OCCUPIER

HOW TO PREPARE FOR ASC 842

THE ULTIMATE LEASE ACCOUNTING GUIDE

PREPARED BY

Lauren Covell, CPA

VP of Finance at Occupier

WHO DOES
ASC 842 AFFECT?

Whether you are a large publicly traded company, or a private business occupying a handful of leased locations, by the end of 2021, you will be faced with the challenge of complying with updated standards for how you account for your lease obligations. A large part of your transition to the new standards will be gathering your lease data to gain a detailed understanding of the financial and non-financial aspects of your leases. You will also be tasked with understanding the new standards and how certain determinations and treatments may impact your balance sheet. In this guide, we will walk through the basics of the new standards, and set you on the right path for tackling compliance.

The new lease accounting standards (ASC 842/IFRS 16) were implemented to increase visibility into the leasing obligations of organizations. Prior to these accounting standards, most leases were not included on the balance sheet. The new standard requires companies to report right-of-use (ROU) assets and liabilities for almost all leases. These changes make it easier for users of financial statements to assess a company's exposure to risk, determine the true financial position of an organization, and facilitate comparisons between organizations.

Your transition process to the latest lease accounting standards can include the development of a new leasing strategy; the creation of new processes and controls; and the selection, management and implementation of new software. Throughout the process, it will be important to incorporate lessons learned from public and private companies that have already adopted the standards in order to continuously improve the implementation and create sustainable processes for ongoing lease accounting.

What are the new lease ACCOUNTING STANDARDS?

The most notable difference under the new accounting standards is companies are now required to capitalize operating leases on the balance sheet — reporting them as ROU assets and lease liabilities. Additionally, companies must disclose more qualitative and quantitative disclosures under ASC 842, such as weighted average discount rate, weighted average remaining lease term, cash paid for amounts included in lease liabilities, and a more descriptive maturity analysis.

Under the new lease accounting standards, more contracts will be leases or considered to contain a lease. For example, embedded leases are commonly found in IT service contracts, where a vendor may provide specific equipment (such as onsite servers). They are also frequently found in supply contracts, dedicated manufacturing capacity contracts, and advertising agreements (such as use of billboards).

If a lease is determined to exist at contract inception, companies will classify and initially measure the ROU asset and lease liability on the lease commencement date, the date the lessor makes the underlying asset available for use by the lessee. The lease classification criteria changes are summarized in the chart below:

LEASE CLASSIFICATION CRITERIA CHANGES:

ASC 840 (Legacy GAAP)	ASC 842	IFRS 16
A lease should be classified as a capital lease if it meets one of the following criteria: • Transfer of ownership. • Bargain purchase option. • Lease term is equal to 75 percent or more of the estimated economic life of the leased property. • Present value of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased property.	A lease should be classified as a finance lease if it meets one of the following criteria: • Transfer of ownership. • Bargain purchase option. • Lease term is for a major part of the estimated economic life of the leased property. • Present value of the lease payments is substantially all of the fair value of the leased property. • The leased asset is so specialized that it would have no alternative use to the lessor at the end of the lease term. Although the lease classification criteria under ASC 842 differ from those under ASC 840, the FASB has stated that an entity may use the bright lines established under ASC 840 when evaluating the more principles-based criteria in ASC 842.	There is only a single accounting model for leases (i.e., all leases are effectively equivalent to finance leases under ASC 842), so classification of leases is unnecessary.

All leases (finance and operating leases), other than those that elect the short-term recognition exemption or materiality exception (IFRS 16 only), must be recognized as of the lease commencement date on the lessee's balance sheet based on the following calculations:

Day 1 Lease Liability = Present Value of Remaining Lease Payments @ Discount Rate*

*For a lessee, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate based on information available at the lease commencement date. Under ASC 842, private companies are permitted to use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term.

Day 1 ROU Asset = Lease Liability + Prepaid Lease Payments + Initial Direct Costs - Lease Incentives

The initial recognition of the lease liability and ROU asset will be the same regardless of lease classification. Subsequent to Day 1, interest and amortization expenses are recognized for finance leases while only a single lease expense is recognized for operating leases, typically on a straight-line basis.

After the lease commencement date, there are numerous reasons a lease term may be amended - to account for a lease extension, early termination of the lease, a change in timing of lease payments, leasing additional space, etc.

Depending on the facts and circumstances, a lease modification may be accounted for by the lessee and lessor as either (1) two contracts – the original contract and a separate new contract, or (2) one modified contract. When a lease modification is accounted for as one modified lease, the lessee and lessor must reassess the lease classification and remeasure the lease utilizing an updated discount rate similar to if it was calculating the Day 1 ROU Asset and Lease Liability.

The time is now:
START IMPLEMENTATION

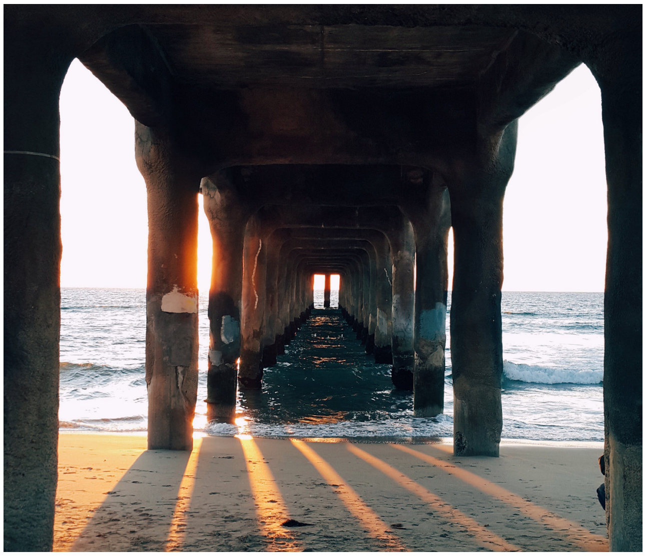
Although the FASB extended the effective date for private companies to transition to ASC 842 to the end of 2021, the deadline is now fast approaching.

If your year end is:	You must transition to ASC 842 by:
December 31, 2021	January 1, 2022
March 31, 2021	April 1, 2022
June 30, 2021	July 1, 2022
September 30, 2021	October 1, 2022

Organizations should make use of all the time between now and the deadline to identify leases, extract data, input data into a lease accounting system, and test the system under the standard's rules, among other steps. To comply with the standards, accounting teams must review their inventory of contracts and perform a series of complex assessments to determine if there is an identified asset within the contract, the scope of the customer's right to use the asset, and the types of economic benefits the customer obtains from the asset. Accounting teams will even need to review outsourced and service agreements, such as contract manufacturing, third party logistics, and data center outsourcing, to determine if the contract is or contains a lease. Despite the growth in technology, most company contracts are not centrally located and are often owned by various stakeholders of an organization. This chaos provides an additional layer of complexity to the implementation process.

Once the lease population into a lease accounting software system is complete with all relevant contracts available, accounting teams must review the leases and abstract all relevant lease inputs. Unfortunately, no artificial intelligence or automated data abstraction tools have been invented to scan these contracts for evidence of implicit assets. Instead, teams will rely on performing a manual contract analysis to review each agreement and follow FASB's flow chart for identifying whether a contract meets the definition of a lease.

The lease accounting standard also increases a lessee's administrative burden due to the required increase in process controls; data collection, analysis, and maintenance; monitoring; internal reporting systems; and, most importantly, audit scrutiny.



Here are some of the key factors contributing to the added burden:

- Data to calculate payments comes from several sources in the organization, including Accounting, Procurement, Accounts Payable, and the asset users.
- Calculation of lease payments is complex.
- Non-lease components in gross or bundled billed payments must be separated (unless the practical expedient not to separate is selected by asset class).
- Calculation of some payments involves judgments and estimates.
- Financial disclosure requirements are expanded.

For most companies, the scale of the administrative requirements will mean additional systems and tactical support. This is especially true if a company's lease portfolio includes many lease schedules with multiple assets, non-homogeneous assets, lessors, countries, or languages.

Given the shrinking time box companies are operating under, support from external resources may be just as important as internal stakeholder participation. The level of effort required to collect data, implement software, and modify business processes will require a significant number of resources with highly specialized skills sets. The challenges are multiplied by the relatively short time period remaining before the compliance deadline.

HOW CAN YOU DRIVE

A SUCCESSFUL IMPLEMENTATION?

1. **Develop a working knowledge of the accounting standard:**
Having a working knowledge of the new accounting standard will allow you to better understand what information you will need, how current processes will need to change, and who needs to be involved.

2. **Designate a steering committee:**
Designate a committee to drive the ASC 842 implementation success. This committee should include people outside of the Accounting team, such as representatives from Financial Planning & Analysis, Internal Audit, Real Estate, Legal, IT, and Purchasing/Supply Chain.

3. **Develop an implementation game plan:**
The following milestones are a great start to consider in your implementation plan.

sales@occupier.com | @occupierhq

3a.

Development of accounting policies and election of practical expedients:
ASC 842 offers explicit practical expedients that can be elected by certain entities or in certain arrangements. These elections include the following:

ia.

Accounting policy elections by class of underlying asset:

Short-term lease, a lease that at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise, may elect not to apply the recognition requirements of ASC 842. Instead, a lessee may recognize the lease payments in profit or loss on a straight-line basis over the lease term.

ib.

Accounting policy elections by class of underlying asset:

A lessee may choose not to separate non-lease components from lease components and instead to account for each separate lease component and the non-lease components associated with that lease component as a single lease component.

ii.

Election for lessors for all leases:

A lessor may exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee.

iii.

Election for private company lessees for all leases:

Private companies may use a risk-free discount rate in lieu of its incremental borrowing rate when assessing lease classification and when measuring its lease liabilities.

iv.

ASC 842 transition reliefs:

1. Use of hindsight in determining the lease term (that is, when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of the entity's right-of-use assets.
2. The package of three practical expedients allows an entity not to reassess at the ASC 842 transition date whether a contract is or contains a lease, lease classification, and initial direct costs if this election is made.
3. Land easement practical expedient allows entities to elect not to assess whether those land easements are, or contain, leases in accordance with ASC 842 when transitioning to ASC 842.

3b.

Compilation of all leases: Most companies are not starting their ASC 842 implementation journey with a centralized location of all relevant leasing information. For instance, the ownership for equipment leases may be distributed across a large number of stakeholders with data fragmented across a number of different asset management systems and spreadsheets. Therefore, accounting teams must hunt to collect all the data from various teams, records, and systems across the business. Below is a listing of tips to ensure you have a complete population of leases:

i.

Ask around:

A strategy for identifying the lease population is simply to ask your employees what they lease. Many companies are distributing mass surveys to business units with a questionnaire about current leasing programs.

ii.

Follow the money:

A list of the past twelve months of disbursements can be reviewed to identify patterns such as recurring payments or other expense profiles that might resemble a lease. Armed with a list of lease candidates, the accounting team can consult the business sponsors who approve the invoice payments to gather more specifics about the line items being billed under each contract.

iii.

Review Completed Work:

Compare maintenance records from your plants, warehouses, stores, and office buildings to your list of leased equipment assets. Are there forklifts, machinery or other types of equipment that is being regularly serviced that are not on your list? If so, track down the assets to find out whether they were leased or purchased.

iv.

Ask for Help:

If you cannot get the answers you are seeking from internal systems, consider going to the source - the leasing company. The lessors know better than anyone the details of each and every asset you are renting from them. Landlords can provide a list of the property addresses as well as details on parking structures, plots of lands, and the floors of the buildings being leased. Equipment lessors can share the serial numbers, vehicle identification numbers, and other asset identifiers for each individual piece of equipment being leased.

3c.

Completion and storage of all lease abstracts:

Now that you've completed all the heavy lifting of finding all of your leases, you will want to organize all relevant leasing information to ensure anyone who needs the information can access it on demand. In addition, performing a lease abstraction for each lease is necessary as you will need all critical lease details to successfully implement ASC 842. As many accounting teams do not have the expertise to abstract all relevant information from leases, this is a great area to look at potentially outsourcing.

4. **Evaluate Internal Resources:**
Does your internal team have the expertise and the capacity to take on a project of this magnitude? If not, companies should determine if the company would benefit from hiring additional FTE or external consultants. One benefit of using external consultants is they often have the expertise and experience to navigate the challenges of this magnitude. However, consultants are often more expensive and typically have short term engagements- leaving the company to drive ongoing ASC 842 compliance.

5. **Solution Selection and Implementation:**
While your company may still be deciding on whether they will utilize a software solution to implement ASC 842, we have found lease accounting software alleviates a huge burden to maintaining compliance with ASC 842 after the effective date. For instance, a company with 300 leases will have to track an average of 230 events in a single year as leases are terminated, new leases are signed, and changes occur throughout the lease term. Real estate leases have frequent rent changes as well as expansion clauses, tenant improvement allowances, and early renewal options that can be executed at various points in a lease. Equipment assets under lease can be lost, stolen, damaged, purchased, returned, renewed, or upgraded during the relatively short term of typical equipment lease. Tracking these activities with spreadsheets and emails will prove challenging even to the most organized of accountants. Therefore, we suggest selecting a software solution to save time and reduce the risk of manual error that working in spreadsheets presents. Also, companies who have invested in lease accounting software are more effective in ways that expand beyond the new standards:

- Better forecasting and budgeting capabilities
- Improved communication with facilities and procurement departments
- Enhanced transparency into the lease portfolio and its impact on key financial metrics
- Access to features that meet unique business needs, such as contingent rent and custom calendars

We are here
TO HELP!

The Purpose of this Guide:

FASB ASC 842 significantly impacts the accounting processes for leases under US GAAP. This guides serves as a blueprint for these new lease accounting standards.

This playbook also advices on how and why to get implementation started early on ASC 842 ensuring you are complaint.

In order to meet the compliance deadline, companies should start:

1. Forming a Project Team with stakeholders from finance, accounting, real estate, and IT
2. Learning and becoming familiar with the new standards
3. Considering software and processes to help with the heavy lifting of ASC 842

About Occupier

Founded in 2018 and headquartered in New York City, Occupier is one of the leading lease solution providers for tenants. The Occupier Team combines their deep experience in the commercial real estate (JLL) and proptech industries (VTS, ProCore, WeWork), and applies it to the world of the occupier.

Tenants are faced with unique real estate challenges and we set out to build digital solutions that automate and streamline the management of your lease portfolio and transactions. We started Occupier with the goal of connecting brokers, real estate teams, and lease accounting professionals so that you can make smarter, more informed leasing decisions for your business.