



# The clock is ticking

How to jumpstart your lease accounting implementation project

CFG I

## Lease accounting: adopting the new standard (ASC 842)

If you run a business, you lease equipment or real estate. It's that simple. Equally straightforward is the fact that the new accounting standards for leases (FASB ASC 842 and IASB IFRS 16) will fundamentally alter accounting by requiring that both operating and finance leases are recognized on a company's balance sheet. It will also impact the operations of almost every organization, regardless of size, industry or geography.

Under the new guidance, an arrangement contains a lease only when such arrangement conveys the right to control the use of an identified asset. This is a change from legacy guidance, in which an arrangement can contain a lease even without control of the use of the asset if the customer took substantially all the output over the term of the arrangement. In addition to the lack of bright lines used under legacy guidance, the FASB added a new criterion which focuses on assets that have a specialized nature with no alternative use at the expiration of the lease. This is important as it may modify the legacy classification.

### The deadline for compliance with the new lease standard is looming

Over the next few years, several trillion dollars of lease assets and off-balance sheet liabilities are likely to be transferred to corporate balance sheets. The deadline for compliance with the new lease standard is looming. Under the FASB's guidance, the standard will take effect for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other organizations, the standard will take effect for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. If filing under IFRS, the standard is effective for annual periods beginning on or after January 1, 2019 for all entities.

**Editor Note:** At its July 17 meeting, the FASB voted to propose a deferral of the effective date for several of its recent standards including ASC 842 - Leases. The ASC 842 proposal would make the effective date for calendar-year-end preparers that are not public business entities for fiscal years beginning after December 15, 2020 (i.e. one-year deferral). The effective date for all other entities would remain unchanged.

Companies we've spoken to say they are anxious to get started but are constrained by inadequate resources, lack of in-house expertise, and finalizing compliance with the new revenue recognition standard. As the clock continues to tick, many are overwhelmed by the magnitude of the project and are unsure how to chart a path toward compliance.





## Start with challenges, finish with benefits

Let's be clear: The hurdles to implementing the new lease standards are high for many businesses. They will need to adopt modern, centralized processes for collecting, testing and recording leases for real estate and property, plant and equipment assets, and must do it all in a matter of months.

And that's daunting, given that the number and locations of leases is often a mystery. Discovering and collecting this data will be a challenge because leases exist in an array of formats across a sweeping landscape of back-office systems and data types. So, it's no wonder, then, that many businesses say collecting and centralizing lease data represents one of their most significant challenges.

What's more, interpreting the standard's financial reporting and disclosure requirements will be an arduous proposition for businesses that lack technical expertise in lease management. Financial management may need to huddle with accounting advisors and counsel to determine accounting practices, as well as discuss possible material changes with company auditors.

While preparing for the new standard will be a burden, it will ultimately help businesses streamline lease management by delivering a methodology to improve lease accounting technologies, processes and professional skills. The ability to better track and manage leases can sharpen visibility into lease spending and enable businesses to negotiate new leases using the power of data. What's more, updated technology solutions can increase the accuracy of accounting, streamline audits, and save time and costs in preparing financial reports, footnotes, and regulatory responses.

Overall, the addition of substantially all leases on balance sheet will give corporate executives, shareholders and investors more accurate financial information about the company. It will also create consistency and comparability for financial statements—and help deliver additional insights into the true value of the business.



## CFGl's four steps for successful implementation

Taking the first steps to prepare for the new accounting standard will seem like a daunting task for many. Each organization will need to fully understand how the ASU will impact the business, develop a phased implementation methodology and identify the right team to effect the changes. Along the way, the expertise of lease accounting experts, whether internal or external, will be critical to success.

The good news? It's a highly manageable initiative. Here's how we suggest you get started.

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### 1. Discovery: Identify project lead and collect lease data and current policies

First, you'll need to identify a lease accounting project leader with deep technical understanding of the new standard as well as an encyclopedic knowledge of the company's lease data. Another requirement is the ability to gauge potential impact to balance sheet ratios and communicate these outcomes to stakeholders. We believe the person best suited to lead the project is typically found in the Controller's office.

We also recommend appointing a steering committee that disseminates information from the project team across the organization. Candidates should be involved in some part of the end-to-end lease process, from execution through the financial reporting. That can include staff from accounting, finance, treasury, operations, procurement, legal, tax, among others.

Among public and private companies, it's very likely that there will be overlaps in professional skills between the revenue recognition and lease accounting initiatives. If you are a private company, you may want to consider combining the two implementation projects to achieve savings in time, costs and resources.

To compile a list of all leases, project leaders will first identify all departments that have or may be aware of leased assets. Only then can they assemble a comprehensive list of all leases—and the specific data points—required by the new standard. This can be tedious and may require digging deep into financial records for rent expense to find simple leases that were not formally tracked in contracts previously.

Lease data collected should include the types and numbers of property, plant, and equipment leases, availability of digital lease data, and gaps in lease

data. It may be up to 50 discrete pieces of data with a potential of two to four hours of review per lease. In our experience, businesses often overlook embedded leases, which may be included as part of a larger service agreement. Embedded leases are often complex arrangements that require closer scrutiny and advanced technical accounting skills.

### 2. Design/evaluation: Set a compliance policy and evaluate leases under new guidance

In step two, the project leader works with stakeholders to establish a threshold and a policy for leased assets and documents the reasoning behind these decisions. It's a good idea to involve external auditors early in the process to obtain buy-in and to ensure decisions are coordinated.

Next, the project leader selects a cross-functional team to coordinate the implementation. It's critical that the project team includes technical accounting experts with deep experience in financial reporting. Then you can mix it up a bit: Members from disparate business units will contribute broad operational knowledge to the project.

After the lease data is collected, the project leader sets accounting policies to determine which leases require adjustment under the new standard. This documentation must be meticulous and comprehensive, with precise guidance on accounting policies, expedients elected, and overall compliance with US GAAP or IFRS. Using internal whitepapers or memos to document policy decisions is a sound practice, one that also can assist external auditors in their audit process. As noted, changes regarding materiality could warrant discussions with a lease accounting expert or an auditor.

### 3. Implementation: Calculate new lease entries and implement financial reporting disclosures

During the implementation phase, you will need to calculate and process the new lease entries for day one entry for operating leases into the balance sheet. As the calculations are being entered, you should continue to have ongoing dialogue with your auditor and provide training for your project team on the new lease accounting policies and considerations. We suggest that the training consist of mock exercises with examples including finance, operating and embedded leases to ensure proper implementation.

You will also likely want to consider lease technology to help automate your lease accounting process as it relates to classification, measurement, recognition and financial statement disclosures.

#### A sample lease arrangement under ASC 842

A lessee enters into a ten-year lease and agrees to make a \$50,000 annual payment at the beginning of each year. First payment is due on lease execution date and the lessee incurs \$15,000 in initial direct costs in the form of broker commissions. The initial measurement of the right-of-use asset and liability is \$407,017 and \$392,017 at a discount rate of 5.87%. The table below highlights the differences in accounting for the lease depending on whether it is classified by the lessee as a finance lease or an operating lease.

[See appendix for an in-depth analysis.](#)

Year	Lease Liability	FINANCE LEASE				OPERATING LEASE		
		Interest Expense	Amortization Expense	Total Lease Expense	ROU Asset	Straight Line Rent Expense	Reduction in ROU Asset	ROU Asset
0	392,017				407,017			407,017
1	362,093	20,076	40,702	60,778	366,315	51,500	31,424	375,593
2	330,413	18,320	40,702	59,022	325,613	51,500	33,180	342,413
3	296,873	16,460	40,702	57,162	284,911	51,500	35,040	307,373
4	261,364	14,491	40,702	55,193	244,209	51,500	37,009	270,364
5	223,771	12,407	40,702	53,109	203,507	51,500	39,093	231,271
6	183,971	10,200	40,702	50,902	162,805	51,500	41,300	189,971
7	141,835	7,864	40,702	48,566	122,103	51,500	43,636	146,335
8	97,226	5,391	40,702	46,093	81,401	51,500	46,109	100,226
9	50,000	2,774	40,702	43,476	40,699	51,500	48,726	51,500
10	-	-	40,699	40,699	-	51,500	51,500	-
<b>Total</b>		<b>107,983</b>	<b>407,017</b>	<b>515,000</b>		<b>515,000</b>	<b>407,017</b>	

## 4. Ongoing: Sustainably manage lease data

Implementation of the new lease standard doesn't conclude at the compliance deadline. That's because compliance with the standard is not a one-time event—it's an ongoing discipline that must be managed and maintained as new leases and accounting changes are added.

What's needed is a centralized data-management system that sustainably manages leases and their impact on balance sheets. Think of it as an opportunity: ASC 842 presents a case to deploy new lease accounting software that automates the standard's data storage, classification, calculation and reporting requirements. That will save you money in the end.

While some businesses still manually manage leasing data on spreadsheets, companies are increasingly storing lease data in digital formats. Trouble is, this information is often incomplete and resides in disparate, unconnected systems, making the collection and integration of data a resource-intensive effort. Assessing and implementing new IT components—or developing new functionality within existing systems—often benefits from the outside expertise of an agnostic third party.

Businesses will also need to monitor and respond to comments on financial statements from regulatory bodies like the FASB and the SEC. Some may also need external assistance to address comments and understand the business implications of new exposure drafts as they are released.



### An outside perspective on your leases

Implementing the new lease standard will require a fresh, clear perspective on your organization's accounting lease contracts, processes and compliance program. It's an initiative that will demand deep technical accounting skills, strategic use of technology and the business acumen to understand potential impacts to financials. CFGI understands that and can work with your organization to help you achieve compliance.

## Appendix

### A sample lease arrangement under ASC 842 (operating and finance)

Adapted from ASC 842-20-55-22 to 55-30 “Example 3 - Initial and Subsequent Measurement by a Lessee”

Lessee enters a lease for a non-specialized piece of standard equipment with lessor

<b>Lease term:</b>	10 years <sup>1</sup>	<b>Fair value of asset:</b>	\$750,000
<b>Economic life:</b>	20 years	<b>Residual value guarantee:</b>	None
<b>Purchase option:</b>	None	<b>Initial direct cost:</b>	\$15,000 (broker commission)
<b>Rent payments:</b>	\$50,000 annually <sup>2</sup>	<b>Lease liability:</b>	\$392,017 <sup>3</sup>
<b>Interest rate:</b>	5.87%	<b>Right-of-use (ROU) asset:</b>	\$407,017 <sup>4</sup>

1. Renewal option for 5 additional years is not reasonably certain to be exercised at commencement date. Therefore, 10-year contractual term = lease term.
2. Rent paid at the beginning of the period, with no escalation.

3. Present value of ten (10) \$50,000 lease payments discounted at 5.87% (beginning of period)
4. Remaining lease liability \$392,017 + initial direct costs \$15,000

**Q** How should the lessee classify the lease?

**A** Operating lease, since none of the following criteria are met:

1. Does the lease transfer ownership of the underlying asset to the lessee by the end of the lease term? **No**
2. Does the lease grant the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise? **No**
3. Is the lease term for the major part of the remaining economic life of the underlying asset? **No (50% of economic life)**
4. Does the present value of the sum of the lease payments and any residual value guarantee by the lessee that is not already reflected in the lease payments equal or exceed substantially all of the fair value of the underlying asset? **No (52% of fair value)**
5. Is the underlying asset of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term? **No**

## Operating lease

### Initial recognition entry

Dr. Right-of-use (ROU) asset	407,017	
Cr. Cash		50,000
Cr. Initial direct cost liability		15,000
Cr. Lease liability		342,017

### Year 1 entry to record the lease payment and expense

Dr. Lease expense	51,500 <b>A</b>	
Cr. Lease liability		20,076 <b>C</b>
Cr. Accumulated amortization		31,424 <b>A-C</b>

Year	Straight Line Rent Expense <b>A</b>	Beginning Lease Liability Balance	Cash Payments <b>B</b>	Interest Expense <b>C</b>	Principal <b>B-C</b>	Ending Lease Liability Balance	Reduction in ROU Asset <b>A-C</b>	Right of Use (ROU) Asset
1	51,500 <sup>5</sup>	392,017	50,000	20,076 <sup>6</sup>	29,924	362,093	31,424	375,593
2	51,500	362,093	50,000	18,320	31,680	330,413	33,180	342,413
3	51,500	330,413	50,000	16,460	33,540	296,873	35,040	307,373
4	51,500	296,873	50,000	14,491	35,509	261,364	37,009	270,364
5	51,500	261,364	50,000	12,407	37,593	223,771	39,093	231,271
6	51,500	223,771	50,000	10,200	39,800	183,971	41,300	189,971
7	51,500	183,971	50,000	7,864	42,136	141,835	43,636	146,335
8	51,500	141,835	50,000	5,391	44,609	97,226	46,109	100,226
9	51,500	97,226	50,000	2,774	47,226	50,000	48,726	51,500
10	51,500	50,000	50,000	-	50,000	-	51,500	-
	515,000		500,000	107,983	392,017		407,017	

5. Cost of lease (ten (10) \$50,000 lease payments + initial direct cost \$15,000) / 10 years

6. (Lease liability \$392,017 - 1st payment of \$50,000 on commencement date) x 5.87%

Operating lease accounting continues to be straight-line rent expense (SLRE) pattern over the term of the lease. However, a company takes into account the interest on the liability and adjusts the ROU amortization. Therefore, a company first calculates the interest and deducts this amount from the SLRE (A-C above) to calculate the ROU amortization (effectively a “plug”).

This approach is based on interpretation of ASU 2016-02 Basis of Conclusion 253 which states “the carrying amount of the right-of-use asset in an operating lease determined in this manner would represent and approximate the present value of the remaining benefits to the lessee at each measurement date.”



## Finance lease

Assume the same facts as the lease classification example on page 7 except that economic life equaled lease term (10 years) causing it to be a finance lease (criteria #3).

### Initial recognition entry

Dr. Right-of-use (ROU) asset	407,017
Cr. Cash	50,000
Cr. Initial direct cost liability	15,000
Cr. Lease liability	342,017

### Year 1 entry to record the lease payment and expense

Dr. Interest expense	20,076 <b>c</b>
Dr. Amortization expense	40,702 <b>a</b>
Cr. Lease liability	20,076 <b>c</b>
Cr. Accumulated amortization	40,702 <b>a</b>

	Amortization Expense	Beginning Lease Liability Balance	Cash Payments	Interest Expense	Principal	Ending Lease Liability Balance	Right of Use (ROU) Asset
	<b>a</b>		<b>b</b>	<b>c</b>	<b>b-c</b>		
1	40,702 <sup>7</sup>	392,017	50,000	20,076 <sup>8</sup>	29,924	362,093	366,315
2	40,702	362,093	50,000	18,320	31,680	330,413	325,613
3	40,702	330,413	50,000	16,460	33,540	296,873	284,911
4	40,702	296,873	50,000	14,491	35,509	261,364	244,209
5	40,702	261,364	50,000	12,407	37,593	223,771	203,507
6	40,702	223,771	50,000	10,200	39,800	183,971	162,805
7	40,702	183,971	50,000	7,864	42,136	141,835	122,103
8	40,702	141,835	50,000	5,391	44,609	97,226	81,401
9	40,702	97,226	50,000	2,774	47,226	50,000	40,699
10	40,699	50,000	50,000	-	50,000	-	-
	<b>407,017</b>		<b>500,000</b>	<b>107,983</b>	<b>392,017</b>		

7. Right-of-use (ROU) asset \$407,017 / 10 years

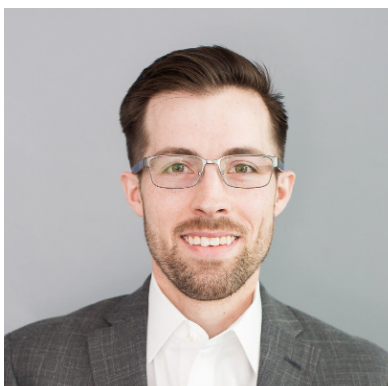
8. (Lease liability \$392,017 - 1st payment of \$50,000 on commencement date) x 5.87%

## Contacts

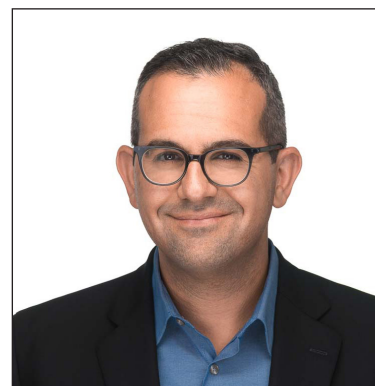
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