THE NEW LEASE STANDARD

a comprehensive guide to ASC 842, GASB 87 & 96, and IFRS 16

LEASECRUNCH®

LEASECRUNCH
SIGNIFICANTLY REDUCES THE TIME NEEDED
TO ACCOUNT FOR AND MAINTAIN LEASES

by helping organizations implement the new lease accounting standards.

LEASE AUDIT "HOW-TO" AND CHECKLIST

1. INTRODUCTION
2. UNDERSTANDING WHAT QUALIFIES A LEASE
3. HELPING CLIENTS MAKE THE RIGHT POLICY ELECTIONS

INTRODUCTION

A CRITICAL PART OF IMPLEMENTING THE NEW LEASE ACCOUNTING STANDARD IS REVIEWING EXISTING CONTRACTS,

determining **what does and doesn't qualify as a lease**, and creating initial journal entries to apply the standard to the balance sheet.

BEFORE REVIEWING YOUR PORTFOLIO OF CONTRACTS, IT'S IMPORTANT TO UNDERSTAND EXACTLY WHAT QUALIFIES

as a lease under the new lease standard.

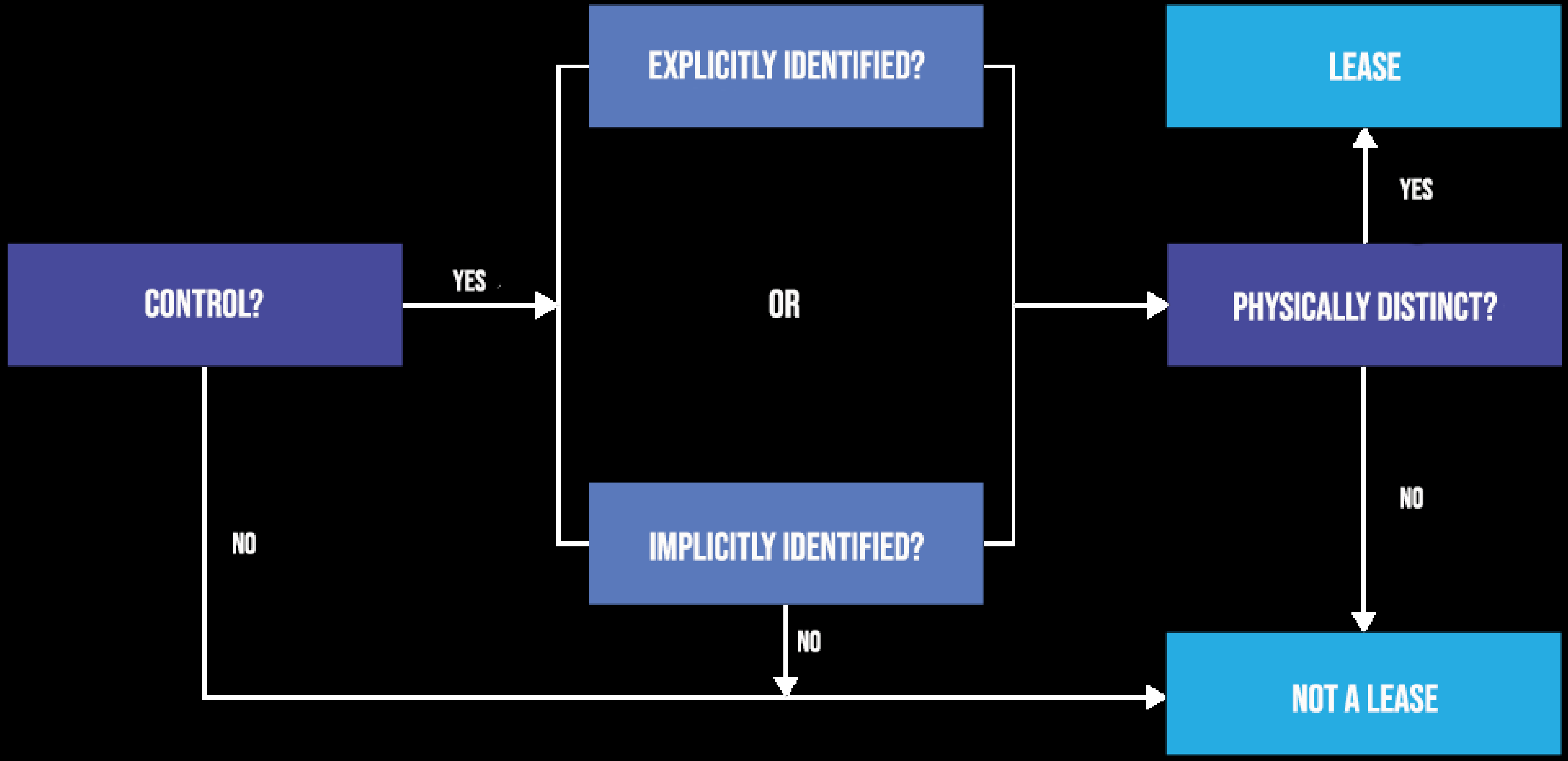
Understanding What Qualifies As A Lease

Under the new lease standard, all leases must be recognized as both an asset and offsetting liability for future lease payments.

This is a big difference from the previous standard, where operating leases were not reflected on the balance sheet.

UNDERSTANDING WHAT QUALIFIES AS A LEASE

There are a few considerations that help determine if a particular contract contains a lease:



LEASECRUNCH®

One key to knowing that you have a lease rather than another type of contract is whether you have the right to control or use an asset.

Additionally, the asset itself must be explicitly or implicitly identified, as well as be physically distinct. Also keep in mind that some leases are actually being leased as part of that vendor contract.

IDENTIFYING EMBEDDED LEASES

Embedded Lease

An organization has an embedded lease when there is a contract with a vendor that uses an asset as part of the value provided and the use of that asset meets the definition of a lease.

A CONTRACT MAY CONTAIN A LEASE EVEN IF IT'S A SERVICE CONTRACT.

TO PROPERLY IMPLEMENT THE NEW LEASE STANDARD, ORGANIZATIONS SHOULD REVIEW EVERY CONTRACT

to ensure **all leases**, regardless of labeling, are **properly included** in the financial statements.

According to 842-10-15-3:

"A contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. A period of time may be described in terms of the amount of use of an identified asset."

For example, the number of production units that an item of equipment will be used to produce.

THE EMBEDDED LEASE IDENTIFIER IS AN EXCELLENT FREE TOOL TO MAKE IDENTIFYING POTENTIAL EMBEDDED LEASES

within contracts vastly simpler and quicker over doing so manually.

LEASECRUNCH®

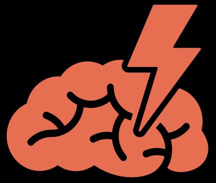
WITH ANY RULE, THERE ARE ALWAYS EXCEPTIONS.

FOR EXAMPLE, THE LEASING STANDARD DOES NOT REQUIRE LESSEES TO APPLY THE GUIDANCE TO LEASES WITH A TERM

of 12 months or less.

ADDITIONALLY, THERE ARE CERTAIN LEASING SCENARIOS THAT EXEMPT THE LEASE FROM CONSIDERATION.

Examples Of Exempt Leases



- Leases of intangible assets (e.g., goodwill, etc)
- Leases to explore or use non-renewable resources (e.g., oil, natural gas, etc)
- Leases of biological assets (e.g., timber, livestock, etc)
- Leases of inventory or assets under construction
- If you comply with the IFRS standards, you may elect to not apply the new lease standard if the underlying asset is of low value

SEPARATING LEASE / NON-LEASE COMPONENTS

LEASECRUNCH®

NOT ALL COSTS RELATED TO A LEASE ARE INCLUDED IN THE LEASED ASSET AND LIABILITY.

Example Of Costs Not Included In Lease Liabilities

A lessor may lease a truck and also include a provision to operate the truck on behalf of the lessee. Providing a driver, maintenance, and gas are not related to securing the use of the truck and these costs would be considered non-lease components.

ON THE OTHER HAND, COSTS ATTRIBUTABLE TO SECURING THE ASSET ITSELF SHOULD BE INCLUDED IN THE LEASE PAYMENTS

for both classifying and measuring the lease.

Example Of A Cost That Should Be Included In Lease Payments

A non-refundable upfront deposit would be considered a lease component.

A HALLMARK OF ASC 842 IS THAT IT REQUIRES QUITE A BIT OF JUDGMENT. THIS MEANS YOU NEED TO THINK ABOUT THE INTENT

of a particular payment to **determine whether it should be included or excluded.**

THIS IS A GOOD STARTING PLACE TO START

when considering how to classify lease-related payments.

Likely To Be Lease Components

- Fixed lease payments
- Lease payments that vary based on an index or rate (see the variable leases section below for differences between FASB and IFRS)
- A fixed portion or minimum for a variable lease payment (see Variable Leases section below for more detail)
- Non-refundable deposit
- Early termination fees (if likely to terminate the lease early)
- Residual value guarantees

THIS IS A GOOD STARTING PLACE TO START

when considering how to classify lease-related payments.

Likely To Be Non lease-Components

- Service contracts for the leased asset (fuel, consulting, maintenance)
- Included parking spaces, if in an area where parking is at a premium
- Common area maintenance

THIS IS A GOOD STARTING PLACE TO START

when considering how to classify lease-related payments.

Not Likely To Be Lease Or Non-Lease Components

- Real estate taxes
- Insurance

POLICY ELECTIONS

A CRITICAL PART OF IMPLEMENTING THE NEW LEASE STANDARD, INCLUDING AUDITING LEASES IS MAKING

the required policy elections, summarized on the next slides.

LEASECRUNCH®

Short-term leases

Lessees may make a policy election not to apply the standard (that is, not recognize a right of use asset or lease liability) to short-term leases of 12 months or less for all classes of underlying assets. If this election is made, the lessee would recognize the lease payments as operating expenses straight-line over the lease term.

This election saves time in accounting for these leases, but the disadvantage is that different accounting policies and processes need to be in place for short-term and long-term leases.

Non-lease components

A lessee may choose, as a practical expedient by class of underlying asset, to account for the lease and non-lease components as a single combined lease component. If this election is not made, the lease payments are allocated to the separate lease and non-lease components, using relative standalone prices (estimated if not readily available).

While this expedient saves time, the lessee will have a larger liability (and ROU asset) by treating non-lease components as lease components.

Discount Rate

An update made by the FASB in November 2021 makes it easier to comply with the new lease accounting standard.

Recognizing the need for additional flexibility on determining the discount rate, the FASB now allows a nonpublic company to elect using the risk-free rate by asset class. While this election and the asset classes to which it applies must be disclosed, this is an important and positive change.

Organizations can now take the extra time to calculate what is likely a higher collateralized borrowing rate for their largest dollar-value leases, such as office space. For lower-value assets, like vehicles or small equipment, the impact of using the more easy-to-determine risk-free rate is twofold: it saves time and the impact to the lease liability is likely far less material.

Classification Criteria

If any of the five criteria in ASC 842-10-25-2 were met, a lessee would classify the lease as a finance lease.

1. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

2. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

3. The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.

4. The present value of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying asset.

5. 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.

Classification Criteria (Continued)

One of these evaluation criteria is whether the lease term is for a major part of the economic life of the underlying asset. Lessees can make a policy election, by class of asset, to define what percentage constitutes a major part.

Although the FASB did not include a bright-line percentage in ASC 842 as in prior guidance, it has indicated that 75% of the asset's remaining economic life is a reasonable approach.

ANOTHER OF THE FIVE EVALUATION CRITERIA IS TO DETERMINE WHETHER THE PRESENT VALUE OF THE SUM

of the lease payments **equals or exceeds** substantially all of the fair value of the underlying asset.

LESSEES CAN MAKE A POLICY ELECTION, BY CLASS OF ASSET, TO DEFINE WHAT PERCENTAGE SUBSTANTIALLY CONSTITUTES “ALL”

Reasonable Approaches And Guidance

Although the FASB did not include a bright-line percentage in ASC 842 as in prior guidance, it has indicated that 90%of the asset’s remaining economic life is a reasonable approach.

The advantage of defining the major part and substantially all using 75% and 90% respectively, is consistent accounting application across the lease portfolio.

Presentation of ROU Assets and Lease Liabilities

Lessees can make a policy election on how to present their finance and operating lease ROU assets and lease liabilities in their statements of financial position and related footnotes. They can elect to present a separate statement of financial position line items for finance lease ROU assets, operating lease ROU assets, finance lease liabilities, and operating lease liabilities.

Or they can disclose in the footnotes, where each of these types of assets and liabilities has been included in the financial statement line items. If leases are not significant, clients may find disclosure in the footnotes to be a better election.

Transition Reliefs

A number of practical expedients are available for lessees to apply to leases that commenced before the standard's effective date. The following practical expedients must be elected as a package and, if elected, applied to all leases. Lessees can elect not to assess:

1. Whether expired or existing contracts are or contain leases,
2. Lease classification for any existing or expired leases, and
3. Whether initial direct costs would have qualified for capitalization for any existing leases.

These three practical expedients can save significant time during the implementation process and we see most organizations adopt them.

Transition Reliefs (Continued)

Another expedient that can be elected for existing leases at transition is to use hindsight regarding lease renewals and purchase options when determining the lease term and in assessing impairment of the ROU asset. This relief can be elected independently of the previous practical expedient, but it must be applied consistently to all leases.

Interestingly, this seems like it would be helpful. In practicality, it opens a proverbial “can of worms” and we see most organizations not electing this expedient.

Another Expedient:

Lessees may apply a single discount rate to a portfolio of leases with reasonably similar characteristics (such as a similar lease term for a similar class of asset). A single discount rate cannot be applied to the entire lease portfolio.

In July 2018, the FASB issued an additional transition relief option for lessees, allowing entities to use the effective date of the new lease standard as their date of initial application.

For example, the initial application date for most privately held companies with a calendar year-end is January 1, 2022 if this transition relief is elected.

With this transition method, comparative prior years on the financial statements do not have to be restated. As you can imagine, almost all organizations following GAAP are electing to not restate prior periods.

LEASE REVIEW CHECKLIST

LEASECRUNCH®

ONCE IT'S TIME TO CONDUCT AN ACTUAL REVIEW OF EACH LEASE, YOU'LL WANT TO WALK THROUGH A NUMBER OF QUESTIONS.

Examples on next slide and/or you can download our free Office Space and Vehicle lease review checklists to simplify the process.

1. Determine if it is a lease for accounting purposes under the new lease standard, taking into consideration asset control and identification.
2. Note general information about the lease, including name, description, lessor, lease terms, termination clauses, renewal options, discount rate, etc.
3. Outline lease payment terms, including payment frequency, amount, start date, and other relevant details.
4. Classify the lease correctly based on ownership, economic life, and fair value of the leased asset.
5. Calculate variable and non-lease payments.

LEASECRUNCH®