LEA Global

ASC 842 Deep Dive & Training

NetLease by Netgain

7/11/2023

CSTGROUP
CPAS AND BUSINESS ADVISORS

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Rising Star Association
2022 WINNER
INTERNATIONAL ACCOUNTING BULLETIN

Welcome – This Webinar Will Begin Momentarily

• Housekeeping Items

- This webinar will be recorded.
- The link to the recording and PowerPoint will be posted on the Events registration page on LEA's member portal post webinar. An email will also be sent to today's attendees, post webinar, with this information.
- Please use the chat box to share comments or questions.
- This webinar is eligible for 1 Continuing Professional Education (CPE) credit.
- Four (4) polling questions – will be initiated throughout this webinar to monitor engagement as required by NASBA standards.
- Your CPE certificate will be emailed to you in a couple of weeks.
- You will receive an email asking you to complete an evaluation of this webinar. Please take time to complete this as your input is valuable when planning for future webinars.

Today's Presenters

Caleb Christensen

- CPA Firm Relationship Manager
- Audit & consulting background
- Responsible for system training, support, and technical accounting consulting

Kara Shelton

- CPA, Audit Principal at CST Group
- 20 years of public accounting experience
- Assurance
- Management Advisory

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Training agenda

Lease accounting

- **ASC 842 Deep Dive**
  - History
  - Financial Reporting Implications
  - Journal Entries
  - Practical Expedients

NetLease Demo

- **Lease**
  - Create a new lease
  - Modify a lease
  - Commence a lease
- **Reporting**
  - Journal entry activity
  - Disclosures

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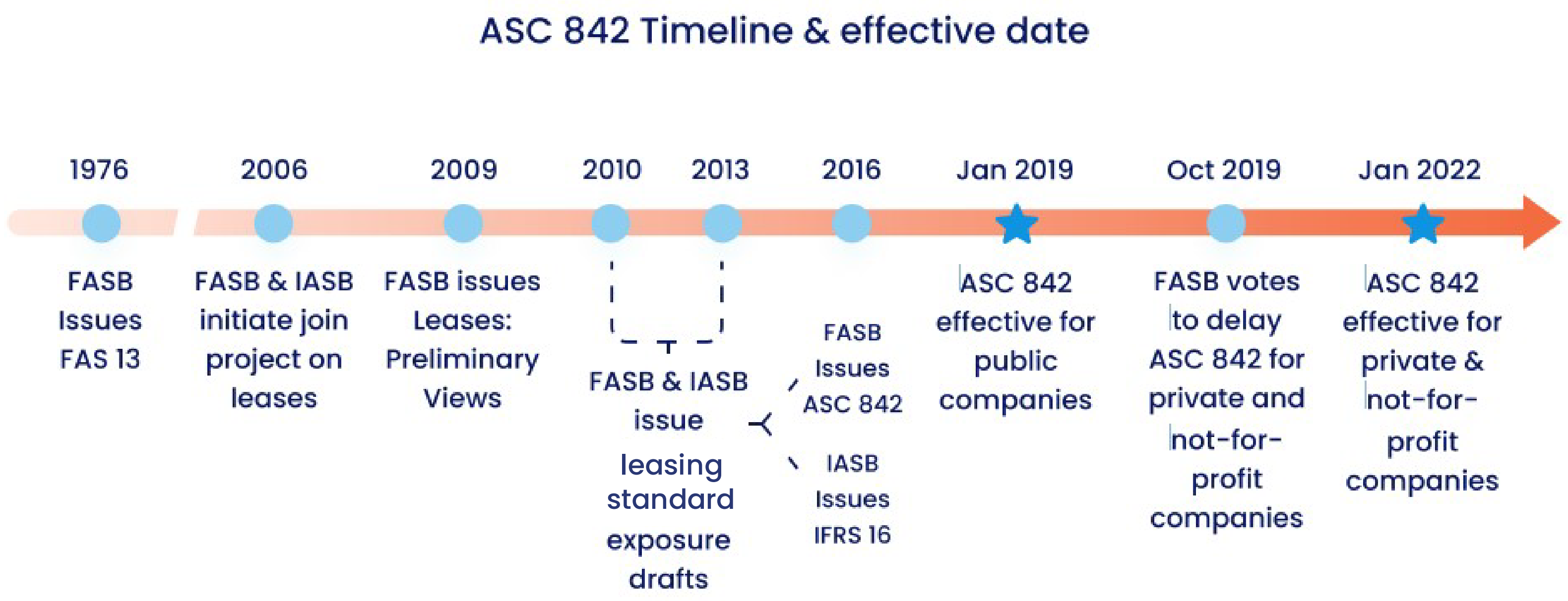
History & effective dates

FASB Privately-held entities: Reporting periods beginning after December 15, 2021

GASB 87: Reporting periods beginning after June 15, 2021



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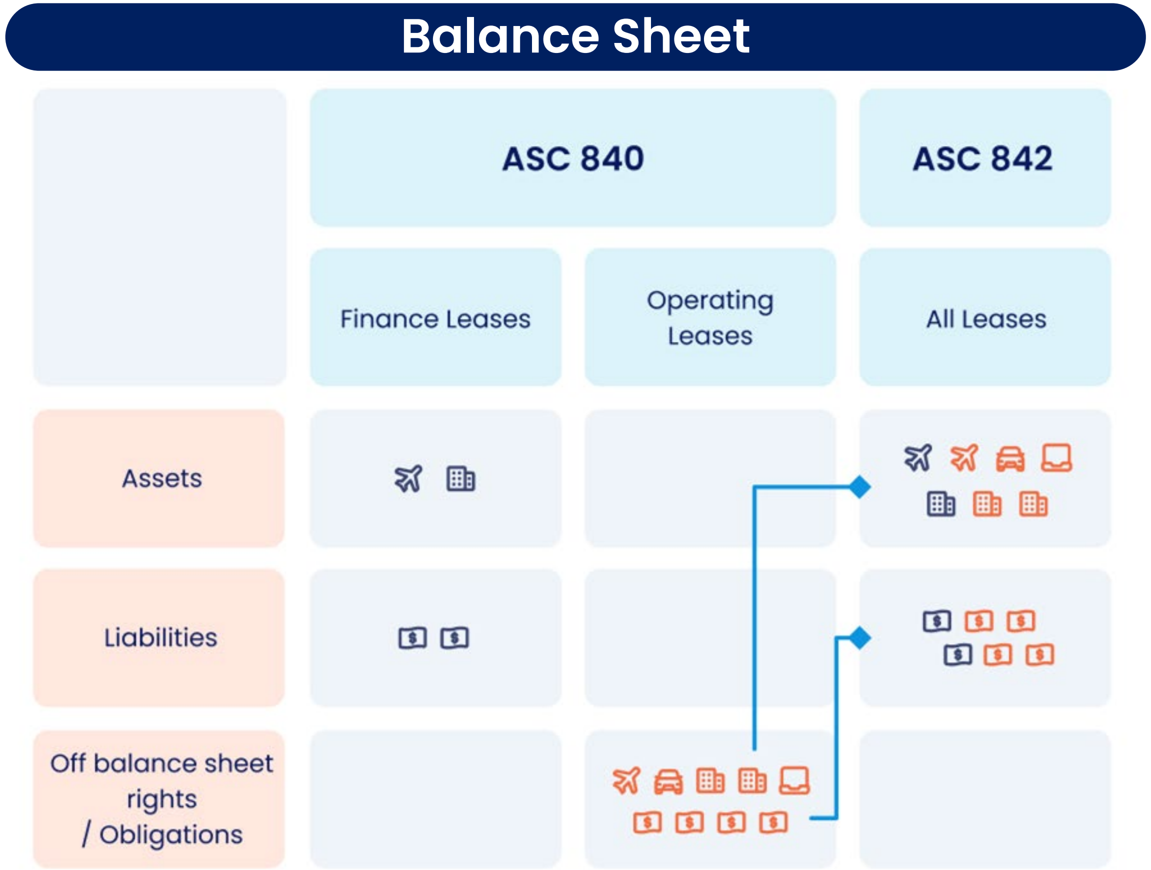
What changed?

Under ASC 840, only capital leases were captured on the balance sheet, while operating leases were on the off-balance sheet and reflected only in the P&L. Leases were classified based on strict guidelines, called “bright lines.” This classification system gave companies the ability to generate lease agreements so that they would qualify as an operating lease, when, in substance, they more closely resembled a capital lease, and therefore remained off the balance sheet.

Now, under ASC 842 virtually all leases must be reflected on the balance sheet. At the time the lease is commenced, a new “right of use” (ROU) asset account is introduced for all lease types, and a “lease liability” is recorded. The biggest impact of this change is on operating leases.

The P&L (no change): For the presentation of operating and finance leases on the income statement, the FASB elected to maintain a distinction between operating and finance leases. In the case of operating leases, an operating cost expense is recorded and included in EBITDA. For financing leases, depreciation and interest expenses are recorded below EBITDA.



Polling Question

How familiar are you with the new standard?

A: Very familiar. I've been following closely since first announced back in 2006
B: Fairly familiar. I've spent time trying to educate myself
C: Slightly familiar. I know the basics, but feel pretty unprepared
D: Not at all familiar. I've heard of it, but that's about it.

More accounting is required

Under the old standard, a fixed-payment operating lease was simple, and monthly entries were all the same:

ASC 840

Lease Scenario

- 3 year fleet vehicle lease
- $500/Month
- $0 Down payment
- Operating lease

Initial & Monthly Entries			
	DEBIT:	Vehicle expense	$500
	CREDIT:	Accounts Payable	$500

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More accounting is required

Under the new standard, there's an initial journal entry and subsequent journal entries that change each month:

Initial Journal Entry: When the lease is commenced, a lease liability is recorded, which is equal to the present value of all future lease payments. A right of use asset is recorded for the same amount and adjusted for initial direct costs, prepayments, or incentives.

Subsequent Journal Entries: Accounting for operating leases is a new concept to understand. Lease expenses must still be recorded on a straight-line basis, and the liability is brought down using the effective interest method. The imbalance between decreasing interest accretion and a constant expense requires companies to "plug" their monthly draw-down of their ROU asset via accumulated amortization. The plug amount will typically increase over the lease term, as shown in the example.

ASC 842

Lease Scenario

- 3 year fleet vehicle lease
- $500/Month
- $0 Down payment
- Operating lease under ASC 842

Initial Entry	DEBIT:	Right of use asset	$16,683
	CREDIT:	Lease liability	$16,683
Month 1 Entry	DEBIT:	Lease vehicle expense	$500
	DEBIT:	Lease liability	$430
	CREDIT:	ROU accum. amort.	$430
	CREDIT:	Accounts Payable	$500
Month 2 Entry (changes each subsequent month)	DEBIT:	Lease vehicle expense	$500
	DEBIT:	Lease liability	$432
	CREDIT:	ROU accum. amort.	$432
	CREDIT:	Accounts Payable	$500

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Lease classifications

Operating: Lessee will recognize lease expense on a straight-line basis over the term of the lease. A right-of-use asset and a lease liability (both discounted by the relevant discount rate) will be established on the balance sheet at commencement and reduced throughout the life of the lease.

Financing: Lessee will recognize interest expense and amortization expense over the term of the lease. A right-of-use asset and a lease liability (both discounted by the relevant discount rate) will be established on the balance sheet at commencement and reduced throughout the life of the lease.

Short-Term: Lessee will recognize expense on a straight-line basis over the term of the lease (less than 12 months). No balance sheet impact.

Low Value: Lessee will recognize expense on a straight-line basis over the term of the lease. No balance sheet impact. Leases are immaterial individually and in aggregate.

Polling Question

How are you currently handling lease accounting for your clients under the new standard?

A: Excel
B: Lease accounting software
C: Nothing yet. I'm here because I know I should be.

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Scope exclusions

ASC 842-10-15-1

An entity shall apply this Topic to all leases, including subleases. Because a lease is defined as a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration, this Topic does not apply to any of the following:

a. Leases of intangible assets (see Topic 350, Intangibles – Goodwill and Other).
b. Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources (see Topics 930, Extractive Activities – Mining, and 932, Extractive Activities – Oil and Gas).
c. Leases of biological assets, including timber (see Topic 905, Agriculture).
d. Leases of inventory (see Topic 330, Inventory).
e. Leases of assets under construction (see Topic 360, Property, Plant, and Equipment).

Transition Methods

Effective:

- Apply the new standard from the transition date forward. Comparative periods in the financial statements are still presented under ASC 840. Highly recommended.

Comparative:

- Apply the new standard for all comparative periods presented in the financial statements. This means that clients will have to retroactively account under ASC 842 rules.

Discount Rate

FASB has three available options for privately-held companies. They are listed below in order of relevance / preference.

1) Rate implicit in the lease:

- In more plain English, the rate implicit in the lease is essentially the profit margin that the lessor will make on the lease. Because of this, the lessor is highly unlikely to include this rate in the lease agreement or even disclose to the lessee the necessary inputs to calculate the rate. The NetLease tool does provide a calculator if the inputs are known, but chances are that the lessee will need to use one of the other two rates. It's worth noting that the rate implicit in the lease is likely the highest of the three allowable rates, which would result in a lower lease liability on the balance sheet.

2) Incremental borrowing rate:

- This rate is defined by the FASB as "The rate that, at lease inception, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset." Think of this as the rate a borrower would have received from a bank had they gotten a collateralized loan on the leased asset for the lease payments (note this could be different than a rate to purchase the asset.) While this rate is much more realistic to obtain than the rate implicit in the lease, some caveats do still exist. Netgain recommends working with auditors to ensure the IBR is within their expectations.

3) Risk-free rate:

- As stated above, non-public companies are permitted to use a risk-free discount rate for leases using a period comparable with that of the lease term. Of the three, this will be the simplest rate to obtain. The US T-bill rate is generally accepted as the risk-free rate.

Polling Question

What percentage of your clients have yet to adopt the new standard?

A: 75% or more
B: Between 50% and 75%
C: Between 25% and 50%
D: Less than 25%

Entity policy elections

ENTITY ELECTIONS	SUMMARY	APPLICATION	GUIDANCE	WHAT WE'VE SEEN
Short-term or low-value leases	As an accounting policy, a lessee may elect not to apply the recognition requirements to short-term leases. Instead, a lessee may recognize the lease payment in profit or loss on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred.	Elected by class of underlying asset	ASC 842-20-25-2	**Typically elected:** Reduces the level of effort of implementation and ongoing accounting. **Low-value threshold:** No prescribed threshold from FASB (IFRS threshold $5,000). Many companies use their fixed-asset capitalization limit for leases as well.
Not separating lease from non-lease components	A lessee may choose not to separate non-lease components from lease components and, instead, to account for each separate lease component and the non-lease components associated with that lease component as a single lease component.	Elected by class of underlying asset	ASC 842-10-15-37	**Typically elected:** Particularly if non-lease components are predictable; high level of effort required during the analysis including determining the stand-alone selling prices of the non-lease components.
Discount rate	A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease instead of its incremental borrowing rate, determined using a period comparable with that of the lease term, as an accounting policy election made by class of underlying asset.	Elected by class of underlying asset	ASC 842-20-30-3	The vast majority of privately held companies are electing to use the risk-free rate despite the balance-sheet gross-up effects.
Portfolio approach	A lessee may account for its leases at a portfolio level provided that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio.	Elected at portfolio level	ASU 2016-02 BC120	**Not typically elected:** In theory, this approach is possible, but clients rarely have a portfolio of leases with characteristics similar enough to be accounted for at a portfolio level.

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Related party leases

In general, if the arrangement allows Lessee or Lessor to terminate without permission from the other party with no more than an insignificant penalty, the arrangement is not enforceable and would not need to be recognized under ASC 842

Under ASC 842: only the ***legally enforceable terms*** of the lease are to be considered

- Lack of documentation can be challenging
- Determining legal enforceability can be challenging
- Continue to apply ASC 850, Related Party Disclosures
- Legal counsel may be required to evaluate legal obligations

Implied lease term:

- Consider intent: the Lessee intends to continue renewing the lease, and past actions support that conclusion
- Consider economic incentives
    - Specialized asset
    - Unique location
    - Other economic factors

Related party leases – Practical Expedient Update

The FASB has decided to allow companies to elect a practical expedient to avoid determining the legal enforceability of written terms and conditions for leases between related parties. **The amendments in this Update provide a practical expedient** for private companies and not-for-profit entities that are not conduit bond obligors **to use the written terms and conditions of a common control arrangement to determine:**

1. Whether a lease exists and, if so,
2. The classification of and accounting for that lease.

The practical expedient may be applied on an arrangement-by-arrangement basis. If no written terms and conditions exist (including in situations in which an entity does not document existing unwritten terms and conditions in writing upon transition to the practical expedient), an entity is prohibited from applying the practical expedient and must evaluate the enforceable terms and conditions to apply Topic 842. This practical expedient is not intended to provide a loophole for unwritten or implicit terms and conditions, however.

Netgain still believes the best practice is to get all related-party arrangements into writing to avoid determining if a verbal agreement is legally enforceable. Once an agreement is documented, the written terms and conditions can be taken at face value, with no legal enforceability analysis required.

Transition reliefs

TRANSITION RELIEFS	SUMMARY	APPLICATION	GUIDANCE	WHAT WE'VE SEEN
Use of hindsight	An entity may also elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the lease term (that is, when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of the entity's right-of-use assets.	May be elected separately or in conjunction with the practical expedient package	ASC 842-10-65-1	**Typically not elected.** High effort and cost for little benefit.
Package of practical expedients: • **Whether a contract is or contains a lease** • **Lease classification** • **Initial direct costs**	An entity may elect the following practical expedients, which must be elected as a package and applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor), when applying the pending content that links to this paragraph to leases that commenced before the effective date: • An entity need not reassess whether any expired or existing contracts are or contain leases. • An entity need not reassess the lease classification for any expired or existing leases (that is, all existing leases that were classified as operating leases in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as finance leases). • An entity need not reassess initial direct costs for any existing leases.	Must be elected as a package	ASC 842-10-65	**Typically elected.** Greatly improves implementation efficiency and costs.

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NetLease demo

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Polling Question

Are you prepared for GASB 96?

A: Yes
B: Unsure. We don't really know what changed.
C: No, we need help

Contact Us!

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