenance, or malfunction.

Answer to Example 3: Fiber-Optic Cable cont'd

- ASC 842-10-55-59: Although Supplier's decisions about repairing and maintaining the fibers are essential to their efficient use, those decisions do not give Supplier the right to direct how and for what purpose the fibers are used. Consequently, Supplier does not control the use of the fibers during the period of use.

Example 3, Case B: Contract Does Not Contain a Lease

- ASC 842-10-55-60: Customer enters into a 15-year contract with Supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong to Tokyo. The specified amount is equivalent to Customer having the use of the full capacity of 3 strands within the cable (the cable contains 15 fibers with similar capacities). Supplier makes decisions about the transmission of data (that is, Supplier lights the fibers and makes decisions about which fibers are used to transmit Customer's traffic and about the electronic equipment that Supplier owns and connects to the fibers).

Answer to Example 3, Case B: Contract Does Not Contain a Lease

- ASC 842-10-55-61: The contract does not contain a lease.
- ASC 842-10-55-62: Supplier makes all decisions about the transmission of its customers' data, which requires the use of only a portion of the capacity of the cable for each customer. The capacity portion that will be provided to Customer is not physically distinct from the remaining capacity of the cable and does not represent substantially all of the capacity of the cable. Consequently, Customer does not have the right to use an identified asset.

Example 4: Retail Unit

- ASC 842-10-55-63: Customer enters into a contract with property owner (Supplier) to use Retail Unit A for a five-year period. Retail Unit A is part of a larger retail space with many retail units.
- ASC 842-10-55-64: Customer is granted the right to use Retail Unit A. Supplier can require Customer to relocate to another retail unit. In that case, Supplier is required to provide Customer with a retail unit of similar quality and specifications to Retail Unit A and to pay for Customer's relocation costs. Supplier would benefit economically from relocating Customer only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favorable to cover the costs of relocating Customer and other tenants in the retail space that the new tenant will occupy. However, although it is possible that those circumstances will arise, at inception of the contract, it is not likely that those circumstances will arise. For example, whether a major new tenant will decide to lease a large amount of retail space at a rate that would be sufficiently favorable to cover the costs of relocating Customer is highly susceptible to factors outside Supplier's influence.

Example 4 – Retail Unit, cont'd

- ASC 842-10-55-65: The contract requires Customer to use Retail Unit A to operate its well-known store brand to sell its goods during the hours that the larger retail space is open. Customer makes all of the decisions about the use of the retail unit during the period of use. For example Customer decides on the mix of goods sold from the unit, the pricing of the goods sold, and the quantities of inventory held. Customer also controls physical access to the unit throughout the five-year period of use.
- ASC 842-10-55-66: The contract requires Customer to make fixed payments to Supplier as well as variable payments that are a percentage of sales from Retail Unit A.
- ASC 842-67: Supplier provides cleaning and security services as well as advertising services as part of the contract.
- ASC 842-10-55-68: The contract contains a lease of retail space. Customer has the right to use Retail Unit A for five years.

Answer: Example 4 Retail Unit

- ASC 842-10-55-69: Retail Unit A is an identified asset. It is explicitly specified in the contract. Supplier has the practical ability to substitute the retail unit, but could benefit economically from substitution only in specific circumstances. Supplier's substitution right is not substantive because, at inception of the contract, those circumstances are not considered likely to arise.

Answer: Example 4 Retail Unit, cont'd.

- ASC 842-10-55-70: Customer has the right to control the use of Retail Unit A throughout the five-year period of use because:
  - Customer has the right to obtain substantially all of the economic benefits from use of Retail Unit A over the five-year period of use. Customer has exclusive use of Retail Unit A throughout the period of use. Although a portion of the cash flows derived from sales from Retail Unit A will flow from Customer to Supplier, this represents consideration that Customer pays Supplier for the right to use the retail unit. It does not prevent Customer from having the right to use the retail unit. It does not prevent Customer from having the right to obtain substantially all of the economic benefits from use of Retail Unit A.
  - Customer has the right to direct the use of Retail Unit A. The contractual restrictions on the goods that can be sold from Retail Unit A and when Retail Unit A is open define the scope of Customer's right to use Retail Unit A. Within the scope of its right to use defined in the contract, Customer makes the relevant decisions about how and for what purpose Retail Unit A is used by being able to decide, for example, the mix of products that will be sold in the retail unit and the sale price for those products. Customer has the right to change these decisions during the five-year period of use.

Answer: Example 4 Retail Unit, cont'd

- ASC 842-10-55-71: Although cleaning, security, and advertising services are essential to the efficient use of Retail Unit A, Supplier's decisions in this regard do not give it the right to direct how and for what purpose Retail Unit A is used. Consequently, Supplier does not control the use of Retail Unit A during the period of use, and Supplier's decisions do not affect Customer's control of the use of Retail Unit A.

Example 5 – Truck Rental

- ASC 842-10-55-72: Customer enters into a contract with Supplier for the use of a truck for one week to transport cargo from New York to San Francisco. Supplier does not have substitution rights. Only cargo specified in the contract is permitted to be transported on this truck for the period of the contract. The contract specifies a maximum distance that the truck can be driven. Customer is able to choose the details of the journey (speed, route, rest stops, and so forth) within the parameters of the contract. Customer does not have the right to continue using the truck after the specified trip is complete.
- ASC 842-10-55-73: The cargo to be transported and the timing and location of pickup in New York and delivery in San Francisco are specified in the contract.
- ASC 842-10-55-74: Customer is responsible for driving the truck from New York to San Francisco.

Answer – Example 5 Truck Rental

- ASC 842-10-55-75: The contract contains a lease of a truck. Customer has the right to use the truck for the duration of the specified trip.
- ASC 842-10-55-76: There is an identified asset. The truck is explicitly specified in the contract, and Supplier does not have the right to substitute the truck.
- ASC 842-10-55-77: Customer has the right to control the use of the truck throughout the period of use because:
  - Customer has the right to obtain substantially all of the economic benefits from the use of the truck over the period of use. Customer has exclusive use of the truck throughout the period of use.
  - Customer has the right to direct the use of the truck. How and for what purpose the truck will be used (that is, the transport of specified cargo from New York to San Francisco within a specified time frame) are predetermined in the contract. Customer directs the use of the truck because it has the right to operate the truck (for example, speed, route, and rest stops) throughout the period of use. Customer makes all of the decisions about the use of the truck that can be made during the period of use through its control of the operations of the truck.

- Because the duration of the contract is one week, this lease meets the definition of a short-term lease.

Example 7 - Aircraft

- ASC 842-10-55-92: Customer enters into a contract with an aircraft owner (Supplier) for the use of an explicitly specified aircraft for a two-year period. The contract details the interior and exterior specifications for the aircraft.
- ASC 842-10-55-93: There are contractual and legal restrictions in the contract on where the aircraft can fly. Subject to those restrictions, Customer determines where and when the aircraft will fly and which passengers and cargo will be transported on the aircraft.
- ASC 842-10-55-94: Supplier is responsible for operating the aircraft, using its own crew. Customer is prohibited from hiring another operator for the aircraft or operating the aircraft itself during the term of the contract.
- ASC 842-10-55-95: Supplier is permitted to substitute the aircraft at any time during the two-year period and must substitute the aircraft if it is not working. Any substitute aircraft must meet the interior and exterior specifications in the contract. There are significant costs involved in outfitting an aircraft in Supplier's fleet to meet Customer's specifications.

Answer: Example 7 Aircraft

- ASC 842-10-55-96: The contract contains a lease. Customer has the right to use the aircraft for two years.
- ASC 842-10-55-97: There is an identified asset. The aircraft is explicitly specified in the contract, and although Supplier can substitute the aircraft, its substitution right is not substantive. Supplier’s substitution right is not substantive because of the significant costs involved in outfitting another aircraft to meet the specifications required by the contract such that Supplier is not expected to benefit economically from substituting the aircraft.

Answer: Example 7 Aircraft, cont'd

- ASC 842-10-55-98: Customer has the right to control the use of the aircraft throughout the two-year period of use because:
  - Customer has the right to obtain substantially all of the economic benefits from the use of the aircraft over the two-year period of use. Customer has exclusive use of the aircraft throughout the period of use.
  - Customer has the right to direct the use of the aircraft. The restrictions on where the aircraft can fly define the scope of Customer's right to use the aircraft. Within the scope of its right of use, Customer makes the relevant decisions about how and for what purpose the aircraft is used throughout the two-year period of use because it decides whether, where, and for when the aircraft travels as well as the passengers and cargo it will transport. Customer has the right to change these decisions throughout the two-year period of use.

Answer: Example 7 Aircraft, cont'd

- ASC 842-10-55-99: Although the operation of the aircraft is essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the aircraft is used. Consequently, Supplier does not control the use of the aircraft during the period of use, and Supplier's decisions do not affect Customer's control of the use of the aircraft.

Questions?

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