Leases: The Countdown Begins for Private Companies & Not-for-Profit Organizations

The countdown begins now for a successful implementation of the new lease standard, Accounting Standards Codification (ASC) 842. The overriding message from public company adopters across all industries is to not underestimate the time and resources needed. The effect on each entity will vary depending on the number and variety of lease types and extent of change from existing industry practices. The new rules may significantly affect an individual lessee’s statement of financial position by increasing lease-related assets and liabilities; this is particularly seen for lessees in the retail, financial services, shipping and other transportation-related industries. Changes may affect compliance with debt covenants and key financial ratios. Impacted entities will face increased disclosure requirements and will need to redraft accounting policies under the new principles and update internal controls.

Finding and reviewing lease and “rental” agreements will be a significant undertaking. This task will require many departments of the entity working together. Implementing the standard likely will require an early start to the process and a clearly defined action plan to comply with the standard’s requirements.

This paper will provide a high-level, quarter-by-quarter action plan to help ensure a smooth, efficient transition. Collaborating early and often with your auditor will help you avoid any unpleasant surprises. Schedule regular time to evaluate progress and discuss challenges, judgments and conclusions. Whether or not you are an audit client, BKD can help.

Effective Dates
Leases ASC 842

Public Entities
Annual and interim reporting periods beginning after December 15, 2018

All Others
Annual reporting periods beginning after December 15, 2019

Lease Adoption Timeline

<table>
<thead>
<tr>
<th>Adoption Date</th>
<th>Q1 2019</th>
<th>Q2 2019</th>
<th>Q3 2019</th>
<th>Q4 2019</th>
<th>Q1 2020</th>
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</thead>
<tbody>
<tr>
<td>2018 Financial Statement Close</td>
<td>Educate</td>
<td>Find Leases</td>
<td>Analyze In-Scope Leases</td>
<td>Document Final Analysis Conclusion</td>
<td>Finalize New Disclosures</td>
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<tr>
<td>Establish Project Guidance</td>
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<td></td>
<td>Review Significant Judgments with Advisor</td>
<td></td>
<td>Draft New Financial Statement Presentation</td>
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<tr>
<td>Determine Scope</td>
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<td></td>
<td>Develop New Policies &amp; Internal Controls</td>
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<td>Communicate Impacts to Interested Parties</td>
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<tr>
<td>Review System Requirements</td>
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<td></td>
<td>BKD’s 2019 Audit Fieldwork, Wrap-Up and Report</td>
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<tr>
<td>BKD’s 2018 Audit Fieldwork, Wrap-Up and Report</td>
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Details for each quarter are included in Appendix A.
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Conclusion

The adoption of ASC 842 may be complex and likely will require significant hours to implement correctly. If you would like assistance complying with the lease standard, contact your trusted BKD advisor. BKD has prepared a library of BKD Thoughtware® on lease implementation issues. Visit our website to learn more.

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Appendix A

First Quarter 2019

Educate

Individuals throughout the organization will need to understand the new lease accounting rules because they represent a fundamental change from current guidance. As highlighted below, finding leases will require cross-functional effort. Certain staff outside the accounting department will need a high-level understanding of the rules to ensure population control.

Establish Project Governance

Create a governance and project management structure. Meetings and communications should include representatives from real estate, property management and lease administration, maintenance, logistics, IT, procurement, legal, financial planning and, of course, accounting. Identify a champion or team to lead adoption efforts and work directly with auditors. Some questions to consider in assessing the size and scope of implementation plans include:

- How many different types of lease transactions exist?
- Where are lease contracts stored?
- Is the procurement process centralized or separately performed at each location/company?
- How are details of lease terms maintained and at what level?
- What systems manage lease data?

Develop and document a project timeline, roles and responsibilities for implementation. Consider team bandwidth and competencies and conclude on the level of outside assistance needed. Determine if accounting staff have adequate resources to perform compliance tasks in addition to regular duties or if additional resources or consultants are necessary for the project. As new processes are developed, have training to educate employees on the changes.

Scoping

Lease Population

First, determine which contracts meet the definition of a lease. At contract inception, entities will need to determine whether a contract is or contains a lease by assessing whether—throughout the period of use—the lessee has the right to direct an asset’s use and substantially obtain all the economic benefits from directing its use.
ASC 842’s scope is substantially the same as ASC 840. However, entities may exclude short-term leases—those lasting a maximum of 12 months at inception, including any options to extend—from measurement as a right-of-use (ROU) and lease liability if the company elects that practical expedient.

**Embedded Leases**

Entities regularly enter into contracts that cover both the right to use an asset and paying for the asset’s maintenance services. Examples of this include leasing a building and paying for maintenance services, or leasing copiers and paying for print management services or maintenance services, all in one agreement. Identifying and collecting the contracts that may contain embedded leases can be tricky, as these contracts do not use the term “leases.” Rather than asking if contracts may contain embedded leases, ask whether any service contracts involve the use of specific assets as part of the service delivery. Discussion with the facilities team and site visits will help uncover these embedded leases. See Appendix B for examples of items to look for.

Lessees have a practical expedient available—by class of underlying assets—to not separate lease and nonlease components. If elected, a lessee is required to account for the lease and nonlease components as a single lease component with special disclosures. The election applies to all leases in a class. While the expedient eliminates the price allocation process, it will increase the total lease liability recorded on the balance sheet.

Lessors have a similar practical expedient; however, it is limited to circumstances in which both:

- The timing and pattern of revenue recognition are the same for the nonlease and related lease component
- The combined single lease component would be classified as an operating lease

If the nonlease component or components associated with the lease component are the predominant component of the combined component, an entity is required to account for the combined component under ASC 606, *Revenue from Contracts with Customers*. Otherwise, the entity must account for the combined component as an operating lease under ASC 842.

*Since almost all leases will be recognized on the balance sheet, an entity’s judgment in distinguishing between leases and services becomes more critical under the new guidance.*
Practical Expedients

FASB acknowledges the challenge of updating long-standing accounting guidance for organizations with a large lease portfolio. The initial standard and subsequent amendments provide substantial relief. Reviewing and incorporating available relief early in the planning process will save considerable time and effort.

<table>
<thead>
<tr>
<th>Optional Relief</th>
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<tbody>
<tr>
<td><strong>Transition Elections</strong></td>
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<tr>
<td>Expendient package – Identification, classification, initial direct costs* (Accounting Standards Update (ASU) 2016-02)</td>
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<tr>
<td>Hindsight (ASU 2016-02)</td>
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<tr>
<td>Land easements (ASU 2018-02)</td>
</tr>
<tr>
<td>Prior period presentation (ASU 2018-11)</td>
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</tbody>
</table>

*Must be elected as a package

Disclosures

Additional data will need to be collected, and additional monitoring and record-keeping will be required. Developing a work plan upfront can avoid duplication of efforts and make data gathering more efficient. For more information, see BKD articles Lease Presentation & Disclosure Requirements: Lessee and Lessor Presentation & Disclosure Requirements.

Review System Requirements

Current lease IT systems primarily focus on lease management rather than accounting and usually handle real estate leases. Today, many entities use spreadsheets to track leases and prepare required disclosure and accounting evaluation. Given the comprehensive accounting and disclosure requirements of the new standard, entities likely will need to supplement their current IT systems or implement new IT systems to address ASC 842 requirements.

Entities with a small lease portfolio may be able to leverage their existing manual processes or IT systems; however, a large portfolio of leases may require significant technology investment. In addition to the initial implementation, consider the effect of ongoing disclosure and remeasurement requirements. For some entities, a hybrid approach may be the best option—selecting a leasing system for a significant portfolio of real estate and property leases and executing a manual process for an insignificant amount of equipment leases. Several public companies regretted their initial conclusion to go it alone and incurred additional time and expense by later overhauling or purchasing IT systems.

*This decision should be re-evaluated after the review of in-scope leases.*
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Second Quarter 2019

Finding the Leases & Required Data Points

The greatest challenge for most entities will be finding the lease population and all the necessary data. Entities with a standardized contract process and centralized repository likely will have an easier time identifying lease contracts. Data challenges include:

- Data housed in various systems and operating units
- Lack of resources
- Information is not all in one agreement
- Number of new data elements required
- Information may not be contained in lease agreements, e.g., the fair value of an asset, the asset’s estimated useful life or the incremental borrowing rate

Some areas to search for leases:

- Accounts Payable – This is the most reliable source for getting a comprehensive, enterprisewide list of leases. Get a report of all invoices paid on a regular basis. Do not only use last month’s data because some leases are only invoiced on a quarterly, semi-annual or annual basis. The list of recurring payments will include not only historical “leases,” but also FASB’s expanded definition of a lease, which includes some outsourcing and service contracts.

- Accounting/Finance/Internal Audit – Various finance groups are responsible for ensuring that property taxes are paid, insurance coverage is obtained and the assets are properly reported. Under current guidance, capital leases are reported on the balance sheet and operating leases are included in the notes disclosure. Drill down from the notes disclosure to the individual leases making up those totals to find out who in your organization is responsible for collecting the lease data today and the tracking mechanisms.

- Procurement/Legal – Although lease requests may originate from various departments (real estate, IT, logistics, store operations), all leases ultimately need to flow through the procurement or legal departments to negotiate pricing and contractual terms; they should know what is being leased, where the contracts reside and be able to provide a list of relevant contracts. Do not only ask for contracts that have the word “lease” in the title; you will need to examine outsourcing and service contracts as well for possible embedded leases.

- Lessor – There is a leasing company on the other end of every contract. These companies might include commercial banks, captive finance organizations or independent leasing companies. These lessors definitely know what you are leasing because they bill you for each lease on a periodic basis.

- Facilities/IT – Someone in the organization is accountable for managing the various leased assets. IT manages leased laptops and data center gear, corporate real estate group manages building leases and facilities manage equipment. These asset owners would be a good source of information.

Education for nonaccounting areas is critical, as many will assume equipment or machines are “rented” and not subject to the new rules.

Analysis of In-Scope Leases

After identification of lease contracts, entities will need to measure those contracts to recognize the ROU assets and liabilities. Evaluation and documentation of contract terms are critical. See Appendix C for the data requirements. The determination of lease payments may seem straightforward; however, it can be complex and affected by factors including—but not limited to—security deposits, bargain and other purchase options, residual
value guarantees, variable components, e.g., payments based on an index, etc. The standard requires more management judgment than previous guidance. Key management judgments include the determination of the lease term, discount rate and amortization period. New machine learning software exists that identifies, extracts and analyzes text in contracts and other documents and may save significant time and effort.

Discount Rate – Private Company Relief

The discount rate used by the lessee and lessor is the rate implicit in the lease at the lease commencement date. If the implicit rate is not determinable, the lessee will use its incremental borrowing rate as of the date of lease commencement. FASB acknowledged private company challenges in determining an incremental borrowing rate and created an accounting policy election for nonpublic business entities to use the risk-free rate when measuring their lease obligations; once elected, it must be used consistently for all leases.

Significant judgments should be properly documented and reviewed with auditors.

Re-Evaluate IT System Capabilities

Reconsider whether improvements to the company’s IT system are necessary after an initial review of lease contracts. In addition to the initial adoption, consider remeasurement and disclosure requirements on an ongoing basis. Determine if additional modifications to the existing system or moving to a new platform is necessary and adjust the project timeline, resources and budget accordingly. Entities implementing new or enhanced system solutions to comply with the new lease requirements will have to assess the related system risks and internal controls, including review of system access, segregation of duties and change management.

Third Quarter 2019

Develop New Policies & Internal Controls

Existing controls will need to be re-evaluated and most likely enhanced for the identification of leases (including embedded leases), evaluation of lease contracts, classification, measurement and recognition of ROU assets and lease liabilities, evaluation of related estimates and preparation of disclosures. Other policies to consider can include:

- Capitalization thresholds for reporting leases
- Framework that addresses “reasonably certain” for the lease term determination
- Process to identify contracts that could contain embedded leases going forward
- Allocation process and procedures for a contract’s nonlease components
- Controls to identify remeasurement triggers

IT System Controls

Entities implementing a system solution to comply with ASC 842’s requirements also will have to assess the related system risks and design and implement related internal controls. These internal controls include:

- Logical access, change management and segregation of duties
- Application controls, such as those that maintain data integrity for the lease information, the accuracy of lease expense computations, ROU asset amortization, interest expenses, etc.
As applicable, secure and accurate integration with other systems, e.g., accounts payable, and data transfers from one system to another or from the subledger to the general ledger. Quantitative disclosures may require additional controls because the necessary information is not readily available through a company’s standard lease process. Entities also should consider that disclosures may be populated from multiple systems, i.e., some disclosures may come from the lease system and others may be populated through the general ledger; as such, new controls may need to be implemented in or around multiple financial reporting systems.

Entities should review initial conclusions of adequacy of internal controls with their auditors.

Document Final Analysis & Conclusions

Proper documentation throughout the implementation process is critical to a smooth year-end audit. Schedule time with the auditor to sign off on all key adoption concepts.

Fourth Quarter 2019

Develop Disclosures

ASC 842 enhanced and expanded disclosure requirements to provide information about the full cost of leases. Have disclosures drafted by the end of the fourth quarter—do not wait until 2020 audit fieldwork. A second set of eyes can help check that requirements are sufficiently addressed and disclosed and allow time for remediation, if needed.

Draft Financial Statement Presentation

Early adopters identified operational challenges in comparable period reporting requirements even under a modified retrospective approach with several practical expedients. The amendments in ASU 2018-11 create an additional (and optional) transition method whereby an entity initially applies ASC 842 at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption without adjusting the comparative periods presented. Prior periods presented would continue under guidance in ASC 840. This method would change when an entity would be required to initially apply the new lease standard’s transition requirements; it would not change how those requirements apply. If elected, an entity would continue to provide the required ASC 840 disclosures for all prior periods.

<table>
<thead>
<tr>
<th>Transition Timing – Private Entities, December 31 Year-Ends</th>
<th>FY 2019</th>
<th>FY 2020</th>
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<tbody>
<tr>
<td>ASU 2016-02, as Issued</td>
<td>ASC 842</td>
<td>ASC 842</td>
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<td></td>
<td>Cumulative catch-up at beginning of first year presented (January 1, 2019)</td>
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<tr>
<td>ASU 2018-11, Optional Transition Relief</td>
<td>ASC 840</td>
<td>ASC 842</td>
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<tr>
<td></td>
<td></td>
<td>Cumulative catch-up at beginning of first year presented (January 1, 2020)</td>
</tr>
</tbody>
</table>
Communicate Expected Changes to Interested Parties

Entities will need to educate lenders, bond investors and analysts, rating agencies and other financial statement users to ensure they understand the changes to financial information upon adoption. Entities must provide visibility and transparency to stakeholders, including the effect on debt ratios that could result from the addition of a large number of new liabilities formerly recorded only in footnotes as operating leases.

Debt Covenants

Careful examination of the effects of increased leverage ratios and potential debt covenant violations will be required. ASC 842 classifies operating lease liabilities as operating liabilities rather than debt, meaning these amounts should not affect the ratios used in debt covenants; however, certain credit agreements may not distinguish between the two. Many debt agreements contain “frozen GAAP (generally accepted accounting principles)” or “semi-frozen GAAP” clauses (meaning that terms are defined by the GAAP in place at the signing of the arrangements). In these agreements, a change in a lessee’s financial ratios that results solely from a GAAP accounting change either does not trigger a debt covenant default or simply requires both parties to renegotiate in good faith.

*Due to the unique terms of indenture clauses and varying state legislation, legal counsel may be required to determine if lease obligations are considered debt for debt service calculations.*
Appendix B – Examples of Potential Embedded Leases

- Agricultural Equipment
- Alarm Equipment
- Buildings
- Communications Equipment
- Construction Equipment
- Conveyor Belts
- Easements
- Forklifts
- Janitorial Equipment
- Laptops
- Medical Equipment
- Music Equipment
- Pallet Jacks
- Real Estate
- Aircraft
- Audio Visual Equipment
- Business Equipment
- Computers
- Containers
- Copiers
- Exercise Equipment
- IT Equipment
- Land
- Manufacturing Machinery
- Medical Technology
- Office Equipment
- Rail Cars
- Restaurant Equipment
- Retail Equipment
- Right of Ways
- Scissor Lifts
- Servers
- Towers
- Transportation Equipment
- Vehicles
- Retail Racks and Shelving
- Rolling Stock
- Semi-Trucks
- Software
- Trucks
- Vessels
Appendix C – Data Requirements

<table>
<thead>
<tr>
<th>Lease Payment Data Points</th>
<th>Lessee</th>
<th>Lessor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed payments</td>
<td>Fixed payments</td>
<td></td>
</tr>
<tr>
<td>Variable payments that depend on an index or rate</td>
<td>Variable payments that depend on an index or rate</td>
<td></td>
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<tr>
<td>Variable payments that are in-substance fixed payments</td>
<td>Variable payments that are in-substance fixed payments</td>
<td></td>
</tr>
<tr>
<td>Lease incentives receivable from the lessor</td>
<td>Lease incentives payable to the lessee</td>
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<tr>
<td>Amount that is reasonably certain to be paid by the lessee</td>
<td>RVG payments that are fixed in substance</td>
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<tr>
<td>under a residual value guarantee (RVG)</td>
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<tr>
<td>Exercise price of a purchase option the lessee is reasonably</td>
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<tr>
<td>certain to exercise</td>
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<tr>
<td>Lease termination penalties if the lease term reflects the</td>
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<td></td>
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<tr>
<td>lessee exercising an cancellation clause or option</td>
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<tr>
<td>Any other payments reasonably certain of being required</td>
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