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Lessons learned from the first adopters of the new lease accounting standard

Executive Summary

- Calendar year-end public companies have completed their adoption of ASC 842.
- Many private companies are just beginning their implementation process.
- Many companies have found the implementation to be more time consuming than anticipated.
- System selection is often the first critical decision.
- Extracting data from lease agreements has been challenging.
- Contracts not traditionally

Overview

Accounting Standards Codification ("ASC") 842, *Leases,* became effective for calendar year-end public companies on January 1, 2019. While many public companies have moved on to the challenges of on-going accounting and reporting under the new standard, private companies are just beginning the implementation process. Before finalizing their adoption plan, private companies can benefit from the lessons learned from those who have already completed their adoption. For calendar year-end private companies, the effective date is January 1, 2020. Depending on the industry and nature of operations, the level of effort to implement the new standard will vary significantly. Generally, those who have adopted the new lease standard are finding that the time required to implement it was greater than they anticipated.

System Selection

Choosing a lease system is often the first and most important decision adopters will encounter. Companies should carefully identify their requirements, based on the data necessary for effective financial reporting (including statutory requirements). While spreadsheets may be used temporarily to meet the adoption deadline, for many companies this is not a viable long-term solution. Companies should also consider all constituents that may be impacted. For example, many lease systems are not designed to meet tax reporting needs.

considered leases may be in the scope of the new standard.

- Private companies are allowed to use the risk-free rate for their incremental borrowing rate.
- Companies must decide whether to include renewal periods, purchase options and termination provisions when calculating the lease liability.
- Both the seller-lessee and buyer-lessor must evaluate sale lease-back transactions to determine whether a sale has occurred.
- Both the lessee and lessor must evaluate whether the lessee had control of an asset during the construction period for build-to-suit lease transactions.
- The new standard requires enhanced qualitative and quantitative disclosures

Data Gathering

Extraction of data from lease agreements remains a challenge for many companies who lack the in-house resources to extract and load leasing data into their systems. Start with a review of existing leases including amendments and asset listings and assess the completeness of the data. Companies should also assess arrangements that did not previously qualify as leases but may fall within the scope of the new standard. This process could be time consuming if companies are missing data or lease contracts or if the contracts are in a foreign language. Consider leveraging technology to expedite this process.

Lease Identification

Contracts not traditionally thought of as leases may be in the scope of the new guidance. Management needs to evaluate new and existing service contracts to determine if they contain an embedded lease component. This will often require new processes and the education of non-finance management personnel throughout the Company about the new standard. Judgment will be necessary to determine whether certain contracts, such as service arrangements, require capitalization. In some cases, a company may not identify many new leases; however, the Company will be required to document and support this assertion for their external audit.

Incremental Borrowing Rate ("IBR")

Whereas some public companies needed to obtain a third-party valuation to determine their IBR, private companies are allowed to use the risk-free rate for a period comparable to the lease term. While significantly less effort than what is required for public companies, private companies will still require processes to calculate lease liabilities using the appropriate rate.

Lease Liability

When calculating the lease liability, companies must decide whether to include renewal periods, purchase options and termination options. Additional information concerning the lease payments may be needed as well. Depending on a company's elections, an allocation between lease and non-lease payments may also be necessary.

Sales Lease-back

The new standard requires that both the seller-lessee and buyer-lessor evaluate whether control transferred such that a sale occurred for accounting purposes. While certain terms may preclude asserting control was transferred, such as when there is a fixed-price purchase option on the underlying asset, the impact of other terms may be more subjective. Even if a lessee does not take title to an asset, they will need to evaluate whether they obtained control of it at any point.

Build-to-Suit Leases

If a lessee is involved in the construction or design of an asset prior to lease commencement, both the lessee and lessor must evaluate whether the lessee obtained control of the asset during the construction period. Under legacy guidance, only the lessee evaluated whether the transaction qualified as a build-to-suit lease. If a lessee obtains control of the asset, the transaction would be viewed as a financing arrangement rather than a lease. A lessee and lessor would then need to determine if and when control transfers from the lessee to the lessor and whether it qualifies as a sale leaseback transaction.

Enhanced Disclosures

The new standard requires enhanced qualitative and quantitative disclosures, intended to increase transparency of a company's lease obligations. These disclosures may require significant judgment and companies will need to determine how they will gather the necessary information and communicate with investors and lenders. In addition, for many companies lease payments will be excluded from earnings before interest, taxes, depreciation and amortization under the new standard.

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