



CONSULTING

BUSINESS ADVISORS AND TECHNOLOGY SOLUTIONS

Lease Accounting (ASC 842) Transition Guidance, Practical Expedients, Discount Rates, and More

Presenters



FRANK BALESTRERI

» Partner

With almost 30 years of experience, Audit & Consulting Partner, Frank Balestreri, specializes in serving private and public clients in the retail, consumer products, manufacturing, distribution, energy and alternative energy industries. Frank has significant experience with both primary and secondary equity offerings, debt offerings, private placements, consolidations, internal controls, and SEC reporting. He has consulted on business combinations, divestitures, impairments and revenue recognition.



KEVIN SHIVES

» Partner

Kevin has over 25 years of experience helping clients optimize their people, processes and systems for competitive advantage. Prior to joining SSF, Kevin has held senior finance and management positions in multiple companies in the SF Bay Area. In his current role as Technology Partner, he works with clients to develop highly effective and cost-efficient corporate governance, internal audit, Sarbanes-Oxley (SOX), accounting systems and process optimization solutions.

Presenters



JOE BRUNEL

» Sr. Manager, Audit

With over 15 years of experience, Senior Audit Manager Joe Brunel specializes in delivering financial statement audit and review services for privately-held businesses. His expertise includes limited scope audit services related to employee benefit plans including 401(k), 401(a), 403(b), and full scope audit services for ESOP plans. He has worked extensively in the manufacturing, distribution, and construction industries.

Guest Presenter



LEASECRUNCH

JESS VENTO

» Senior Director of Accounting | Client Success

Jess has a knack for operations, process improvement, and helping her staff exceed expectations. Jess has an MBA in Leadership and Management and a BA in Accounting, both from Ottawa University's Brookfield, WI campus. Jess' varied professional experience includes working for companies like US Bank, Harley-Davidson Motor Company, Burke Properties, and Founders 3 Real Estate Services. She has spent the last few years working directly with clients to meet and exceed their goals while leading a large accounting team.

At LeaseCrunch, she serves as the go to resource for CPA firms, coordinating what they need to successfully implement the new lease standard and adopt lease accounting software. Jess has been President of the Accounting & Financial Women's Alliance (AFWA) Milwaukee Chapter where she is still a member and is also a member of TEMPO Milwaukee's Emerging Women Leaders group.

In her free time, she enjoys live music of her husband's band, helping out her daughter's sports teams and improving her golf game.

Firm Overview



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M&A • Multi-State & International



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Employee Benefits Plan



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SOX • Sustainability

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- » 40+ Years in Business
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- » Thousands of hours dedicated to community service each year
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SSF Consulting Overview

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LEASERUNCH

Agenda



- Key Definitions
- Lease Accounting Overview
- Transition Guidance
- Practical Expedients
- Discount Rates
- Demo of LeaseCrunch
- Q&A

Key Definitions

Finance Lease: A lease that meets one or more criteria in paragraph 842-10-25-2 (Think capital lease)

- Ownership Transfer
- Option to purchase
- PV of payments plus residual is substantially FV
- Lease term for “major part” of asset life
- Specialized nature – no alternative use

Operating Lease: Any lease other than a financing lease

Commencement Date: Date on which the underlying asset is available for use

Economic Life: The period that the asset is expected to be economically usable by one or more users

Key Definitions

Lease Term: Noncancellable period where the lessee has the right to use the asset, including:

- Option periods if they are reasonably certain to exercise
- Option periods to terminate if it is reasonably certain to NOT exercise
- Option periods to extend or terminate where the decision is held by the lessor

Discount Rate for the Lease Liability:

- The rate implicit in the lease unless indeterminable
- Incremental borrowing rate
- *For private companies, policy election to use the risk-free rate*

Incremental Borrowing Rate: Rate of interest a lessee would have to pay to borrow

Key Definitions

Right of Use Asset (ROU): An asset that represents the Lessee's right to use the underlying asset for the lease term

Initial Direct Costs: Incremental costs that would not have been incurred if you didn't enter the lease (Commissions, architect fees)

Residual Value Guarantee: Guarantee of value made to the lessor at the end of the lease term

Lease Liability: Obligation to make required payments and reasonably certain extension options

Lease Modification: Change to the terms and conditions that results in a change in scope or the consideration for a lease

Short-term Lease: A lease that at the commencement date has a lease terms of 12 months or less and does not include an option to purchase the assets that the lessee is reasonably expected to exercise

Lease Accounting Overview

EFFECTIVE DATE

Public and international companies:
FISCAL YEAR AFTER DEC. 15, 2018

Private organizations:
FISCAL YEAR AFTER DEC. 15, 2021

- ASC 842 replaces ASC 840
- In ASC 840, capital leases were recorded on the balance sheet, while operating leases were disclosed as a footnote in financial statements. These “Off – Balance Sheet” operating leases were thereby excluded from important financial ratios that would allow stakeholders to evaluate a company’s performance
- The goal of ASC 842 is to overcome this blind spot and provide increased visibility into leasing obligations on financial statements

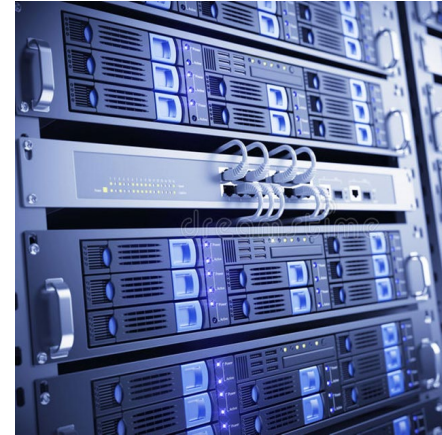
Adoption Requirements

- Lease policies and practical expedients are selected and disclosed in the footnotes
- Right of Use asset and lease liability are computed and recorded on the balance sheet using a discounted present value
- Operating and Financing leases are to be reported separately on the balance sheet and in the footnote disclosures
- Select an adoption reporting method
 - **Effective date method:** Comparative periods are unchanged (Retrospective application at the beginning of the period of adoption)
 - **Comparative method:** The earliest comparative period is restated (Retrospective application to each prior period presented)

What is a Lease Under ASC 842?

Lessee must have the **right to control** the use of the asset.

- Control exists if you have both of the following:
 - Right to obtain substantially all the economic benefits through the agreement term
 - Right to direct the use of the **identified asset**
- Lessor does not have substantial substitution rights
- Must be a physical asset explicitly or implicitly identified





Transition Guidance

1. Review Your General Ledger Accounts

Look specifically for fixed recurring and variable payments for existing leases and other contracts, which may have embedded leases under the new standard.

- Embedded leases are determined by the lessee's use and control over any identified assets in the agreement. The most common embedded lease is typically within an IT service contract if it specifies underlying hardware that may be included.

Identify all balance sheet accounts related to the following – prepaid rent, deferred rent, rent deposits. Ensure all accounts are reconciled as of 12/31/2021, since these will be eliminated and netted against the Right of Use Asset (ROU) upon adoption at 1/1/2022.

2. Inventory Contracts: Review Key Terms & Payments

Create an inventory of your contracts and review key information in those contracts, including:

- Fixed payments
- Indexed payments
- Renewal options
- Residual guarantees
- Initial direct costs
- Lease incentives
- Options to purchase

In addition, payments to the lessor may include fixed non-lease payments such as insurance, maintenance, and taxes. There is a policy election that allows these costs to be included in the calculation of the ROU Asset and Lease Liability should a company desire to do so.

3. Separate Fixed and Variable Payments

Fixed lease payments are those recurring payments that are the same amount each month, including payments with a fixed percentage increase based on specified dates or anniversaries.

In contrast, a payment based on an unknown future rate such as the CPI index or lessee's sales are considered variable. These are treated differently under the new standard.

- Practice point – variable lease payments are not included in the calculation of the ROU Asset or the Lease Liability upon adoption, but they need to be tracked since they are required to be disclosed in the footnotes to the financial statements.

4. Consider Policy Elections & the Election of Practical Expedients

Policy Election Options:

- Combine fixed lease and non-lease payments – this will simplify the calculation of the ROU asset and lease liability while simultaneously simplifying the monthly accounting for non-lease payments.
- Use the interest-free rate to avoid determining the discounted rate – calculating the implicit rate or the incremental borrowing rate can be an involved process.
- Exclude leases with payments of twelve months or less – but these still need to be tracked for disclosure purposes.
- Apply the same discount rate to a class of assets or assets with a similar lease term – this mitigates the need to calculate/estimate the discount rate for each leased asset.

4. Consider Policy Elections & the Election of Practical Expedients

Practical Expedients Options:

- Must elect as a group
- Not to reassess expired or existing contracts that contain leases under ASC 842
- Not to reassess operating and capital leases under ASC 840 that will be operating and financing leases under ASC 842
- Not reassess initial direct costs for existing leases

Separate Election

- May elect to use hindsight to reassess leases for determining the lease term, purchase options, and termination payment

5. Evaluate Contracts to Determine Financing Lease Vs. Operating Lease Classification

Financing Lease

- Transfers ownership to the lessee
- The purchase option is reasonably sure to be exercised
- The lease term is the major part of the economic life of the asset
- The present value of the lease payments and residual value is substantially all the asset fair value
- The asset is specialized in nature for the lessee and has no alternative use

Operating Lease

- Ownership stays with the lessor
- There is no option to purchase the asset
- The lease term is not a major part of the asset's economic life
- The value of the lease payments does not equal or exceed the fair value of the underlying asset
- The asset is not so specialized to only have use for the lessee

6. Evaluate Financial Statement Adoption Options

Effective Date Method – The comparative reporting period is unchanged, and any cumulative effect is applied at the beginning of the adoption period. This eliminates the need to restate the prior period presented

Comparative Method – The earliest period presented is restated at the beginning of the period

Practical Expedients

Practical expedients are applied consistently to all leases for leases that commence *before* the adoption date. Practical expedients may be elected separately or in conjunction with one or more expedients.

- Lessees may elect to account for non-lease components as part of the lease payment components to which they relate. Examples of non-lease components are payments to lessors to cover property taxes, insurance, or maintenance. Others include fixed or variable payments using an index rate.
- Lessees may use hindsight in determining the lease term, and in assessing the likelihood that a lessee purchase option will be exercised or terminate the lease.

Practical Expedients (continued)

- Lessees may elect to not reassess whether existing or expired land easements that were not previously accounted for as leases under ASC 840 contain a lease under ASC 842.
- An entity may elect (All or Nothing as one Package):
 - Not to reassess whether expired or existing contracts contain leases under ASC 840 and would contain leases under ASC 842
 - Not to reassess lease classification for expired or existing leases. Operating leases under ASC 840 will be operating leases under ASC 842 and capital leases under ASC 840 will be financing leases under ASC 842. Keep in mind, this practical expedient only applies if there are no errors with the initial classification.
 - Not to reassess initial direct costs for any existing leases.

Practical Expedients (continued)

- Adoption method option – as previously noted in the adoption requirements, the **effective date** method of adoption is a practical expedient that provides the option to apply the new guidance at its effective date without having to adjust the comparative financial statements.
- Short-term leases – under GAAP, a short-term lease is defined as a lease that is 12 months or less without a purchase option that the lessee is likely to exercise. The practical expedient election does not require capitalization of short-term leases under ASC 842.
- Private Company Discount Rate Alternative – The risk-free interest rate can be utilized rather than a company's incremental borrowing rate or a discount rate implicit in a lease contract.

Discount Rates

With the adoption of ASC 842, companies will expect to see a significant increase in the number of leases reported on their Balance Sheet. Selecting and estimating the lease discount rate will have an impact on the lease liability and right of use asset on the Balance Sheet. 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.

- **Implicit Rate (IR)** – defined as the rate of interest at a given date that causes the aggregate present value of (1) the lease payments and (2) the amount that a lessor expects to derive from the underlying asset following the end of the lease term.

Discount Rates (continued)

- **Incremental Borrowing Rate (IBR)** – defined as the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.
- **Common myths about IBR**
 - IBR is the interest rate on an easily accessible line of credit – this was allowable under ASC840, but under ASC842 lessees must use a collateralized rate.
 - IBR is the weighted average interest rate that a lessee pays on its other debt – lease terms and other economic characteristics will vary precluding use of a blended rate.
 - A lessee can use the same IBR for all of its leases – ASC 842 applies on the individual lease level and IBR needs to be determined for each individual lease.

Discount Rates (continued)

- **Incremental Borrowing Rate Examples:**
 - Rate on Existing Debt
 - Borrowing Rate of Similar Entities
 - Rate Quoted by a Lender
- **Risk-Free Rate (RFR):** Practical expedient alternative for private companies. The RFR is the rate of a zero-coupon U.S. Treasury instrument using a period comparable with the lease term.
- **Discount Rate Reassessment:** Lessees are required to reassess the discount rate when there is a modification (change to the terms and conditions of a contract, terminates the right to use an underlying asset, or extends/shortens the lease term).

Discount Rates (continued)

- **Disclosures Related to the Discount Rate:** Lessees are required to disclose information about any significant assumptions or judgments to apply ASC 842. This may include the determination of the discount rate for the lease. In addition, if a lessee elects the accounting policy to use the RFR, they should disclose this policy, assuming it is considered to be a significant accounting policy.

Discount Rate Impact

<u>FASB ASC 842 Footnote Comparison</u>	YE 2022-12	YE 2022-12
Lease Assumptions:		
Discount	2%	7%
Monthly Payment	\$10K	\$10K
Term	60 months	60 months
Deferred Rent under ASC 840	\$10K	\$10K
Lease expense		
Operating lease expense Jan to Dec 2022	118,000	118,000
Other Information		
Operating cash flows from operating leases	120,000	120,000
ROU assets obtained in exchange for new operating lease liability	571,474	507,966
Weighted-average remaining lease term in years for operating leases	4	4
Weighted-average discount rate for operating leases	2%	7%
Maturity Analysis		
2023-12 to 2026-12	480,000	480,000
Total undiscounted cash flows	480,000	480,000
Less: present value discount	(18,299)	(59,962)
Total lease liabilities	461,701	420,038
Balance Sheet Presentation Comparison		
ROU Asset		
January 2022 Adoption (Less Liability Less \$10K Deferred Rent)	561,474	497,966
Dec-22	453,701	412,038
Lease Liability		
January 2022 Adoption	571,474	507,966
Dec-22		
Short-Term	111,989	94,284
Long-Term	349,712	325,754
Total	461,701	420,038

Our Offering & Approach

We provide a scaled approach to meet our clients lease accounting needs. From consulting and guidance to fully outsourced lease accounting implementation and administration—and everything in between.



Assessment, Planning & Support Services

We help develop an effective implementation plan, including practical expedients, to meet new requirements now and in the future.



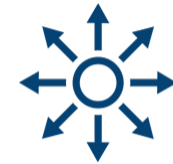
Financial Reporting

We help the clients team optimize the time-consuming and complex work needed to gather and analyze the lease data required for effective financial reporting.



Software Implementation

Our consultants help streamline, simplify and automate compliance by implementing a lease accounting solution for adoption and ongoing administration and reporting.



Full Outsourced Administration

Eliminate the burden on staff and management with fully outsourced lease compliance and administration.

A grayscale photograph of a woman standing and pointing at a whiteboard in a meeting room, while a man sits at a table with a laptop. The room has large windows and indoor plants. A vertical green bar is on the left side of the image.

LeaseCrunch Demo

Recap

- ASC 842 is effective beginning January 1, 2022, for calendar year-end private companies and nonprofits
- Preparing for the transition
 - Review your GL accounts for recurring payments and prepaid/deferred rent
 - Inventory your contracts
 - Separate fixed and variable payments
 - Consider all options under the various policy elections and practical expedients
 - Choose an implementation method that best fits your company needs
 - Understand the nuances and effects different discount rate options have on your Company financial statements and disclosures
- Reach out with questions, or if you need support, etc.

www.ssflp.com/lease-accounting-advisory

Topics for our next webinars

- Lease modifications
- Financial statement presentation and disclosure
- Post ASC 842 adoption best practices and lessons learned

Chat in additional topics you would like us to cover related to ASC 842



Questions?

Thank You!

For questions, contact us:

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