

ASC 842

LEASE ACCOUNTING HANDBOOK

FOR PRIVATE COMPANIES

For private companies who are implementing processes, controls, and systems to achieve and maintain compliance with the lease accounting standard

A 2021 Guide for Private Company Lessees



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Introduction to the ASC 842 accounting standard

Lessons learned from public company and earlier private company implementation projects demonstrate that ASC 842 often requires more effort than originally anticipated. Developing a strong understanding of the compliance requirements for the latest standards is crucial for lessees to adopt on time and without material weakness.

Why the standards were introduced

The change to lease accounting rules comes with many other accounting standard updates, all created with the purpose of closing loopholes in accounting guidance that could potentially allow private companies to mislead financial statement users as to the true nature of the company's financial state.

ASC 842 closes the lease accounting off-balance sheet loophole which allowed private companies to report their operating leases, often a major portion of the lease portfolio, in the footnotes of financial statements. Under the standard, private companies are required to capitalize operating leases on the balance sheet — reporting them as right-of-use assets and lease liabilities. As a result of the shift, operating lease obligations face increased auditor scrutiny, pushing private companies to focus on ensuring accuracy and completeness of what they report as well as leading to greater comparability of financial statements.

Knowing your deadline

The following is a table showing when private companies need to transition to the new rules:

If Your Year End Is:	You Must Transition To The New Standards By:
December 31	January 1, 2022
March 31	April 1, 2022
June 30	July 1, 2022
September 30	October 1, 2022

Given the significant work required for this transition, many private companies are considering starting the process well in advance of the deadlines.

Organizations with sizable lease portfolios 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.

Lessons learned from public companies

Most public companies significantly underestimated the complexity associated with implementing the lease accounting standards. They started late. They did not assign enough resources. And they did not allocate enough budget. A recent KPMG survey found that the cost of lease accounting projects increased at 62% of companies over the prior 12 months. And almost one-fourth of companies are spending more than \$500K on implementation.

The good news is that private companies have extra time to adopt the standards. And private companies can learn from the mistakes of their peers in public markets by avoiding the key pitfalls that created much of the last-minute chaos around the initial deadlines. Be sure to plan to address these challenges as you drive toward completeness and accuracy:

- **Finding leases**
- **Abstracting data**
- **Connecting decentralized systems and processes**
- **Engaging the business for ongoing compliance**
- **Training**



See also the eBook on “9 things private companies can learn from public companies”

[Read the eBook](#)

The major changes

The most notable change is the capitalization of operating leases, which occurs under both FASB's ASC 842 and the International Accounting Standard Board's IFRS 16. However, the FASB and IASB split on how to classify operating leases, with the FASB deciding to keep the dual classification model of operating and finance leases, and the IASB dropping the operating classification so that all leases greater than \$5,000 in value and longer than 12 months in length are classified and accounted for as finance leases.

Under finance lease accounting, an asset and liability are recorded at the present value of the lease payments on the balance sheet. On the income statement, the lease is recorded as a straight-lined depreciation expense plus a front-loaded interest expense.

Under FASB's operating lease accounting, operating leases are capitalized but accounted for differently from finance leases (previously called capital leases). The present value of the operating lease payments is recorded as a separate asset and liability and the profit and loss (P&L) expense remains as the straight-line average expense.

Most notable is that the operating lease liability is not be classified as a debt, but rather as an "other" operating liability. This is significant as it does not impact debt covenants that limit debt.

The FASB allows a short-term lease (12 months or less) exemption, but not an exemption for leases less than or equal to \$5,000 in value.

The FASB lease classification test is as follows:

A lessee shall classify a lease as a finance lease if the lessee effectively obtains control of the underlying asset as a result of the lease. A lessee effectively obtains control of the underlying asset when the lease meets any of the following criteria at lease commencement:

- a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- c. The lease term is for substantially all of the remaining economic life of the underlying asset.
- d. The sum of the present value of the lease payments and the present value of any residual value guaranteed by the lessee amounts to substantially all of the fair value of the underlying asset.
- e. 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.

When determining lease classification, one reasonable approach to assessing the criteria for c and d would be to use the "bright line" tests of ASC 840 to determine how to define "substantially all"

- a. Seventy-five percent or more of the remaining economic life of the underlying asset is a major part of the remaining economic life of that underlying asset.
- b. Ninety percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.

Exhibit 1:

Executive summary of the lease accounting standard

Timeline:

- The final standard was issued in 2016.
- Public companies began transitioning to the standard January 1, 2019.
- Private companies transition starting January 1, 2022.

Lessee accounting standard summary

- Capitalize all leases (except those exempted as noted above) at the present value (PV).
- For the IASB, all capitalized leases have a P&L pattern that is front-loaded (rent expense replaced by straight-line amortization of the asset and imputed interest on the liability).
- The initial measurement of variable lease payments included in lease assets and lease liabilities includes only variable lease payments that depend on an index or a rate, measured using the index or rate at lease commencement.

Variable rents based on a rate (e.g. LIBOR) or an index (e.g. CPI) are booked based on spot rates. Variable rents based on usage or lessee performance (e.g. sales) are not booked unless intended as a tool to avoid capitalization (also known as disguised minimum lease payments which have to be estimated and capitalized).

For the FASB, one should reassess and book variable lease payments that depend on an index or a rate only when the lessee is reassessing the lease liability for other reasons (e.g., when there is a change to the lease term upon the occurrence of a significant event or a significant change in circumstances within the lessee's control). The changed lease payment (due to changes in the rate or index) still needs to be tracked to provide footnote disclosure of future lease payments. The IASB voted to require reassessments whenever the reference index or rate in a variable rent cause changes the future of contractual rents.

- For the FASB, short-term leases (with terms of 12 months or less), including renewals where the lessee is reasonably certain to exercise to renew, can be accounted for under the off-balance sheet method with additional disclosure. For the IASB, short-term and low dollar value leases of \$5,000 or less (even if material in the aggregate) can continue to be accounted for off-balance sheet if so elected.

SECTION I

The ASC 842 lease accounting standard: timing, key provisions, and changes in direction

Key changes for the latest standard

For US lessees, adoption of the rules creates a significant change from ASC 840 reporting where operating leases are off-balance sheet.

Leases capitalized:

The rules require a lessee to capitalize all leases longer than 12 months. While leased assets are capitalized normally, lease obligations should be recorded using the lease term and lease payments based on assumptions related to contractual rents, including:

- Bargain or compelling renewal rent and purchase options where the lessee is reasonably certain to exercise the options
- Variable (contingent) rents
- Likely payments under residual guarantees

Estimates of lease term and lease payments:

For purchase and renewal options, a lessee should reassess whether the exercise of an option is “reasonably certain”

(and thus must be recognized) only upon the occurrence of a significant event or a significant change in circumstances that is within the lessee’s control.

Transition:

Existing capital leases are grandfathered under ASC 842.

For the FASB, lessees may choose between two available transition methods. The first is a “modified retrospective” approach where all operating leases existing at or entered into after the date of initial application are booked on a prospective basis, but those that expire in the periods of comparative statement will not have to be rebooked. The asset and obligation are booked at the PV of remaining rents at the earliest date presented in the financial statements.

The second transition option is a practical expedient that was approved in 2018 which allows private companies to “recognize a cumulative-effect adjustment to the opening balance of retained earnings” at their adoption date. Both transition methods must be applied in the same way.

Present value calculation:

The lessee calculates the PV of the estimated lease payments using the implicit rate in the lease, if it is known to the lessee, or the company's incremental borrowing rate (the interest rate the lessee would incur to borrow under a secured loan with terms similar to those of the lease) The implicit rate is defined as follows in the FASB standard:

"The rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that the lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) the deferred initial direct costs of the lessor "

The PV is considered to be both (1) the value of the right to use the leased asset (ROU asset), and (2) the "principal" balance of the obligation to pay rent (lease liability) This amount is recorded as both an asset and a liability

The Profit & Loss statement:

For finance leases, the asset is amortized as an expense in the P&L over the estimated lease term on a straight-line basis (SL) Interest expense is imputed on the lease liability The sum of the interest and amortization creates a front-loaded lease expense pattern. Capitalized operating leases continue to use the straightline average rent as the expense, and operating lease assets and liabilities are reported separately from capital lease assets and liabilities

Lease payment breakdown:

Under the standard, the lease payment for a finance lease is broken down into: (1) an interest component (charged to P&L), and (2) a principal component

Lease cost for operating leases:

The reported lease cost for those leases that qualify as operating leases is the same as it is under current GAAP, that is, the straight-line average of the lease payments reported as rent expense The "rent expense" is the sum of the imputed interest on the liability and amortization of the asset

Exhibit 2:

Lease accounting under the standard: a real-world example

Operating lease example:

Here's an example of how the lease accounting standard under the FASB's approach would work for an operating lease based on provisions of the standard.

A company leases several PCs for three years. The rent is \$1,700 a month for 36 months (\$61,200 in total). Under the standard, this lease would likely be considered an operating lease as the PV is less than 90% of the fair market value. Thus, the lease must be capitalized and reported as a right-of-use asset and liability on the balance sheet.

At a 5.5% incremental borrowing rate, the present value of the rental payments is \$56,557. This is the amount that is capitalized on the balance sheet.

The lessee's initial balance sheet entries are:

- Debit Right-of-Use Lease Asset = \$56,557
- Credit Capitalized Lease Obligation = \$56,557

On the P&L, the first year's imputed interest expense is \$4,425 and the amortization expense is \$15,975. Together, these two items total \$20,400 for the first year's lease expense. Under the current GAAP standard, the rent expense would total \$20,400 on a straight-line basis.

Table 1.

PC Lease example: assumptions and calculations

Assumptions		
Rent in advance	\$1,700	
Term in months	36	
Incremental borrowing rate	5.50%	
Fair value of leased assets	\$65,000	
Calculations		
PV of payments - Inception	\$56,557	87% of \$65,000 FV
PV of payments - Year 2	\$38,729	
PV of payments - Year 3	\$19,896	
Total rent	\$61,200	

Table 2.

Annual journal entry summary

Assumptions		
ROU asset	\$56,557	
Capitalized operating lease liability		\$56,557
Entry to record first year's liability activity		
Rent expense (imputed interest)	\$2,572	
Liability	\$17,828	
Cash		\$20,400
Entry to record asset activity		
Rent expense (amortization of asset)	\$17,828	
Asset		\$17,828

Finance lease example: Below is an example of the IASB's approach for the same lease as in the example above.

A company leases several PCs for three years. The rent is \$1,700 a month for 36 months (\$61,200 in total). Under IAS 17, this is considered an operating lease, as the PV of the payments is less than 90% of the fair value of the assets and is accounted for as an off-balance sheet transaction. Under the IASB standard, the lease must be treated as a finance lease. That is, it is capitalized and reported as an asset and liability on the balance sheet with interest expense and amortization expense reported on the P&L statement.

At a 5.5% incremental borrowing rate, the present value of the rental payments is \$56,557. This is the amount that is capitalized on the balance sheet. The lessee's initial balance sheet entries are:

- Debit Right-of-Use Lease Asset = \$56,557
- Credit Capitalized Lease Obligation = \$56,557

On the P&L, the first year's interest expense is \$2,572 and the amortization expense is \$18,852. Together, these two items total \$21,425 for the first year's lease expense. Under the current IASB standard, the rent expense would total \$20,400 on a straightline basis. Thus, capitalizing the lease has increased the company's lease expense by \$1,025 in the first year. The cross-over point occurs in the second year of the lease, when the total lease expense under the standard would be less than the expense under the current IASB standard.

Table 1. IASB method PC lease example assumptions and calculations

Assumptions	
Rent in advance	\$1,700
Term in months	36
Incremental borrowing rate	5.50%
Fair value of leased assets	\$65,000
Calculations	
PV of payments - Inception	\$56,557
Total rent	\$61,200

Table 2. Annual journal entry summary

Entry to capitalize the lease at inception		
ROU asset	\$56,557	
Capitalized operating lease liability		\$56,557
Entry to record first year's liability activity		
Imputed interest expense	\$2,572	
Liability	\$17,828	
Cash		\$20,400
Entry to record first year's asset activity		
Amortization expense	\$18,852	
Accumulated amortization		\$18,852

Table 3. Income statement impact of Front-ended lease expense

Entry to capitalize the lease at inception			
Year	1	2	3
FASB method	\$20,400	\$20,400	\$20,400
IASB method	\$21,425	\$20,419	\$19,357
IASB B/(W) than FASB	(\$1,025)	(\$19)	\$1,043
%	-5%	0%	5%

Evolution of key issues regarding lease payments

Lease term

The FASB and IASB decided that the lease term is defined at inception as the contractual term plus renewal or purchase options, where the lessee is “reasonably certain” to exercise the option to renew or purchase. This is essentially a reversion to ASC 840. Under ASC 840, a renewal or purchase option is included in the lease term if there are bargains or if there is “compulsion” to exercise --- where the lessee would incur an economic penalty for failure to exercise the option. Under the standard, for purchase and renewal options, a lessee should reassess whether the exercise of an option has now reached the level of “reasonably certain” (and thus must be recognized) only upon the occurrence of a significant event or a significant change in circumstances that is within the lessee’s control. The FASB and IASB agreed that the term “reasonably certain” is a high hurdle.

Variable Lease Payments

Only certain variable lease payments are included in the lessee’s lease capitalization, including:

- Variable lease payments that depend on an index (like the CPI) or a rate (like LIBOR, using the spot rate at lease inception for floating leases).
-

- Variable lease payments that are “disguised” minimum lease payments based on usage of the underlying asset or on lessee performance—in other words, payments that are “reasonably certain,” in which case an estimate of the expected rents must be capitalized.

Change in required adjustment of variable rents

Lessees are required to reassess index- or ratedependent variable lease payments only when they are reassessing the lease liability for other reasons. For example, reassessment may be required when there is a change to the lease term upon the occurrence of a significant event, or when there is a significant (but controllable) change in the lessee’s circumstances. Do not overlook the requirement to disclose future lease payments, meaning that although a FASB company is not required to rebook when variable rents change, it is required to disclose the adjusted payments.

Residual guarantees

Lessees need only include the likely payment under a residual guarantee in the lease payments capitalized – not the full amount of the residual guarantee. Residual guarantees are common in synthetic leases, TRAC leases, split TRAC leases, and open-ended fleet leases.

Impact of the ASC 842 standard

Financial impact – significant, but less than originally envisioned:

For many US private companies, the overall financial impact of the lease accounting changes is not as great as originally thought. Certainly, the impact of capitalizing leases is significant, as it puts new assets and liabilities on the balance sheet. However, due to the FASB decision on the operating lease expense pattern, the impact on profitability for many private companies is not significantly different from what was true under the legacy standards. Some financial ratios and measures are impacted. However, IASB companies are seeing much more significant changes including higher debt amounts, permanent lost capital, new permanent deferred tax assets, and temporary reduced earnings.

For most leases, the amounts capitalized are generally the same as the estimates used by major ratings agencies. For IASB companies, the increase in liabilities classified as “debt” due to capitalizing operating leases may result in debt covenant breaches that requiring negotiation and adjustment. US bankruptcy laws do not consider operating lease obligations as debt, as do many other countries, so the FASB decided to classify operating lease obligations as non-debt “other” liabilities. Also, financial measures like return on assets, liabilities to net worth, etc., may change, so a lessee should make pro forma calculations to determine if loan covenants, other contracts, or internal performance and incentive plan measures using those measures are affected.

Tax impact — minimal, depends on jurisdiction:

Lessees should investigate the following areas further with their tax departments to determine if there are any tax changes that may result with the standard:

- In many taxing jurisdictions, typically in North America, the income, sales, and property tax

code for leases are entirely independent of the accounting treatment. Regardless of what changes take place, there is expected to be no impact on taxing in these jurisdictions. As such, the lease versus buy decision is not impacted by taxes. In the same jurisdictions, however, the changes to lease accounting for IASB companies may increase the administrative burden with regards to tracking differences, which are expected to occur under capitalized operating leases. IASB companies also have to track operating leases for personal property tax purposes, as they are not taxable for the lessee. The difference in administrative cost of tracking tax treatments that differ from book treatments is not expected to be material for private companies with an Enterprise Lease Lifecycle Automation platform that has strong accounting and reporting capabilities.

- In other taxing jurisdictions, and as sometimes seen in Europe, the tax code makes reference to or uses the accounting treatment for the purposes of calculating taxable income without any adjustments. The new standards may in fact impact the amount of taxes paid in these jurisdictions. However, there are certain taxing jurisdictions taking action to ensure that such accounting changes do not impact taxes by revising the tax code to be consistent with the existing standards. Again, where timing differences occur, you are required to track deferred tax amounts.
- Personal property tax and sales tax could possibly be impacted in some taxing jurisdictions. Ordinarily, the responsibility to pay these amounts is determined by the legal substance of the lease contract or within the lease contract terms. The accounting treatment would not impact either the amount or responsible party for these payments. Nevertheless, private companies should consult with their tax departments to ensure there are no tax consequences as a result of the lease accounting changes in all of the countries and taxing jurisdictions in which they transact or a nexus exists.

Operational impact — substantial increase in administrative burden:

The ASC 842 lease accounting standard 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.

- There is an expanded definition of what is included in lease payments – in particular variable payments and expected payments under residual guarantees.
- Data to calculate payments come from several sources in the organization.
- 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 for all asset classes).
- Calculation of some payments involves judgments and estimates.
- Calculations to determine the amounts to record in order to capitalize operating leases are complex.
- Financial disclosure requirements are expanded.
- Income tax reporting and accounting may be more complex.
- For most private companies, the scale of the administrative requirements means additional systems and tactical support.

To meet the timetable for implementation, lessees must prepare now

For those lessees that have not already adopted, it is critical to not underestimate the timetable for implementation. This is especially true if a company's lease portfolio includes many lease schedules with multiple assets, non-homogeneous assets, lessors, countries, or languages.

It is likely to take more than twelve months for some private companies to fully overhaul the lease accounting processes, systems, and controls that are required to comply with the standard. Private companies must: (1) understand the rules to determine compliance requirements, (2) start and complete a transition process, and (3) develop an ongoing process for complying with the new standard beginning on the effective date.

The lease accounting rules are complex and lessees must read them in detail to understand how to comply and what the implications are.

Setting objectives and defining compliance and ROI success

To address the lease accounting changes, private companies have to change how they manage their leasing activities. Accounting for operating leases was relatively simple, since those leases were treated as operating expenses. Accounting for capitalized operating leases, however, requires a much more rigorous approach, given the increase in risk and complexity. Such complexity issues include the impact of estimation errors as well as the increased compliance requirements of the Sarbanes-Oxley Act.

As with any change-management project, you should start by defining the objective, scope, and strategy of the project or process. See an example of an objective that you might establish for your company's transition to the standard. It is deliberately stated in past tense as if it has already been accomplished. The objective is not exclusively focused on compliance. Instead, it is designed to yield financial returns from the investment in compliance by improving the financial performance of your leasing process and portfolio.

Objective example:

By the implementation deadline for the lease accounting changes, we will have developed, deployed, documented, and iteratively refined a leasing process that is compliant with the lease accounting standard. This process will be well-controlled, auditable, automated, and scalable, and we will be able to demonstrate that we made good economic decisions throughout the lease lifecycle.

See the metrics you can employ to measure how well you achieved the objective.

Metrics example:

We know we have been successful in meeting this objective because:

- We can generate reports with the push of a button, quickly and easily, for:
 - The lease accounting changes that reflect the final lease accounting standard.
 - Preparation of our financial reporting disclosures, including SEC-required comparable, with full audibility.
 - Internal management of all lease terms that require timely decision making.
 - All stakeholders who use the data, trust the data.
- All stakeholders in the leasing process receive timely, accurate, and complete reporting and notifications, especially notifications about the end of term.
- The financial performance of our lease portfolio, process, and people is measurable and continuously improving. For example, we know quantitatively how much money we are saving by leasing rather than buying. And we know how much money we could be saving if specific underperforming people and groups managed their leases assets at the end of term more effectively and returned assets on time. We can provide those underperformers with the automated notifications and scorecards that they need to improve their performance quickly and easily.

SECTION II

Transitioning to the standard: how to meet the requirements while delivering savings and ROI

Introduction

The remainder of this handbook provides comprehensive guidance on implementing the ASC 842 lease accounting standard. The transition process requires the collaboration of many individuals and departments within your company. At the same time, the process we recommend here delivers major efficiencies in the handling of lease-related information across your entire company and improve the financial performance of your leasing process and portfolio. The result: significant, recurring, annual cost savings for the company as a whole and a measurable, quantitative, positive ROI for your compliance project. Thus, while this transition process is motivated by the need to comply with the

standard, it is also an investment in managing the company's leasing activities more efficiently and effectively. Therefore, if properly implemented, the process will pay for itself and bring continuous, sustainable, and annual returns.

We recommend an 8-step process (page 17) that will most effectively get your entire company into compliance with the standard.

Review your leasing policies:

In view of: (1) the complexities of the standard, (2) the additional administrative burdens, and (3) the changes that are required, it is critical at the start of the transition process that you thoroughly evaluate your company's leasing policies.

Lease versus buy:

Review of your leasing policies includes reviewing your lease versus buy (LvB) analyses. Previously, LvB analysis and decision making were primarily based on economics, as operating leases were offbalance sheet and treated as an operating expense. Now that operating leases have to be capitalized, there are financial metrics that must also be considered.

The analysis will focus on the after-tax implicit cost considering timing of lease payment cash disbursement, tax cash flows, and non-accounting expenses. Nevertheless, the changes in financial ratios should be analyzed to the extent that they impact the LvB decision.

In an asset purchase, depreciation is stretched out over the asset's useful economic life. For IASB lessees, if an asset is leased, depreciation may be accelerated and spread over a shorter lease term. Thus, under the latest lease accounting rules, because of additional assets on the balance sheet and the acceleration of lease costs (at least for IASB lessees), the return on assets/return on equity calculations will look worse for a now capitalized operating lease.

However, for FASB lessees, under these rules operating leasing will still look better than buying. That's because the amount recorded will be less than the cost of the asset and the reported lease cost will be level—not front-ended.

Why leasing is still attractive despite the accounting changes:

Your review of leasing policies should also take into account the quantitative and qualitative reasons why leasing is still a strategic financial tool.

Under the rules, the accounting benefits for leasing (off-balance sheet financing) only partially recede. They remain only to the extent that the PV of the rents is less than the cost of the asset, in which case the lessee capitalizes only the PV. In that case, from a budget perspective, the amount of capitalized lease payments is less than the cost amount had the asset been purchased. Under certain leases like synthetic leases, TRAC leases, and auto/truck fleet leases the amount capitalized may be significantly lower than the cost of the asset.

There are many reasons why private companies lease, and most still remain favorable per the chart below.

A likely outcome of the changes in the accounting rules is that private companies may decide to negotiate different lease terms—possibly shorter terms. They may also choose CPI variable rents versus stepped up contractual rents.

Reason for leasing	Details	Status after latest rules
Raise capital	Additional capital source, 100% financing, fixed rate, level payments, longer terms	Still a major benefit versus a bank loan especially for SME & non-investment grade lessees with limited sources of capital
Low cost capital	Low payments/rate due to tax benefits, residual & lessor low cost of funds	Still a benefit versus a bank loan
Tax benefits	Lessee can't use tax benefits & lease vs. buy shows lease option has lowest after-tax PV cost	Still a benefit
Manage assets; Residual risk transfer	Lessee has flexibility to return asset	Still a benefit — if lessee can manage end of term
Service	Outsource servicing of the leased assets	Still a benefit
Convenience	Quick & easy financing process often available at point-of-sale	Still a benefit
Regulatory	Capital issues	Regulators should still treat ROU assets as "capital free" as they are an accounting contrivance and do not represent an asset in a bankruptcy liquidation
Accounting	Off-balance sheet	Partial benefit if the PV < cost of the asset, which should be true for all operating leases, especially high residual assets with tax benefits. The operating liability is not debt—no impact to debt covenants

Source: <https://www.elfaonline.org/docs/default-source/industry-topics/accounting/leaseacctingleasebuydecisionqb07132016.pdf>

Sale-leaseback transactions

Also under the ASC 842 rules, sale-leasebacks that were transacted to remove assets from the balance sheet will no longer provide this relief except to the extent the PV of the payments is less than the book value of the asset. The capitalized value of the saleleaseback rents replace the asset cost on the balance sheet.

FASB decided that for a transaction to be considered a sale-leaseback, the sale must meet the requirements of the Revenue Recognition joint standard (ASU 2014-09/ ASC 606/IFRS 15). However, “continuing involvement” in the form of a fixed price purchase option (even if it is not viewed as a bargain) precludes sale recognition under that standard. The FASB clarified that an ordinary leaseback (meaning with no option to purchase) does not trigger that clause and precludes sale-leaseback accounting. The FASB also decided that the presence of a fair market value purchase would also not preclude sale treatment provided that the asset was readily available in the marketplace and not specialized (this may be a high hurdle to meet).

- The IASB concluded that a “substantive repurchase option” precludes sale recognition.
- “Failed” sale-leasebacks are accounted for by the seller/lessee as a loan and the asset remains on its books. For the lessor, the transaction is recorded as a loan.
- The FASB decided that if the leaseback is classified as a finance lease, the transaction would not be considered a sale. In other words, if the risks and rewards of ownership are being transferred back to the seller-lessee, no sale really happened.
- For those sale-leasebacks that meet the Revenue Recognition sale criteria, both parties treat the lease like any other lease.
- For the gain, the two Boards split: the FASB concluded that the full gain should be recognized just as it is with any other sale. The IASB held that only the portion of the gain applicable to the residual asset can be recognized at sale.
- If the official sale price is higher or lower than the market price (“off-market”), a reduced sale price is treated as a prepayment of rent; a higher sale price is treated as additional financing by the buyer-lessor to the seller-lessee.

Transitioning to the standard: a comprehensive 8-step process

For many private companies, leasing is still to be an important technique for acquiring the use of assets. At the same time, given the nature and complexity of the requirements under the ASC 842 standard, the transition will require substantial time and effort.

To help those private companies that have not yet transitioned achieve compliance in an efficient and timely fashion, we have devised an 8-Step Transition Process that guides you from creating an internal transition team to acquiring lease lifecycle automation platform that simplifies your compliance efforts with the new lease accounting standard.

When properly followed, this process can result in substantial savings for your company and will ultimately pay for itself. By following this process, your firm will be in the forefront of private companies that are well prepared and in full compliance with the latest standard.

Step 1: Create a lease lifecycle project team

Private companies should create a Lease Lifecycle Project Team to oversee the transition process, establish timelines, and be fully responsible for timely and effective completion of the project. The team should include representative stakeholders that lease equipment, administer leases, or use information concerning leases. These would include Finance/Treasury, Lease Administration, IT, Accounting, and other business units. In some cases, depending on the degree of technical complexity or internal sensitivity of the asset type, there may be a need for a specialized team devoted to leasing of specific asset types (e.g., a global executive auto program).

Step 2: Deploy software designed for your processes and portfolios – Lease Lifecycle Automation for real estate and equipment leases

If your company is still using spreadsheets, a fixed asset sub ledger, or an asset management system (a system without the required lease and accounting capabilities) to manage your portfolio of leased assets, it is critically important to acquire software specifically for your unique requirements. Full lease lifecycle automation is required to capture the data and documents and maintain the completeness and accuracy required to generate auditable financial reporting. Furthermore, you must verify that your software provider meets the lease accounting standard's requirements and can support your firm's transition process.

Because leasing is fundamentally an interdepartmental, cross-functional, decentralized process in most large, geographically distributed, private companies, selecting a software system that is web-based or cloud-based is essential to including all of your stakeholders, wherever they may be, in order to achieve your objective. The software-as-a-service model is now widely accepted and available as a delivery model.

If you are an international company, the software should be multicurrency and multilingual. It should also have multi-lessor capabilities (i.e., it should be lessor-agnostic), because most large private companies lease from a mix of commercial banks, vendors, and independent leasing companies. This eliminates the possibility of using any software system offered by a single lessor (often offered to clients in an effort to monopolize

their leasing business). Your software provider should also have the ability to integrate with not only your internal ERP, procurement, and asset management systems, but also your lessors' systems to achieve straight-through processing (STP).

You also need to be able to load any kind of asset into the system—essentially, whatever you lease: real estate, furniture, airplanes, forklifts, water coolers, copiers, rail cars, pea pickers (seriously), etc.

To determine whether a particular lease administration and accounting software package is appropriate, start by giving the prospective software provider a sample data set so that you can test your data in their system. Then, test whether or not the system can generate capital lease debits and credits for each asset, each transaction, and the portfolio as a whole. If it can't perform these basic and essential functions, it won't support your firm's transition to the lease accounting requirements, and you should continue to investigate alternatives. The ability of your lease administration and accounting software to easily integrate into your ERP is also important. Your software vendor should have the ability to export journal entries at both the asset and summary levels with any account configuration.

Once you have decided on appropriate lessee software, you should configure and integrate the system for maximum efficiency. You should: (a) include your organizational structure, GL coding, and other business coding; (b) set up users, groups, and their authorizations; (c) integrate the system with your single sign-on, purchasing, accounts payable, and general ledger systems where appropriate; and (d) train your stakeholders.

Step 3: Establish a totally new, retrospective lease information database

To be absolutely sure that you have all the information you need to move forward under the standard, you should establish an entirely new lease information database. Of course, you already have accumulated a substantial amount of data about your current leases. But setting up a completely new database ensures that all members of the company's team and all departments that need the information for compliance have it at their fingertips. This procedure also ensures that your current database is completely accurate, especially if you scrape the data from the original documents or reconcile your existing data to your original documents.

Here are the steps we recommend:

- Create a master list of data elements by obtaining all relevant reports and data from all stakeholders within your company.
- Compile a complete set of all internal lease-related documents.
- Capture the required schedule-level and asset-level data for every lease by abstracting and cleansing the data from the documents.
- Reconcile and integrate data from other sources, including lessors, vendors, and internal asset management systems.
- Require asset owners to attest to the accuracy and completeness of the data.
- Populate your lease administration system with key financial variables such as the borrowing rate for the company, the spot rate for floating rate leases, and the CPI for leases with CPI-based variable rents.
- Load your lease information database into the lease lifecycle automation platform.

Step 4: Build a reports library and automate the distribution of reports to stakeholders

Create a set of reports that allows you to report on and analyze all leases and underlying assets, expenses, and obligations in your lease portfolio. The software that you choose should have a library of canned reports immediately available when you load your database. In addition, you should be able to easily build your own reports from scratch. The reporting should be automatically updated when you load the data and documents for a new lease. In addition, your software should enable you to send the reports automatically to any other specified stakeholder on a routine basis.

Step 5: Analyze and triage the end of term – generate immediate savings and better data

- Generate reports for all asset classes based on their end-of-term status: return, buyout, or renew.
- Generate an “evergreen” report to determine the status of leases that are past their original lease end date, including all contractual renewals (intentional) and automatic evergreens (unintentional).
- Follow up with asset owners and asset users for every lease schedule past due and resolve the issues:
 - Update information in the lease administration system at the asset level.
 - Recalculate expected payments if it is a partial buyout or partial return, and reconcile this against invoices.
 - Perform analysis with users to determine the best economic option, make the decision, and act on it.
 - Calculate savings created from these actions.
- Configure end-of-term internal and contractual notifications.
- Develop procedures to manage the end of term effectively:

- Pay attention to the date required to notify lessors about end-of-term decisions and use it as a marker to determine when to notify asset owners.
- Include asset-level data and economic analysis of end-of-term options in a spreadsheet to accelerate the decision about lease renewal.
- Require a decision and, if necessary, a commitment, for the return of the equipment by the deadline.
- Send follow-up automated notifications on the date committed for the return of the equipment and require the asset owner to report the date the equipment was returned, so that you can determine if you owe anything to the lessor.
- Create an asset owner scorecard, which measures the performance of each asset owner, and distribute it to the asset owners and their supervisors.

Under the lease accounting changes, increasing the percentage of timely returns reduces the lease term for prospective lease transactions.

Step 6: Maintain database accuracy and completeness

In order to maintain the accuracy and completeness of your lease information database, you must capture all new leases as they become available. Because of the decentralized nature of many private companies, this is often difficult to do. One strategy that has proven to be effective is to mandate that users around the world use a common, simple, and automated country-specific lease versus buy tool that is integrated with your lease lifecycle automation software. This allows you to see all of the LvB activity, such that if the outcome of the LvB analysis is a recommendation to lease, you can track the transaction as it moves through your automated process. LvB is the earliest opportunity to establish

a control that enables distributed, local decision making while facilitating centralized visibility. Here are the steps we recommend to maintain the accuracy and completeness of your database:

- Gain visibility into your leasing pipeline by mandating a global lease versus buy process and tracking lease originations.
- Identify internal sources for a variety of variables, including intentions to exercise options to renew leases or options to purchase.
- Manage transactions for efficiency and the benefit of internal users; capture new leases as they are signed.
- Send periodic notifications to asset owners to test the accuracy of the data and capture changes during the lease term.

Step 7: Roll out the leasing process globally

Having completed all of the previous steps, you are ready to implement the transition to the ASC 842 lease accounting standard. Here are the steps in the global rollout:

- Develop a launch strategy that works for your company and culture (e.g., by business unit, country, etc.).
- Take into account the degree of centralization/ decentralization within the company and with respect to the conduct of leasing activity.
- Seek to enable decentralized work and decisionmaking with centralized controls and reporting.
- Test-launch the transition roll-out with early adopters and streamline the process

by incorporating the lessons learned (e.g., Six-Sigma approach for repeatability and scalability).

- Train users (or train the trainers, as appropriate for your company's culture) on the new processes, procedures, and tools.
- Communicate with all concerned to achieve universal adoption of the processes.
- Listen to feedback and suggestions from users to improve the processes incrementally, especially concerning ease of use.

Step 8: Ongoing activity — generate accounting information required by FASB and IASB monthly and annually

After completing this intensive preparation and roll-out process, you are ready to transition to the standard at the effective date and continuously improve the performance of your leasing program.

Then you need to develop and implement operating procedures to generate the accounting information required for financial reporting under FASB/IFRS rules as required. Using the automated reporting function of your lease lifecycle automation platform, you can access and analyze complete, accurate, and up-to-date lease information. Then you can calculate: (1) contractual rents and bargain renewal rents, (2) the variable rents for the term, (3) any expected payment under residual guarantees, (4) the PV of the total estimated payments over the term, and (5) the principal and interest of the lease obligation.

Keeping internal groups up-to-date

Meet routinely with the Controller's team:

On each accounting reporting date as defined by your Controller's team, review the assumptions for variable rent with the Controller's Department and review your renewal assumptions (whether there has been a change in determination regarding bargain renewals) with the operations department. Also determine whether floating rate or CPI variable contractual rents have changed or if there is a change in the expected amount to be paid under residual guarantees. If changes are material, you may revise the PV calculation for future contractual and renewal rents and provide the new PV, principal, and interest run-out to the controller's department. Or, you may choose to input the new numbers into your lease accounting and administration system.

While the requirements have been greatly relaxed with regards to reassessment, when practical, and when acceptable to your auditors, there can be improved financial reporting by reassessing on a more frequent basis than what is required under the standard. Regardless of the requirements to reassess, management should be aware of all economic changes to their balance sheet. Continual monitoring of changes to future contractual payments is considered best practice.

Auditors may look at historical renewals to corroborate assumptions being made on existing leases. Private companies should assume that historical renewal and evergreen activity are readily available for audit scrutiny. This requires systems that are more sophisticated and transparent than traditional ERP systems.

Provide Controller with reports for financial statements:

Prepare disclosure information annually for the controller's department to be included in the annual report's leasing footnote. The following are the quantitative disclosure requirements for lessees:

1. Finance lease expense, segregated between amortization of ROU assets and interest on lease liabilities.
2. Operating lease expense.
3. Short-term lease expense, excluding expenses relating to leases with a lease term of one month or less.
4. Variable lease expense.
5. Sublease income.
6. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows and between finance and operating leases.
7. Supplemental non-cash information on lease liabilities arising from obtaining ROU assets, segregated between finance and operating leases.
8. Weighted-average of the remaining lease term, disclosed separately for finance and operating leases.
9. Weighted-average discount rate for finance and operating leases as of the reporting date.
10. Gains and losses arising from sale and leaseback transactions.

The FASB decided to retain the requirement for a lessee to disclose a maturity analysis of its lease liabilities. This analysis shows the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years, and reconciles the undiscounted cash flows to the discounted lease liabilities recognized in the statement of financial position.

Provide journal entry

information: Provide information for necessary journal entries directly from the lease lifecycle automation platform, which has a lessee accounting subledger that can generate debits and credits at a detailed asset level and/or general ledger summary level.

Conduct a periodic review of estimates:

Every time the company reports earnings, you should re-run the entire process as outlined above, contacting internal sources to get new estimates of key information; then, input changes to the system and assess any requirements for adjusting journal entries. As discussed, the requirements in this regard have been relaxed for financial reporting, but best practices would continue to require this be performed on an annual or more frequent basis, if not for compliance purposes, for economic analysis of leasing metrics.

Send reports for tax leases to the tax team:

Each year, provide to the tax department actual rents paid under “true” (tax) leases and accounting lease expenses for those leases. This information is to be included in the company’s tax return and used to prepare deferred tax entries, as the accounting expense may be different from the tax deductions for those leases. You should specifically provide the actual rent paid (for the tax return) and the deferred tax accounting entry.

The bottom line: if you haven’t already, start now

Getting ready for the implementation of the ASC 842 lease accounting standard is going to take a great deal of resources, dedication, smart planning, and cooperation across all groups in the organizations that are involved with leasing activity.

Based on public and private companies that have already completed the implementation project, the time frame from start of the transition to total readiness could be in the 9-18 month range, or perhaps longer, depending on the complexity of the portfolio. It may take 3-6 months to secure the budget and resources to move forward in the transition program. It may take an additional 6-12 months to establish the systems and set up the processes and procedures to prepare the company’s financial and accounting systems to be ready. The more lease transactions in a company’s portfolio, the longer the transition is likely to take.

You may already be behind

First steps:

- Budget the time and resources required to perform the work.
- Determine the proportions of internal resources vs. outsourcing (see next section) to deploy to the process.
- Determine whether a behind-the-firewall or SaaS application is best for the company. Conduct a build versus buy analysis for this decision.
- In planning, allow a minimum of one year for implementation of this transition process; 12 to 18 months if it is a global program (i.e., more than 5 countries).

Consider Lease Lifecycle Automation software

Leasing is inherently cross-functional and interdepartmental. It typically involves a wide variety of stakeholders, including Procurement, regional and corporate Treasury, asset users, operations managers, asset managers, regional and corporate Controllers, Lease Accounting, Financial Reporting, FP&A, and internal and external auditors. Whether your portfolio is domestic or global, enabling all of your stakeholders to access the same cloud-based software and promptly get the tools they need will help you establish and monitor controls of any lease transaction, regardless of changes in location, jurisdiction, personnel, or exchange rates. Here are some features to expect from an Lease Lifecycle Automation platform:

- You can access a suite of cloud-based, multilingual software services that automates the end-to-end lifecycle of leases via the web.
- You can drive down the cost of capital using competitive capital sourcing features in any country around the world.
- During the term, you can track leases, assets, lessors, stakeholders, and any related events in any jurisdiction using portfolio management features.
- At the end of term, you can improve the timeliness of decision making and return performance by configuring the software to automatically notify users prior to the end of term, and you can include the economic analysis and logistical instructions for any option in the lease.
- You can generate reports that quantify the financial performance of your portfolio and the operational performance of your stakeholders.
- You can employ a robust lease accounting subledger that you can use to generate debits and credits at the asset, schedule, or portfolio levels, including an audit history to ensure controls and auditability of each transaction.
- You can integrate with procurement systems (e.g. iProcurement, Ariba) and ERP systems (e.g. Oracle, SAP) for straight-through processing.

Consider outsourcing: drive maximum savings quickly

If you do not have the resources, time, or expertise to manage the transition smoothly, consider outsourcing tasks in your leasing program to a managed service provider. Several global vendors offer an affordable suite of lease administration services. Outsourcing to a service provider will save you considerable time, money, and headache. Get the service provider to make a compelling business case based on quantitative savings (i.e., identifying hard and soft cost savings). If they prove their business case, check their references to ensure that they have previously faced situations similar to yours.

In summary

Your transition process to the latest lease accounting standards will 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 ongoing, sustainable processes for lease accounting.

About LeaseAccelerator

LeaseAccelerator provides a global Lease Lifecycle Automation platform that improves free cash flow and ensures long-term compliance across equipment and real estate assets. Thousands of users rely on our Software-as-a-Service (SaaS) platform to manage and automate 700,000 leases valued at \$200 billion across 5 million assets in 172 countries.

The LeaseAccelerator platform includes integrated asset-level accounting, reporting, governance and stakeholder performance management, along with a competitive leasing marketplace fueled by a unique global lessor network of more than 500 bidders. Using this strategic financial platform, customers gain business insights about decentralized assets and stakeholders from centrally managed, rich lease data. On average, customers save 7% on lease financing in our lease marketplace and 10% on lease costs through better end-of-term management. Customers can leverage expert training or choose to outsource the leasing process using one of our trusted managed service providers.

Talk with our team about how LeaseAccelerator can help you meet the private company ASC 842 deadlines.