Accounting for Leases Under ASC Topic 842 – *Have You Started?*

While not effective until January 1, 2019 for calendar year public companies, companies should not delay starting their implementation plans for ASC 842 *Leases*, even if they are still working to finalize the adoption of ASC 606 – as the saying goes, there is no rest for the weary!

The principal reason for the FASB taking on the project was to eliminate off-balance-sheet accounting for operating leases by lessees. ASC 842 requires a lessee to recognize a right-of-use asset and a lease liability for substantially all operating leases. The only exception that ASC 842 provides is for leases that qualify as short-term leases (i.e., a lease with a "lease term" of not more than 12 months). On initial recognition, the lease liability will equal the present value of the payments allocated to the lease. However, the income statement treatment of operating leases will not change under ASC 842, even though the lessee has recognized an asset and a liability. Under ASC 842, a lessee will recognize expense for operating leases on a straight-line basis over the lease term, just as it does under ASC 840. Although lessees will be required to recognize a liability for operating leases, ASC 842 requires the lessee to present or disclose operating lease liabilities separately from other liabilities (including finance lease liabilities).

ASC 842 provides a number of practical expedients that, if elected, should help to ease the burden of adoption, but companies should not be lulled into a false sense of comfort that adopting the new standard will be a walk in the park, even though it may seem like it in comparison to the experience of adopting the new revenue standard.

There are many aspects of the new Leases standard that necessitate early action. Unless a company has an extremely limited number of leases, it will likely need to select and implement a new lease accounting system. With a limited number of leases, a company could conceivably comply with ASC 842 by supplementing its existing processes for and controls over compliance with ASC 840 *Leases* with spreadsheets that would allow it to track the adjustments required to record a right of use asset and lease liability at the date of the financial statements in a well-controlled manner. However, as the number of leases and complexity increase, relying on spreadsheets in the SOX era will not be sustainable.

In addition to selecting an accounting software solution, companies will need to ensure they have identified and captured all of their leases, including those leases embedded in agreements to buy or sell goods or services.

Companies that do not have a centralized repository of leases may need to spend time ensuring they have identified all (or, at least, all material) leases. While companies have been required to disclose future minimum rental payments in the financial statements for years, they will need to be prepared to demonstrate to their auditors how that disclosure captures all material leases, including embedded leases, in the run up to the effective date of ASC 842. It is possible that what was previously "good enough" for disclosure purposes under ASC 840 will not be "good enough" for recognizing an asset and liability under ASC 842.

Selecting and implementing a system and gaining assurance that a company has identified all of its leases could take a significant amount of time and needs to be done before a company can begin the process of inputting data on leases existing at the beginning of the earliest period presented (January 1, 2017 for calendar year public companies).* Depending on the number of leases, the process of inputting data into the system could require a significant amount of time.

Companies will also want to understand early on in the process of adopting ASC 842 what impact, if any, recognizing an asset and liability for operating leases will have on compliance with debt covenants. If borrowing agreements do not exclude operating leases from covenant calculations that use balance sheet measures as inputs, companies will need to

**Subject to potential amendment as discussed at the FASB's November 29, 2017 meeting* start discussions with lenders to ensure that they are not in default when they initially report under ASC 842.

In addition to the above, companies will need to establish and document accounting policies that comply with ASC 842 for leases with commencement dates, or leases that are modified, after the effective date, along with processes and controls over those new policies.

How Can FTI Consulting Assist

FTI Consulting has an established group of seasoned accounting professionals with extensive experience helping clients in these situations. Our team has significant lease accounting expertise and is well versed in the new guidance. FTI Consulting combines the responsiveness of a local firm with the significant technical expertise, resources and scalability of a worldwide consulting firm, with over 3,700 employees in 26 countries around the world. We can fill the gap when a registrant requires high-quality technical assistance beyond what your audit engagement team is allowed to provide under the independence rules. Our SEC and Accounting Advisory practice is comprised of senior professionals with extensive experience with GAAP and SEC reporting issues, including former FASB Board members, Big Four audit partners and senior managers (including former Big 4 National Office experts), as well as former SEC staff. Our "National Office" includes a former Board member of the FASB who was responsible for oversight of the leases project, as well as a former accounting firm National Office partner who was responsible for updating that firm's lease book. In addition to assisting companies in properly interpreting, applying and documenting the new guidance, FTI Consulting can also employ our extensive public accounting and project management experience to help the audit process go more smoothly and efficiently.

Areas where FTI Consulting can assist companies with their adoption of ASC 842 include:

- Establishing a project management office to develop and manage the plan for transitioning to Topic 842
- Identifying all of a company's leases, including, as a starting point, assessing the completeness of the population of leases included in the lease commitments footnote to the financial statements
- Establishing a centralized repository for all lease agreements
- Assisting management in reviewing and selecting software that complies with the requirements of Topic 842
- Reviewing all lease contracts and inputting relevant information from existing leases into the selected lease accounting software
- Reviewing contracts for the purchase of goods or services to identify any embedded leases
- Reviewing and testing the output of the software for a sample of leases
- Drafting accounting policies that comply with Topic 842
- Determining what additional information will be required to comply with Topic 842's disclosure requirements and identifying the source of that information
- Identifying processes and controls over lease transactions, including disclosure controls, that will either change or be required upon the adoption of Topic 842
- Providing training to all groups that will be affected by the adoption of Topic 842

The following are some of the key differences between ASC 842 and ASC 840, other than the recognition of a right-of-use asset and lease liability for operating leases, that will affect how companies account for leases subsequent to the adoption of ASC 842:

Scope

ASC 842 defines a lease more narrowly than ASC 840 did, which will result in lessees and lessors identifying fewer leases embedded in contracts for the provision of goods or services. That in turn will affect how the seller (lessor) reports revenues on those contracts. Under ASC 840, the seller was required to allocate a portion of the consideration to the lease, resulting in reporting a lesser amount as revenue from the sale of goods or services. Under ASC 842, the seller will report the consideration as revenue from the sale of goods or services.

Lease Payments

ASC 842 eliminates the allocation of a portion of the consideration in the lease to executory costs (real estate or personal property taxes, insurance on the leased asset, maintenance) when determining how the lease should be classified. ASC 842 allows a lessee to allocate the consideration in the contract between the lease component(s) and non-lease component(s), but restricts non-lease components to those activities that deliver a product or service to the lessee. Under ASC 842, payments to the lessor for maintenance of the leased asset will qualify as a non-lease component, but payments for taxes and insurance will not. Prohibiting the allocation of a portion of the consideration for reimbursements of lessor costs like taxes and insurance could result in classifying a lease as a finance lease rather than an operating lease because the payments used to determine lease classification will be greater under ASC 842 than they were under ASC 840.

Foreign Currency Leases

ASC 842 will result in greater income statement volatility for operating leases denominated in a foreign currency than resulted under ASC 840 because ASC 842 requires the lease liability to be remeasured to the lessee's functional currency each period using the current exchange rate, while remeasuring the right-of-use asset into the functional currency using the historical exchange rate.

Sale-Leaseback Transactions

ASC 842 makes it easier for the seller-lessee to account for transactions involving real estate or integral equipment as a sale and leaseback, but will make it more difficult for them to account for transactions involving equipment as a sale and leaseback. To account for a transaction as a sale and leaseback instead of a financing, the seller will be required to surrender control over the asset. Accordingly, a seller cannot have an option to repurchase the asset at a fixed price, and even the use of a fair value repurchase option is constrained. Equipment sale-leaseback transactions typically provide the seller with a fixed-price repurchase option. Under ASC Topic 842, that feature will result in the seller accounting for the transaction as a borrowing. However, a seller can retain risks associated with the transferred asset without violating the requirement that it transfer control over the asset to the purchaser. That change will make it easier to account for transactions, particularly those involving real estate or integral equipment, as sales.

Unlike ASC 840, ASC 842 will require a buyer-lessor to assess whether it has obtained control over the asset; under ASC 840, the buyer-lessor only considered whether it had legal ownership of the asset. If the buyer-lessor has not obtained control over the asset (because, for example, the lessee has an option to repurchase the asset for a fixed price), ASC 842 requires the buyer-lessor to account for the transaction as a loan to the seller-lessee.

Build-to-Suit Leases

ASC 842 revises the criteria for determining whether a lessee should be treated as the owner of an asset under development, focusing on circumstances that would result in the lessee being deemed to control the asset. The changes to the criteria for determining whether a lessee should be deemed to be the owner of an asset under construction should reduce the number of circumstances where a lessee is required to account for the asset under construction as if it owned the asset.

Lease Classification

Under ASC 840, companies that use leasing as a means of selling their product often purchase residual value insurance in order to be able to classify a lease as a sales-type lease (under the "90% test"). ASC 842 changes the criteria for sales-type lease classification. Under the revised criteria, the lessor is only allowed to consider payments to be made by the lessee. If the lessor needs to purchase residual value insurance to meet the 90% test, rather than recognizing the transaction as a "sale" of the asset, the lessor will account for the arrangement as a direct financing lease (i.e., a loan). Any selling profit that would have been recognized under ASC 840 will instead be recognized as part of interest income over the term of the lease. Further, ASC 842 removes the guidance that would allow a lessor to classify a lease with significant contingent rentals as an operating lease, even if it tripped one of the four tests for classification as a sales-type lease (for example, where the lease term exceeds 75% of the estimated economic life of the leased asset). In that case, a lessor may be required to recognize a loss on the sales-type lease at the commencement date, even if no economic loss is expected once expected contingent rentals are considered.

FTI Consulting's Expertise with ASC 842

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