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Lease Accounting – Are you ready for your 2nd year end?

December 2023

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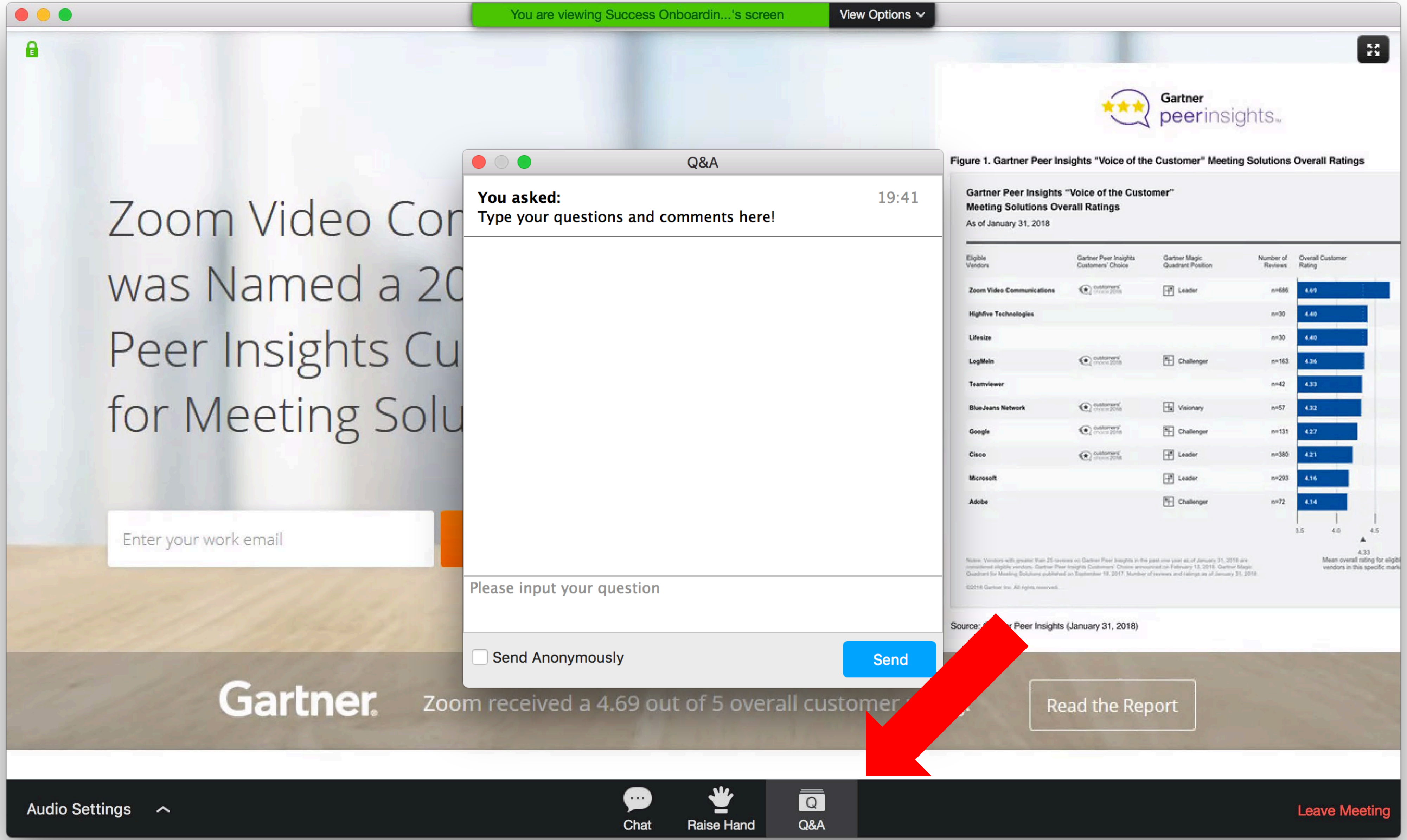
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Gartner
peerinsights
Figure 1. Gartner Peer Insights "Voice of the Customer" Meeting Solutions Overall Ratings
Gartner Peer Insights "Voice of the Customer"
Meeting Solutions Overall Ratings
As of January 31, 2018
Zoom Video Communications
HighFive Technologies
Lifesize
LogMeIn
Teamviewer
BlueJeans Network
Google
Cisco
Microsoft
Adobe
Source: Peer Insights (January 31, 2018)
Zoom Video Cor
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Enter your work email
Q&A
You asked:
Type your questions and comments here!
19:41
Please input your question
Send Anonymously
Send
Gartner
Zoom received a 4.69 out of 5 overall customer
Read the Report
Audio Settings
Chat
Raise Hand
Q&A
Leave Meeting

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Agenda

- Overview of ASC 842 - Refresher
- New Leases (completeness)
- Day 2 Lease Accounting Impairment
- Lessor – ASC 326 impacts
- Disclosures
- What's next?

First Polling Question

How many leases do you currently have?

A. Less than 5
B. 6 to 15
C. 15 to 30
D. Over 30

ASC 842 Recap

ASC 842 Overview

- All leases now on your balance sheet
  - Operating Leases – Expense is recognized straight line as operating lease cost
  - Finance Leases – Recognize amortization and interest expense – Expense typically higher in beginning of lease, lower at end
  - Leases go on at the present value of payments; Use incremental borrowing rate or elect the risk-free rate
  - Can elect not to record short term leases (<12 months)
- Footnote disclosures are more in-depth
- Contracts not traditionally thought of as a lease – require lease accounting under ASC 842 (Embedded Leases)

Lease Classification

- Any new lease or modified lease needs to be assessed for type of lease and asset/liability recorded as applicable
  - Finance Lease – If meet one of 5 criteria
    - The lease term (with reasonably certain renewals) is more than 75% of remaining economic life
    - The PV of payments over the term (with reasonably certain renewals) is more than 90% of th asset's fair value
    - There is a purchase option that is reasonably certain to be exercised
    - Ownership transfers at the end of the lease
    - The asset is of such a specialized basis that it can not be leased to anyone else
  - Short term if ORIGINAL lease term plus reasonably certain renewals are LESS THAN 12 months
  - Operating lease if none of the above were met
- New lease liabilities are recorded at the PV of payments. New lease assets are the liability less any lease incentives received prior to lease commencement, plus any ren paid before commencement plus initial direct costs.

Lease Completeness

Full Inventory of Leases

- Embedded leases – lease hidden in a service
  - Internet with Modem
  - GPS service
  - IT service – where you get a dedicated server or colocation
- Any contract with an identifiable asset and the right to direct the use and obtain all economic benefits is a lease.
- Small leases – Copiers, postage machines, coffee/water coolers
- Note – Software licenses are specifically EXCLUDED from ASC 842.

Inventory Process

- Look at new vendors
  - Vendor reports or General Ledger activity
  - Compare to what was reviewed at adoption
  - Look at supporting invoices or contracts for any new vendors with recurring payments
- Ask all departments/managers to provide any new agreements signed during the year
  - Review to see if any asset is included
- Update your list – with vendor/contract information, conclusion on whether it is a lease, whether you are recording – and if not – why (immaterial, short term)

Second Polling Question

Which of the below would not be recorded on the balance sheet as a lease?

A. Agreement for office space for 5 years
B. Quarterly payments for postage machine over 3 years
C. Lease of forklift for 12 months, with no renewal options
D. Dedicated colocation included in 5 year IT service agreement

Day 2 Lease Complexities

Lease Changes

- Under ASC 840 – it was a “record it and leave it” mentality. No adjustments until the next renewal was signed.
- Under ASC 842 – leases are CONTINUALLY reassessed
- What is a “Reasonably Certain Option” can change throughout the term
- Whenever a change occurs – you must evaluate and remeasure the lease.

Lease Changes – Remeasurement Events

Remeasurement or Valuation Events include

- New lease – Lease begins when you have “access”
- Sign extension or termination
- Lease additional space
- Change timing of payments
- Invest in significant leasehold improvements that make the next renewal term reasonably certain
- Declining financial performance – can make reasonably certain options that were previously valued NOT reasonably certain

New Lease – Early Access

- In June 2023, a Company signs a new 5 year lease for office space.
- The lease states that the commencement date and rent starts once construction is complete – which is expected to be 12/1/23.
- The Company received access to the building on 7/1/23 to work on leasehold improvements.
- The lease inception date is 7/1/23
- Payments are $5,000 a month starting 12/1/23 and going through November 2028.
- Inherent rate is unknown and Company uses the risk-free rate – which is 4.19% at 7/1/2023
- The fair value of the asset was $350,000
- The present value of payments as of 7/1/23 is $266,500.
- The lease is operating.
- The Company will record a ROU asset and liability of $266,500 at 7/1/2023
- Expense for July to December 2023 will be $4,615 per month or $27,692.

Remeasurement – Sign an extension

- Lease is currently valued through a term ending 6/30/2024 with remaining rents of $10,000 a month. The asset value at 12/1/2023 is $63K and the liability $69K.
- On 12/1/2023, you sign a renewal agreement with the landlord to extend the lease to 6/30/2029 and agree to payments of $12,000 from 7/1/2024 through 6/30/2029.
- Risk-free rate is 4.14% at 12/1/2023
- New lease term is 67 months (12/1/23 to 6/30/29)
- The present value of payments as of 12/1/23 is $703K
- Lease test shows lease is still operating.
- The Company will record an increase to **both** the ROU asset and liability of $634K as of 12/1/2023. (703K new liability less 69K old liability)

Remeasurement – Sign an extension

	Payments	Imputed Interest	Liability Reduction	Liability Balance	Lease Expense	Asset Reduction	Asset Balance
Beginning Balance				$260,518.18			$260,518.18
Jan-22	$ 8,000	$ 941	$ 7,059	$ 253,459	$ 9,200	$ 8,259	$ 252,259
Feb-22	$ 8,000	$ 915	$ 7,085	$ 246,374	$ 9,200	$ 8,285	$ 243,974
Mar-22	$ 8,000	$ 889	$ 7,111	$ 239,263	$ 9,200	$ 8,311	$ 235,663
Dec-22	$ 9,000	$ 637	$ 8,363	$ 168,047	$ 9,200	$ 8,563	$ 159,647
Jan-23	$ 9,000	$ 607	$ 8,393	$ 159,654	$ 9,200	$ 8,593	$ 151,054
Feb-23	$ 9,000	$ 576	$ 8,424	$ 151,231	$ 9,200	$ 8,624	$ 142,431
Mar-23	$ 9,000	$ 546	$ 8,454	$ 142,777	$ 9,200	$ 8,654	$ 133,777
Apr-23	$ 9,000	$ 515	$ 8,485	$ 134,292	$ 9,200	$ 8,685	$ 125,092
May-23	$ 9,000	$ 485	$ 8,515	$ 125,777	$ 9,200	$ 8,715	$ 116,377
Jun-23	$ 9,000	$ 454	$ 8,546	$ 117,231	$ 9,200	$ 8,746	$ 107,631
Jul-23	$ 10,000	$ 423	$ 9,577	$ 107,654	$ 9,200	$ 8,777	$ 98,854
Aug-23	$ 10,000	$ 389	$ 9,611	$ 98,043	$ 9,200	$ 8,811	$ 90,043
Sep-23	$ 10,000	$ 354	$ 9,646	$ 88,397	$ 9,200	$ 8,846	$ 81,197
Oct-23	$ 10,000	$ 319	$ 9,681	$ 78,716	$ 9,200	$ 8,881	$ 72,316
Nov-23	$ 10,000	$ 284	$ 9,716	$ 69,000	$ 9,200	$ 8,916	$ 63,400
Dec-23	$ 10,000	$ 249	$ 9,751	$ 59,249	$ 9,200	$ 8,951	$ 54,449
Jan-24	$ 10,000	$ 214	$ 9,786	$ 49,463	$ 9,200	$ 8,986	$ 45,463
Feb-24	$ 10,000	$ 179	$ 9,821	$ 39,642	$ 9,200	$ 9,021	$ 36,442
Mar-24	$ 10,000	$ 143	$ 9,857	$ 29,785	$ 9,200	$ 9,057	$ 27,385
Apr-24	$ 10,000	$ 108	$ 9,892	$ 19,892	$ 9,200	$ 9,092	$ 18,292
May-24	$ 10,000	$ 72	$ 9,928	$ 9,964	$ 9,200	$ 9,128	$ 9,164
Jun-24	$ 10,000	$ 36	$ 9,964	$ (0)	$ 9,200	$ 9,164	$ (0)

	Payments	Imputed Interest	Liability Reduction	Liability Balance	Lease Expense	Asset Reduction	Asset Balance
Beginning Balance				$702,934.89			$697,334.89
Dec-23	$ 10,000	$ 2,425	$ 7,575	$ 695,360	$ 11,707	$ 9,282	$ 688,053
Jan-24	$ 10,000	$ 2,399	$ 7,601	$ 687,759	$ 11,707	$ 9,308	$ 678,744
Feb-24	$ 10,000	$ 2,373	$ 7,627	$ 680,132	$ 11,707	$ 9,335	$ 669,409
Mar-24	$ 10,000	$ 2,346	$ 7,654	$ 672,478	$ 11,707	$ 9,361	$ 660,048
Apr-24	$ 10,000	$ 2,320	$ 7,680	$ 664,798	$ 11,707	$ 9,387	$ 650,661
May-24	$ 10,000	$ 2,294	$ 7,706	$ 657,092	$ 11,707	$ 9,414	$ 641,247
Jun-24	$ 10,000	$ 2,267	$ 7,733	$ 649,359	$ 11,707	$ 9,440	$ 631,807
Jul-24	$ 12,000	$ 2,240	$ 9,760	$ 639,599	$ 11,707	$ 9,467	$ 622,339
Aug-24	$ 12,000	$ 2,207	$ 9,793	$ 629,806	$ 11,707	$ 9,501	$ 612,839
Sep-24	$ 12,000	$ 2,173	$ 9,827	$ 619,979	$ 11,707	$ 9,535	$ 603,304
Dec-28	$ 12,000	$ 286	$ 11,714	$ 71,139	$ 11,707	$ 11,422	$ 69,383
Jan-29	$ 12,000	$ 245	$ 11,755	$ 59,384	$ 11,707	$ 11,462	$ 57,921
Feb-29	$ 12,000	$ 205	$ 11,795	$ 47,589	$ 11,707	$ 11,503	$ 46,419
Mar-29	$ 12,000	$ 164	$ 11,836	$ 35,753	$ 11,707	$ 11,543	$ 34,875
Apr-29	$ 12,000	$ 123	$ 11,877	$ 23,876	$ 11,707	$ 11,584	$ 23,291
May-29	$ 12,000	$ 82	$ 11,918	$ 11,959	$ 11,707	$ 11,625	$ 11,666
Jun-29	$ 12,000	$ 41	$ 11,959	$ 0	$ 11,707	$ 11,666	$ 0

Remeasurement – Significant LHI

- Lease is currently valued through 6/30/2024 with remaining rents of $10,000 a month. The asset value at 9/1/2023 is $90K and the liability $98K.
- The current lease agreement has 2 more renewal options of 5 years each with rents flat at $10,000.
- In September 2023, the Company commits to a plan to upgrade the production facility at a cost of $5 million.
- That triggers a remeasurement because the 2 renewal options are now “reasonably certain” to be exercised.
- In September 2023, you would revalue the lease through 6/30/2034. The present value of payments as of 9/1/23 is $1,042K
- The Company will record an increase to **both** the ROU asset and liability of $944K as of 9/1/2023. (1,042K new liability less 98K old liability)

Remeasurement – Amendment/Landlord Incentive

- Lease is currently valued through 6/30/2024 with remaining rents of $10,000 a month.
- In September 2023, the Company commits to a plan to upgrade the production facility at a cost of $5 million. They sign an amendment with the landlord to extend the lease to 6/30/2034 with flat rent. In addition, the landlord agrees to reimburse $500k of the construction costs when construction is completed- which is expected to be 7/1/2024.
- In September 2023, you would revalue the lease through 6/30/2034. The present value of payments and the landlord incentive is $561K (130 monthly payments of $10K and a credit of $500k in July 2024)

	Old	New
Liability	$ 98,043	$560,885
Asset	$ 90,043	$552,885
Monthly Expense	$ 9,200	$ 6,092

Remeasurement – Shorten Lease

- Lease is currently valued through 6/30/2029 (initial term through 6/30/24 plus reasonably certain renewal of 5 years) with monthly rent of $10,000.
- In September 2023, the Company determines that they will likely NOT renew the lease past 6/30/24
- That triggers a remeasurement because the renewal option is NOT "reasonably certain" anymore.
- The asset and liability balance at 9/1/23 are both $618k
- In September 2023, you would revalue the lease through 6/30/2024. The present value of payments through June 2024 is $98K
- The Company will record a DECREASE to **both** the ROU asset and liability of $519K as of 9/1/2023.

Lease Change – CPI Increase

- On 1/1/2022, the Company entered into 5 year lease for office space.
- The lease calls for monthly rent of $1,000 with annual CPI increases. There is no minimum CPI increase.
- At 1/1/2023 the landlord informs the Company that rent is going up 5% so will be $1,050
- The liability and asset would be NOT be revalued on 1/1/2023.
- The additional $50/month will be expensed and treated as variable rent.

Third Polling Question

Which of the below would not require the ROU asset to be revalued?

A. Sign lease amendment
B. Remodel office with $1 million in LHI
C. Exercise termination option
D. Get CPI rent increase from landlord

Impairment

Impairment Implications

- ROU assets for both operating and finance leases need to be considered in your quarterly and annual impairment reviews of long lived assets (PP&E, intangibles) under ASC 360.
- Current impairment models need to be updated to include leases
- For finance leases – you include only the asset (not the liability) in total assets evaluated. However, you exclude any expense/cash outflows when calculating recoverability.
- For operating leases – you have two options:
  - Include the net asset/liability in total assets and cash flows include the outflow for rent expense.
  - Include only the asset and exclude any rent payments when calculating future cash flows (i.e. same method as finance leases).

Impairment Process – ASC 360

- Determine the asset group
- Evaluate triggering events
- Perform Step 1 – recoverability test
- Perform Step 2 – compare fair value to carrying amount and calculate impairment
- Once impaired, ROU assets are amortized straight line

Lessor – ASC 326

Net Investment in Leases

- Lessors with sales type or direct financing leases will have a Net Investment in Lease recorded (receivable)
- ASC 326 – Credit Losses requires recognition of an allowance for credit losses
- Allowance should be recorded on the date that the lease receivable is recognized
- Should be recorded even if risk of loss is remote
- Risk of loss should be measured on a pool basis – with assets of similar risk characteristics
- Risk is based on historical factors adjusted for current and forecasted conditions

Fourth Polling Question

Which of the following assets would not be evaluated for impairment under ASC 360?

A. Operating lease asset
B. Equipment
C. Goodwill
D. Leasehold improvements

Disclosure Considerations

Disclosures – 2nd Year Considerations

- Short term and variable lease cost – How to track?
- Options available – those valued (included in the ROU asset) and those not valued – This may need to be updated depending on lease changes during the year
- Assumptions on Lease vs Non-Lease costs – Any changes due to new underlying asset type?
- Commitments under leases that have not started and are not in the reported liability – Consider subsequent events
- Reasonably certain renewals are included in the balance sheet – May change if you now valued reasonably certain options
- Lessor – address ASC 326 disclosures

What’s next?

Process Improvements

- Central repository for all contracts
  - Approval processes
  - Monitoring vendors
  - Communication of new contracts
- Chart of account changes
- You should have an annual control process that compares your fixed asset records to your lease terms.
- Reevaluate Software Decisions

Fifth Polling Question

What do you use to track your leases?

A. Excel
B. Software – internally managed
C. Outsourced lease accounting/software
D. N/A

Automation Options

- Excel
  - Ok if one or two leases, but disclosures and remeasurements are more difficult & time consuming
  - Not too late to switch to software or outsourced lease accounting
  - Audit – more time
- Software
  - Different options – allow you to track all aspects of lease; not just accounting – most charge per lease
  - Ask for recommendations

Outsource Lease Accounting

Outsource Accounting

- Use software licensed to CPA;
- Expertise to guide you through initial recording, remeasurements, lease inventory and ensure compliance
- Not always practical to maintain internal staff that possess the skills needed for lease accounting
  - Day 2 decisions and remeasurements not always straightforward
- Cost beneficial

How Insero can help?

- Outsource your Lease Accounting
- Assist with evaluation and implementation of your own lease software
- Update and document your impairment model
- Other lease assistance
  - Questions on lease structure
  - Buy vs lease evaluations
  - Construction and leasehold improvements
- Reach out to Ann at Ann.Montgomery@Inserocpa.com

Questions?

New Lease – Straightforward

- Lease for office space started 12/1/2023 for 5 years (tenant got access 12/1)
- Payments are $5,000 a month
- Company has elected to use the risk-free rate – which is 4.14% at 12/1/2023
- The fair value of the asset was $350,000
- The present value of payments is $275,500.
- The lease is operating.
- The Company will record a ROU asset and liability of $275,500 at 12/1/2023
- Expense for December 2023 will be $5,000