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WEBINAR

Implementing Leases: A Practical Approach, Challenges, & Opportunities

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Meet the Presenters



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Liz is an audit partner responsible for overseeing engagement performance for various FORVIS locations. Her 30+ year career has concentrated on accounting & auditing implementation & training of professional personnel



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John is the National Service Leader for Assurance at FORVIS. John has over 25 years auditing both public & private companies in the technology, manufacturing & distribution, & services industries, including private equity backed entities

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Objectives

After today's session you should be able to

- Recall the standard's effective date
- Recognize the various decisions that need to be made
- Develop a plan for establishing a complete lease population
- Identify challenges to & opportunities of implementation
- Create a timeline for implementation
- Identify resource needs, selecting the right tool & process changes required

Let's Start with Some Basics

- What is ASC 842, Leases?
- At the highest level, what is it trying to do/accomplish – why was this standard issued?
- When is it required to be implemented?
- Who does this affect?

When

Effective Date

- For calendar year end private companies reporting in accordance with GAAP – January 1, 2022, was the effective date
- This is the date you implement the standard & record the implementation entry
- Everything that happens **AFTER** that date needs to be evaluated as to whether or not it is in scope of the standard & is potentially a new lease or an old lease that is being modified

What & Who

- “All” leases, including operating leases, are now recorded as liabilities on the balance sheet – with a “corresponding” right of use asset
 - Operating leases are straight line lease expense
 - Finance leases are front loaded interest & amortization expense
- Any entity following U.S. GAAP is required to implement
 - Immaterial – but you need to “prove” immateriality – could be simple to do, or not so simple to do

Decision Time

- Once you know this is for you
 - What are some of the early decisions you need to make?
 - Why do you need to make these decisions? How important are they?

Early Decisions

- First decision – which method of adoption will you use?
 - More on that next
- Certain implementation decisions need to be made & most adopters are following a certain pattern or trend to those decisions... but you should understand your population before making these decisions (in other words, the trend may not be suitable for your circumstances)
 - Generally, adopters gather data about their leases first – Why? Because is it helpful to understand your lease characteristics: your types, your terms, the variety, & the frequency of changes before making decisions affecting the accounting for the population
 - Once you know your population's characteristics, be thinking about what kind of tool you need to record all this data – it should be one that provides you with the journal entries, amortization schedules, & footnote disclosures

Method of Adoption – Two Choices

- Most prevalent choice – adopt as of beginning of year it is effective
 - ASC 842 only affects year of adoption & beyond
 - Pro: Easier
 - Con: Years are not comparative
- Least prevalent choice – restate all years presented
 - All years presented in the financial statements are restated as if the standard was adopted at the beginning of the earliest year
 - Pro: Years are comparative
 - Con: More time-consuming & likely more difficult

Know Your Leases

Gather your lease documentation & establish the population

- Two populations of leases
 - The contracts that have historically been accounted for as leases
 - + Use prior year GAAP footnotes as a start
 - + Gather all documentation
 - + Ensure that documentation is up to date, agrees to accounting, & has been properly executed
 - + Summarize the terms for input into lease accounting system
 - The contracts that were NOT historically accounted for as a lease, however they are, in fact, leases – often called embedded leases
 - + See next slide

Embedded Leases

- Some leases were incorrectly not accounted for as leases in the past
- Often these were considered immaterial or just ignored & forgotten, since no balance sheet impact
- Standard does not allow you to carry forward errors
- Start with audited financial statements & identify & reconcile all expense accounts to the issued financial statements to ensure a complete population
 - Risk weight accounts based on probability of it containing a lease
 - + **Payroll Expense – low risk** *versus* **Equipment Expense – high risk**
 - + Think – where are your embedded leases?

Possible Common Embedded Leases

- IT expense (servers, laptops, modems, set top boxes)
- Office expense (office equipment)
- Rent expense not already part of your lease footnote (warehouses)
- Equipment expense (yard equipment, other office equipment)
- Advertising expense (billboards)
- Postage expense (postage machine)
- Copy expenses (copy machines)
- Vehicle expenses (auto leases)
- **LOOK AROUND – How many assets do you see? Do you own or rent them?**

What Do I Do with These Possible Leases?

- Once a high-risk account is identified
 - Obtain & inspect documentation for contracts that are repetitive, not one time only
 - Determine if an asset is involved in the delivery of the service
 - Determine if the arrangement should have been accounted for as a lease
- If determined to be a lease, retain documentation, extract terms, be prepared to enter data into your lease accounting system
- **Do not underestimate the time it takes to complete this process.** Be thorough & document this carefully so that your external accountant can verify your conclusions

The Use of Artificial Intelligence

- When reviewing contracts for terms – do you have the bandwidth to perform this task? Contracts can be a few pages long to hundreds of pages long.....
- Can you use artificial intelligence to ‘review’ your documents & extract the relevant terms?

Embedded Leases Seem to Be Everywhere

- Recent conversations about embedded leases
 - Porta-potties
 - Dumpsters
 - Trash bins
 - Security cameras
 - Potted plants
 - Music equipment & white noise machines
 - Decorative artwork

Time to Make Decisions

- Now that we know about our lease characteristics
- Let's talk more about the decisions – also known as “practical expedients”
 - Are they really practical & expedient?
 - What patterns have emerged from our experience with adopters?

Practical Expedients

- Some relate to day one adoption, some relate to day two ongoing accounting
- Some are an “all or none” choice, others are by “class of underlying asset”
- They (almost) ALL require a right-of-use asset & lease liability to be recorded
- EASY TO REMEMBER
 - Most prevalent choice is to adopt all expedients EXCEPT “HINDSIGHT”
- **FIRST expedient: Short term lease exception**
 - Total *initial* term is twelve months or less – it is still a lease; lease expense is recorded but no ROU or liability is recorded
 - Careful – if you don’t have a lease, you don’t have leasehold improvements either!!

Other Practical Expedients

- **SECOND Decision: Package of three** – do not reassess any ASC 840 leases being brought onto the books on the adoption date
 - Whether or not it is a lease
 - its classification (operating/finance) or
 - initial direct costs that had been previously capitalized

- Stay the course on your previous ASC 840 determinations until that lease is modified, terminated, or expires) (or if an error occurred under ASC 840 in the past)
 - All or none choice
 - Pro – easier
 - Con – cannot reassess even if you want to
 - This also impacts those embedded leases – they come on using ASC 840's definitions

Practical Expedients Continued

- **THIRD Decision: Combining lease & nonlease components**
 - Do not need to calculate standalone values for components for purposes of allocating consideration in order to calculate the lease liability (this can be VERY time consuming). You cannot use the contract's allocation of amounts to the various components – you must separately determine the standalone values
 - Not all or none – can choose by class of underlying asset
 - Pro – easier – maybe even MUCH easier
 - Con – likely a larger liability – which can lead to a finance lease classification

Practical Expedients Continued

- **FOURTH Decision: Discount rate**
 - Must use rate implicit in lease if known – rare that it is known for real estate or specialized equipment but may be reasonably estimated for equipment or vehicles
 - If not known – use incremental borrowing rate (IBR) or choose private company practical expedient to use risk-free rate (RFR)
 - IBR – incremental, similar term, collateralized by similar asset
 - + How will you calculate this? Do you have evidence to support?
 - + More expensive choice than RFR
- RFR – less expensive choice but likely a larger liability – &, again, could trigger finance lease

Hindsight

- **FIFTH Decision – NOT TYPICALLY SELECTED: Hindsight**

- Use facts up to the transition date (nothing AFTER transition date)
- Could change classification (beware, this interacts with package of three)

- Why is this one not selected?
 - + Much more difficult to implement
 - + All or none – can't cherry pick

 - + There are more practical expedients, we have only covered the ones that affect almost everyone

Lease Challenges Are Many

- How do I capture all these pieces of data?
- Is it an enforceable contract?
- How do I handle leases that are not properly documented?
- Is the asset really controlled by the lessee?
- How do I calculate standalone value for allocation to the lease & nonlease components?
- Are any amounts variable, based on outcomes not yet known?
- How do I account for leases when amounts are based on indexes or rates?
- What is the lease term? (reasonably certain to be exercised (high threshold) based on economics, not intent of lessee)
- How do I account for the land underneath the building I am leasing, or the land under the parking lot, or the easement?

Financial Statement Considerations

- Recording leases on the books has some financial statement implications
 - How are the balance sheet & the income statement affected?
- What are the mechanics of the initial entry to adopt?

Balance Sheet Impacts to Consider

- Operating & Finance leases should not be in the same line item
- Liability is both short-term & long-term
- Right of use asset is only long-term
 - Working capital is affected
 - Confirm how change affects covenants
- Generally, lenders do NOT consider operating leases to be 'debt'
 - Confirm with your lender
- Pre-ASC 842 balances collapsed into right of use asset on the date of adoption. Deferred rent, etc...

Income Statement Impacts

- Finance lease
 - Interest expense & amortization are separately accounted for
 - Expense is front loaded
- Operating lease
 - Lease expense
 - + Equals the sum of interest expense (same amount as finance lease) & amortization; however, amortization is calculated as the difference between straight line lease expense & interest. It is a plug. Expense is NOT front loaded; it is straight line.

Entry to Adopt

- Calculate lease liability by discounting the payment stream
 - Add or subtract leftover ASC 840 balances (deferred rent, tenant improvement allowances, initial direct costs)
 - Result equals plug to record the right of use asset
- Usually no retained earnings impact due to selection of package of three practical expedients

What Happens After Day One

- All new leases go on the books using ASC 842 – no more carryover of ASC 840 conclusions
- Leases recorded on day one are amortized, paid, & accreted until the lease is modified, terminated, or expired. That is – those beginning ASC 840 balances brought on as ASC 842 right of use assets & liabilities are carried forward until a ‘change’ occurs

Are There Other Considerations?

- Processes may need overhauling
 - Entering into & documenting new leases
 - Recognizing modifications when they occur
 - Ongoing financial accounting

- Do you have the right accounting package for your lease portfolio?

- Do you have the resources to accomplish this?

Opportunities Abound

- **Uncovering unfavorable leases**
 - Leases may be out of sync with the current economic environment – can they be renegotiated?

- **Managing cost**
 - Some leases may no longer be necessary or in line with your strategy; centralizing the process under a master lease may reduce costs

- **Reducing risk**
 - Assignment of authority, document retention, & retrieval

FORVIS Help – LeaseVision

- Excel-based tool – works with GASB & FASB
- Assumes package of three & NO hindsight
- You pay a one-time fee, own the spreadsheet
- Generally 10 – 300 leases is sweet spot
- Comes with training & help videos
- Provides professional literature
- Comes with artificial intelligence to ‘read’ your contracts
- Gives you the reports you need, including footnote disclosure data
- Allows you to start today – no IT considerations
- Easy-to-understand formulas & ability to understand the results

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FORVIS Help

- **LeaseVision**
 - Excel-based tool, can begin today!
 - Pay a one-time fee, own the spreadsheet
 - Generally 10 – 300 leases is sweet spot
 - Comes with a roadmap & half-day of implementation assistance—our “easy button” for you
- **Data input**
 - Can assist with input into a model/tool
 - Can utilize AI to speed the process
- **Small number of leases—consultation**
- **Large number of leases—software implementation**
- **Audit/review of output/adoption**

Questions?

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