Changes to Lease Accounting: ASC 842

Key Challenges of the New Lease Standard

- What is a lease? - The new standard has completely revised and changed the scope of lease accounting:
    - A contract does not have to have the word "lease" in it to be a lease. For example, some service contracts that include the use of a piece of equipment may include an embedded lease. Identifying contracts with embedded leases is important as external auditors will be looking hard at this.
    - Other "lease" transactions may not be deemed to be a lease under the new standard. For example, in a lease contract, if a lessor has the right to replace an asset, the transaction may not be a lease, whereas, if those substitution rights are limited, either economically, implicitly or explicitly, lease accounting may apply. Lessor substitution rights must be carefully considered to determine if the lease contract involves an identified asset.
    - Certain types of leases have been completely scoped out of lease accounting, for example oil and gas leases or leases of intangible assets.
    - Leases of asset components are especially challenging. For example, the lease of a length of pipeline maybe a lease whereas a lease of a portion of a pipeline capacity may not be a lease.
- Is now a good time to change contract language to better accommodate the new standard? For example, adding a clause in new agreements that the lessor will provide necessary data to better enable compliance.
- Coordination between the new revenue recognition standard and the new lease accounting standard should be carefully considered. For instance, contracts involving embedded leases and lessor variable consideration:
    - First look to the leasing standard to determine if an embedded lease exists,
    - Then to ASC 606 to determine how to bifurcate the variable components,
    - Then back to the leasing standard to determine how to account for the leasing components, and
    - Back to the revenue standard to determine how to account for the non-lease components.
- Lessor variable consideration is treated differently for lease components than for non-lease components. All of this may be eliminated with an optional election. Similarly, sale-leaseback transactions require careful analysis of the 5 steps of ASC 606 to determine if a sale has occurred.
- The new lease standard introduces the concept of the customer's "control" of an asset to determine if an asset has been leased. Control of an asset does not have to be for the entire length of a contract nor is it absolute. This determination of control for many contracts will require significant judgement. For example, the owner may retain the right to direct the customer to operate an asset in a specific manner, but the customer is deemed to control the asset (protective rights).
- Impacts to the balance sheet could be significant as more leases (asset and liability) may be recorded. This will require significant judgement for many companies in determining how much to record including the determination of:
    - The amount of the "right-of-use-asset" and the amount of the lease liability (lessees), which may be different
    - In-substance fixed payments
    - Residual value guarantees and debt guarantees that are in-substance residual value guarantees

- Third party residual value guarantees (lessors)
- The implicit rate of interest
- Lease payment and residual value collectability (lessor)
- Determination of whether or not the asset is of a "specialized nature"
- The determination of initial direct costs. For example, third party legal costs to draft or negotiate a lease agreement are NOT considered initial direct costs whereas third party broker fees are

ü With the requirement to capitalize almost all leases longer than 12 months, and some leases less than 12 months in duration, lessee debt covenants and certain non-GAAP financial measures may be dramatically affected:

- Adoption of the new leasing standard will increase almost every company's liabilities and any debt covenant involving liabilities may be adversely affected, including the all-important debt to equity ratio.
- On the other hand, EBITDA may be more favorable due to the amortization of lease components.
- Advanced communication to stakeholders of the impact on debt covenants and non-GAAP financial measures is critical.

ü There are many practical expedients and optional elections that require careful analysis and consideration for each company. These include:

- Accounting for lease and non-lease components
- 12-month election
- Portfolio election
- Period of adoption elections

ü Lease classification may require significant judgement. Lessees will classify leases as one of two types of leases: (1) finance lease or (2) operating lease, and lessors will classify leases as one of three types of leases: (1) sales-type, (2) direct financing or (3) operating lease, using 5 criteria for lessees and 7 criteria for lessors. While the criteria are similar to existing lease guidance, the new lease standard eliminated bright lines and requires subjective determinations of:

- Guaranteed/unguaranteed/third party guaranteed residual value
- Purchase options
- Economic life of leased assets, especially leases involving land (under the new standard, such leases MAY be classified as finance leases)
- Renewal options
- Variable lease payments
- Termination penalties
- What constitutes a "major part" of the remaining economic life
- What is "Substantially all" of the fair value of a leased asset.

ü Lease modifications are challenging for both lessees and lessors as a modification may be accounted for as a termination and creation of a new lease OR as a modification of an existing lease that could change the classification (finance, sales-type, direct financing or operating lease) and consequently, the accounting for the existing lease. Each modification should be carefully considered and analyzed including modifications that:

- increases or decreases the lease term,
- grants an additional right-to-use asset,
- terminates all or a portion of the lease, or

- changes the timing and/or amounts of lease payments.

ü Disclosure requirements are extensive and include qualitative and quantitative disclosures about finance, operating, sales-type, direct financing and operating leases. For example, lessees will need to reconcile its annual leasing cost in a footnote and include other information such as:
  - gains or losses on sales or leaseback transactions,
  - the amount of operating cash flows from finance leases,
  - the amount of operating cash flows from operating leases,
  - the amount of financing cash flows from finance leases,
  - the amount of right-of-use assets obtained in exchange for new finance lease liabilities,
  - the right-of-use assets obtained in exchange for new operating lease liabilities,
  - the weighted-average remaining lease term for finance leases,
  - the weighted-average lease term for operating leases, and
  - the weighted-average discount rate for finance leases and for operating leases.

ü Stakeholder communications should be top-of-mind, especially pertaining to the impact on loan covenants and financial statements. Do you understand preliminary impacts so you can begin early communications?

How Can We Help?

1. High level or detailed analysis of the potential impact of the new lease pronouncement on the Company's balance sheet and loan covenants
2. Project management (change management)
3. Assistance in analyzing options, elections and practical expedients (cost, benefits, intangibles, etc.)
4. Complete solutions for adoption or selected assistance as necessary
5. Assistance in generating journal entries for all capitalized leases
6. Independent testing of internal controls over financial reporting (ICFR) for leases; both from a design and operating effectiveness standpoint
7. Board, management, and staff presentations and for training programs to support lease accounting changes
8. Technical resources for challenging lease accounting issues

Why Use Us?

1. Independent of your external auditor thus protecting their independence
2. Dedicated staff trained for 'cradle-to-grave' planning and implementation support
3. Deep understanding of the new standard as our leaders have lectured and written commentary on the new standard since the project was started by the FASB
4. Internal auditing, which can be potentially leveraged by your external auditor
5. Ability to turn on or off services to best fit your needs
6. Support to help peak period demands
7. Flexible engagement terms to ensure a collaborative approach