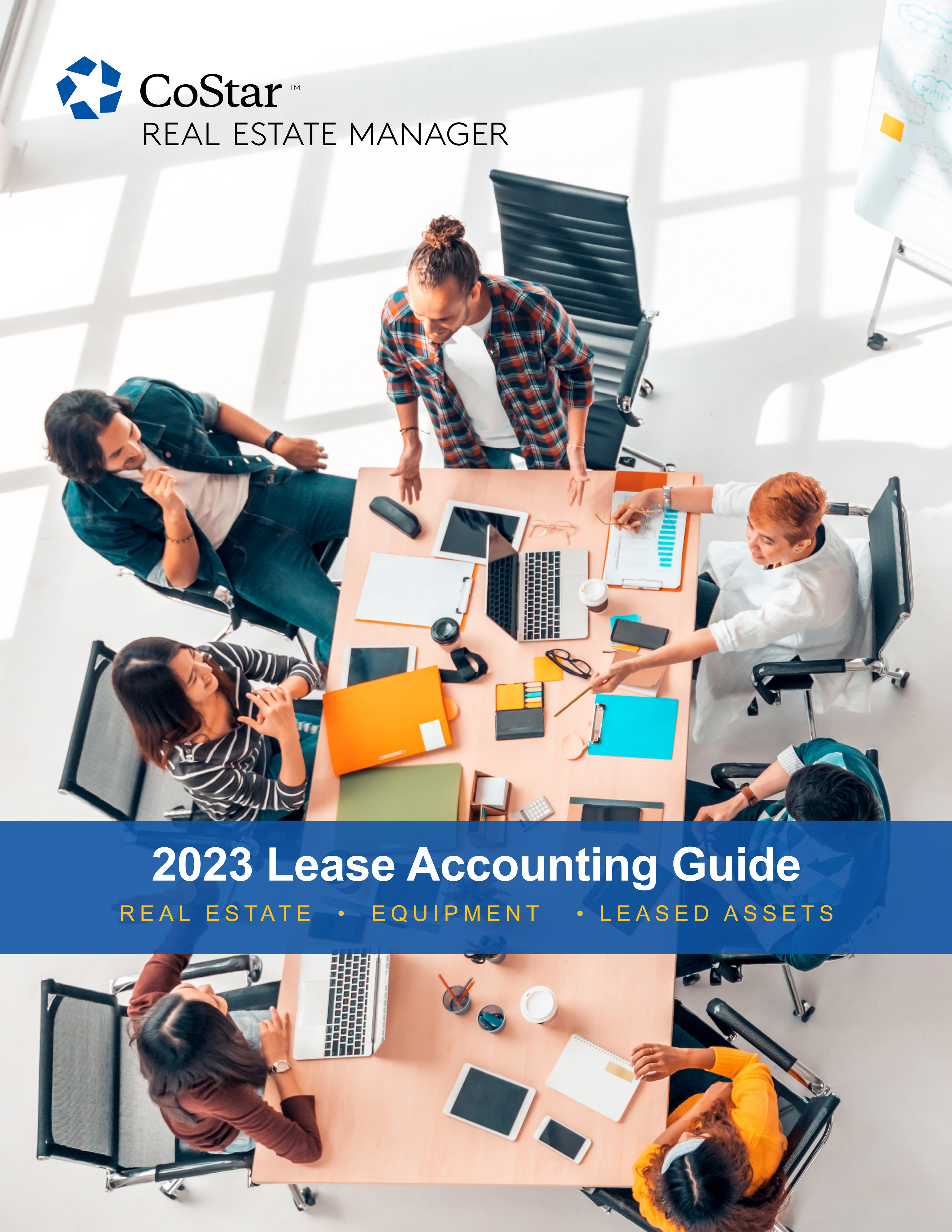

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REAL ESTATE MANAGER

2023 Lease Accounting Guide

REAL ESTATE • EQUIPMENT • LEASED ASSETS

A 12 Step Guide for Successful Project Management

After being discussed for the better part of a decade, the new FASB and IASB lease accounting standards were official in 2016. Public companies had to comply in 2019, and non-public companies originally had an extra year. Due to COVID and other unanticipated delays, non-public companies received an additional two-year reprieve. The deferrals are over, and the time for non-public companies to create a compliance plan is here.

For most large organizations, adding real estate and equipment leases on the balance sheet is a sizable task. This guide – co-authored by the former lease accounting manager with the largest home improvement retailer in the U.S. – offers organizational leaders practical, real-world insight into creating a lease accounting compliance plan. Insights from hundreds of successful public company projects have added to this body of knowledge.

While organizations may certainly have unique challenges, this guide provides a proven, 12-step framework that every company should take on the journey toward lease accounting compliance success:

12 Steps for Lease Accounting Compliance

1. **Obtain a complete understanding of ASC 842 and/or IFRS 16**
2. **Set a compliance timeline**
3. **Meet with a cross-functional group of leasing stakeholders**
4. **Organize a project team**
5. **Select a software solution for lease management and reporting**
6. **Compile a list of all leases**
7. **Evaluate compliance with existing ASC 840 accounting standards**
8. **Evaluate the HR impact and adjust staffing/training plans**
9. **Set internal accounting policies around leasing**
10. **Evaluate the process flow for leases and adjust to ensure efficiency**
11. **Review new processes, software, policies, and pro-forma results with auditors**
12. **Set up a sustainable process for managing leasing data**

While this guide provides useful pointers for compliance with specific guidelines of the new standard, it primarily focuses on the process refinements needed for compliance. The FASB (www.fasb.org) and IASB (www.ifrs.org) websites are valuable resources for more information specific to GAAP guidance and interpretation.

5 MINUTES

5 Minute Version: The Quick Read!

Each step in this guide includes a highlighted summary that should take no more than five minutes of reading to get the short version of the entire process.

1. Obtain a complete understanding of ASC 842 and/or IFRS 16

When the FASB and the IASB started the lease accounting project years ago, the goal was to create a unified set of rules requiring a balance sheet presentation of lease liabilities. Operating leases were widely considered to be a source of off-balance sheet financing, which is why the boards pursued requirements for adding assets and liabilities associated with leasing to the balance sheet.

The goal of requiring almost all leases to be presented on the balance sheet was accomplished. However, the boards did not achieve full convergence of the specific rules. The FASB decided to retain a two-model approach with operating and financing leases, while the IASB selected one model for all leases.

Recording virtually all leases on the balance sheet is a complex task. There are many factors to consider, and companies should make sure the appropriate lease accounting expertise is available. The lease accounting subject matter expert (or team) should have an extensive understanding of the new standards and possess a deep knowledge of company-specific lease data. Companies can utilize an internal subject matter expert, hire or contract someone with expertise, or rely on an external consulting group to gain this essential knowledge base.

5 MINUTES

5 Minute Version:
Obtain a full understanding of ASC 842 and/or IFRS 16

- Virtually all leases will need to be recorded on the balance sheet
- There are some complex changes in the new rules, and all companies should leverage the knowledge and expertise of subject matter experts for complete compliance

2. Set a compliance timeline

One of the most publicized deadlines for the new lease accounting guidance is December 15, 2021, when US non-public companies must adopt the new FASB standard. However, there are many factors to consider in setting a compliance timeline. Many non-public companies view this as a year-end 2022 deadline. However, for companies that present financial statements with a two-year look-back for comparative periods, the deadline for lease data management and processes is effectively backdated to January 2020. Early adoption is always an option, and many non-public companies have elected to accelerate their compliance efforts. A different compliance deadline may be applicable, required, or even favorable, to some organizations when:

- A non-public company is considering going public through an IPO or SPAC.
- A business combination is considered that would unite a non-public company with a public company.
- A company needs to set processes in place during a less busy time of year, strategically avoiding a year-end time crunch.

5 MINUTES

5 Minute Version:
Set a Compliance timeline

- Most companies will need to be in compliance by the end of 2018, with data going back to early 2017
- Many company-specific details of the new standards can affect compliance timelines
- Some companies may find it is advantageous to adopt new standards early

3. Meet with a cross-functional group of leasing stakeholders

Typically, a company's leasing practices impact a diverse group of stakeholders across the organization. Departments often use leases with very little impact on or involvement from other internal groups. Because existing accounting rules do not require the majority of leases to be capitalized, a large portion of leases are approved based on expense budgets in a decentralized process. However, under the new accounting rules, companies need to adopt a more centralized process of collecting, testing, and recording leases for real estate and non-real estate assets. Specifically:

Real estate leases often represent the majority of the financial materiality for companies, related to compliance. Since real estate management is often a centralized function, the data is usually higher quality, but there are data gaps related with compliance. With leases centrally managed, these data gaps are more easily closed.

Non-real estate leases are often less material financially than real estate leases (many exceptions based on industry segment), but can introduce tremendous complexity. Since equipment is historically decentralized in many companies, the leases, processes, lease data, and lease structures are varied and geographically diverse. Suppliers and master leases introduce further complexity. With the variety of equipment leases used by larger companies, lease counts can easily be in the thousands or even tens of thousands.

Departments that have traditionally maintained almost total control of lease data will need to be informed of process changes. Because management of leases has been decentralized, it will be important to obtain buy-in from various groups to ensure all data is captured and new procedures are followed. It is also important to emphasize that the new processes are being implemented due to changes in regulations, not to take away departmental control or autonomy. Stakeholders should take away an understanding that new processes and systems will provide an opportunity to strengthen everyone's ability to manage the business.

Groups to consider including in stakeholder meetings and communications:

- **Real Estate** – Retail and Corporate Buildings and Land
- **Property Management and Lease Administration**
- **Maintenance** – Forklifts, Pallet Jacks, Scissor Lifts
- **Logistics** – Trucks, Conveyor Belts, Trailers, Rail Cars
- **IT** – Servers, Copiers, Software, Computers
- **Procurement** – Involvement with Most Leases
- **Legal** – Involvement with Most Leases
- **Financial Planning** – Budgeting and Forecasting of Lease Cost
- **Accounting** – Financial Reporting and Lease Accounting
- **Treasury** – Incremental Borrowing Rate and Debt Covenant Impact
- **Tax** – Book/Tax Differences

5 MINUTES

5 Minute Version: Meet with a cross-functional group of leasing stakeholders

- Leasing has been a traditionally decentralized process
- Centralizing lease data will be key to success
- Communicate early to obtain buy-in from all stakeholders

4. Organize a project team

A core team should be established to work on the project. The accounting group is the best choice for a department to lead such an initiative due to the technical nature of lease reporting requirements. While many departments will be involved as stakeholders, a group of four or five key departments should be more heavily involved as project leads. Below is a suggested group of departments to make up the core team. However, there will be variations from company to company.

- **Accounting** – Due to the subject matter and the requirements for financial reporting
- **IT** – Because the solution will likely involve implementing new software
- **Program and Project Management** – To add expertise in keeping the project on track/budget
- **Property Management and Lease Administration** – Because of interest in the solution selected and will most likely be responsible for some data input

5 MINUTES

5 Minute Version: Organize a project team

- Establishing a core project team is critical to success
- Consider including project leaders from Accounting, IT, Project Management, and Lease Administration

5. Select a software solution for lease management and reporting

Many companies have tracked leases manually with multiple tools and systems. Real estate and equipment leases were sometimes managed in central repositories, but few companies had a mechanism to track and report data for all leases. Now, the new accounting standards will necessitate a software solution for tracking leases in most organizations. Because the new accounting rules require virtually all leases to be tracked and reported on the balance sheet, most companies are opting to convert existing fragmented and/or manual lease tracking mechanisms to one company-wide lease management and reporting solution.

A centralized system is likely to reduce the overall expenditure for lease administration across any organization, but there are certain pricing factors to consider when shopping for lease accounting software. Keep in mind that not all systems offer the same pricing structure. Many large enterprise options have large overhead costs, while other models are priced solely on the number of system users. A better pricing model focuses on the amount of data managed – based either on the number of leases or amount of data managed – and provides unlimited system users for all departments and stakeholders in the organization.

10 Essential questions to assess lease accounting solutions from software providers include:

1. **Can your solution produce standard disclosure and roll-forward reports with built-in audit details?**
2. **Does your system provide drag and drop ad-hoc report writing capability for every user?**
3. **Does your system automate accounting policy compliance checks and validation of lease data?**
4. **Is your platform backed by a financially stable organization for long-term data management?**
5. **Can standard, retrospective, and batch remeasurements be performed in the system, or are manual spreadsheets required?**
6. **Can amortization schedules be split into different components for items like TIA for book/tax differences or favorable/unfavorable rent for purchase accounting?**
7. **Are discount rates matched to leases automatically, or is manual work required to set up each lease?**
8. **Can company-specific fields be added to the lease abstract and made available for ad-hoc reporting?**
9. **Is data available within the lease accounting application to research real estate fair market values?**
10. **Does your system readily integrate with existing ERP and IWMS systems?**

Selecting a software should involve a thorough process, and company representatives should establish a set of tests to allow the software to demonstrate functionality. Five of the most important and recommended testing scenarios are:

1. **Verify correct results under ASC 840, ASC 842, and IFRS 16 by testing the following major variations:**
   - With and without escalations
   - With and without a free rent period
   - With payment on the first day of the month and on the last day of the month
   - With partial first month's rent requiring proration
   - Renewal (option exercise)
   - Modified Retrospective (transition approach)
   - Assuming renewal options from commencement
   - Mid-term Termination
   - Impairment

2. **Modify key components of the above examples to verify proper Finance and Operating Lease calculations.**

3. **Test non-lease components such as utilities, CAM, and insurance for:**
   - Monthly payments
   - Annual payments in advance
   - Separation of lease and non-lease components or combination of lease and non-lease components depending on accounting policy

4. **Review percentage rent (variable rent) functionality.**

5. **Review CPI (or other index-driven) increases.**

5 MINUTES

5 Minute Version:
Select a software solution for lease management and reporting

- A software solution for lease management and reporting is a necessity for compliance
- Be sure to evaluate software thoroughly and select a proven provider
- Develop a list of test scenarios to verify system functionality

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6. Compile a list of all leases

The amount of data needed to make calculations for transferring almost every lease to the balance sheet is voluminous. Companies must create an accurate and comprehensive list of all leases and pull the data points that will be required for the calculations.

The list of potential sources of lease information and data points provided in this section is a helpful starting point. However, individual companies may have lease scenarios that require different or additional data.

Potential sources of lease data may include, but aren't limited to:

- **Legacy real estate system**
- **SharePoint sites or other repositories of scanned agreements**
- **Fixed asset records (for existing capital leases)**
- **Surveys sent out to the field asking for units to identify leases under their control**
- **Lease footnote and disclosure work papers from previous years**
- **File cabinets and desks (many companies have a large portion of leases still in paper form)**
- **Lessor vendor software (some vendors have online tools available for tracking leases)**
- **P&L (locating lease expenses in the financial statements and tracing them back to the source may be the best way to identify some leases)**

Common Critical Lease Data Points

- Building Name
- Address 2
- State
- Country
- Suite
- Lease Template
- Abstract Reviewed By
- Verification Status
- Lease Agreement Date
- Rent Commencement Date
- Original Lease Expiration Date
- Current Lease Commencement
- Current Term
- Lease Status
- Lease Recovery Type
- Lease Life Remaining
- Rentable Area
- Pro Rata Share
- Additional Use
- Currency
- Option Dates
- Client Lease ID
- Address 1
- City
- Zip Code
- Floor
- Building Type
- Abstract Prepared By
- Lease Email Address
- Lease Hierarchy
- Possession Date
- Lease Contacts
- Straight-line Amount
- Fair Market Value
- Residual Value
- Useful Life
- Specialized Nature
- CAM information
- Option Notice Due
- Original Lease Commencement
- Original Term
- Current Lease Expiration Date
- Term Comment
- Lease Type
- Last Possible Expiration
- Tenant Space Information
- Measure Units
- Primary Use
- Account Type (AP or AR)
- GL Accounts Impacted
- Option Amounts
- Option Status
- ASC 840 (FAS13) Classification
- Asset Value
- Incremental Borrowing Rate
- Bargain Purchase Option
- Transfer of Ownership
- Notes
- Legal Entity
- Tenant Legal Name

Additional Data Points for Equipment

- Supplier
- Location ID
- Model
- Variable Rate
- Variable Rate Terms
- Model Number
- Master Lease
- Equipment Type
- Asset Tag #
- Serial Number
- Variable Rate Type
- Model Description
- Unit Number
- Service Agreement

ASC 842 defines a lease 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. Control over the use of the identified asset means that the lessee has both (1) the right to obtain substantially all of the economic benefits from the use of the asset and (2) the right to direct the use of the asset. The IFRS 16 definition is very similar.

Companies that have started compiling a list of leases are usually stunned to realize how many leases they have. In many cases, the list grows as the project continues. This is why it's most effective to start compiling early and get to a complete list as soon as possible.

The most often overlooked agreements are usually embedded leases, where a lease is included as a part of a larger agreement. Examples of this include when sound equipment is leased as a part of a music streaming service, or alarm equipment is leased as a part of a monitoring service. While it is not possible to include every conceivable type of lease in this guide, the list below can be used as a checklist to evaluate the variety of assets that many large organizations obtain through leasing.

- Agricultural Equipment
- Alarm Equipment
- Buildings
- Communications Equipment
- Construction Equipment
- Conveyor Belts
- Easements
- Forklifts
- Janitorial Equipment
- Laptops
- Medical Equipment
- Music Equipment
- Pallet Jacks
- Real Estate
- Aircraft
- Audio Visual Equipment
- Business Equipment
- Computers
- Containers
- Copiers
- Exercise Equipment
- IT Equipment
- Land
- Manufacturing Machinery
- Medical Technology
- Office Equipment
- Rail Cars
- Restaurant Equipment
- Retail Equipment
- Right of Ways
- Scissor Lifts
- Servers
- Towers
- Transportation Equipment
- Vehicles
- Retail Racks and Shelving
- Rolling Stock
- Semi-Trucks
- Software
- Trucks
- Vessels

5 MINUTES

5 Minute Version: Compile a list of all leases

- Use multiple sources to pull together a list
- Don't forget embedded leases
- Use the lists in this section to help ensure all leases and data points are included

7. Evaluate compliance with existing accounting standards

As companies compile lease information, accounting practices may need to be adjusted under the current ASC 840 (FAS 13) and/or IAS 17 guidance. Changes should be evaluated with materiality (financial significance in terms of GAAP) in mind and could warrant a discussion with company auditors. Some of the practical expedient opportunities in the new standard assume that accounting has been handled correctly under existing guidance. Applying GAAP under the new rules create more of an impact on financial statements than under existing rules. Separating lease and non-lease components under existing guidance usually requires a slight geography shift on the P&L, but impacts assets and liabilities under the new standard.

5 MINUTES

5 Minute Version:
Evaluate compliance with existing accounting standards

- Preparing for the new lease accounting rules may expose compliance issues with current requirements
- Keep materiality in mind
- Understand the impact to practical expedients
- Review with auditors

8. Evaluate the HR impact and adjust staffing/training plans

Without a doubt, some companies with large lease portfolios have a dedicated lease accounting expert who has been intently following the lease accounting changes. However, many companies have assigned lease accounting to an associate in the accounting department who also has other responsibilities. With increased compliance demands and scrutiny, companies need to re-evaluate whether existing accounting staff is sufficient or if additional investments are necessary.

Consulting firms have lease accounting professionals available for engagements to support existing staff with the skills needed to manage a successful lease accounting project. It is important to ask consultants specifically about lease accounting expertise and qualifications. Lease accounting is a specialized and nuanced area, and consultants with deep experience in lease accounting should be considered.

Training should also be a central part of any plan for technical accounting, accounting process, and solution implementation. Top accounting firms have online resources that are updated frequently and can be a great source of knowledge. For more formalized, classroom-style training, check with local CPA societies for CPE (Continuing Professional Education) events on the topic of lease accounting.

5 MINUTES

5 Minute Version:
Evaluate the HR impact and adjust staffing/training plans

- Ensure accounting staff can handle compliance tasks in addition to regular duties
- Consider hiring additional resources or consultants for the project
- Consider training needs to implement new processes

9. Set internal accounting policies around leasing

The new lease accounting guidance is detailed and extensive in its requirements. It also achieves the goal of moving to a more principles-based framework. Now more than ever, it is important to have a solid corporate policy around lease accounting.

Principles-based accounting allows companies to apply general guidelines to present financial statements in a way that is most meaningful, and design accounting policy to best represent the business. However, this flexibility comes with some risk. Companies should be vigilant in their documentation process, recording exactly how accounting policies are set and why the policies comply with GAAP.

Many companies use formal "memos to file" or "internal whitepapers" to document policy decisions, and a good practice is to have the company's auditors approve the policies as implemented. This approval process will help ensure the interpretation of GAAP is correct and save time in the annual audit process.

When applicable, companies should consider the following areas from a policy perspective:

- Thresholds to replace bright-line tests
- Application of the practical expedients package
- Organization of leases into groups or portfolios to streamline the use of interest rates and other variable considerations
- Materiality

While IFRS 16 sets a $5,000 threshold for materiality for balance sheet presentation, ASC 842 leaves this amount to be determined by organizations. Therefore, a reasonable approach would be to set materiality for lease capitalization at a level similar to the fixed asset capitalization threshold.

5 MINUTES

5 Minute Version: Set up internal policies around leasing

- New standard is more principles-based and will require more robust company policies and controls
- Set new policies and discuss with auditors

10. Evaluate the process flow for leases and adjust to ensure efficiency

Wise decisions regarding the new FASB and IASB lease accounting standards provide an opportunity to add value to the company by streamlining processes, empowering better decision-making, and realizing cost savings.

Data reliability fosters complete and accurate accounting, improved auditability, and time savings in preparing financial reports, 10K footnotes, budgets, and forecasts. Timesavings can also be realized with the right software selection, as routine reports can be automated or run at the click of a button.

Leases tracked in silos across a company are often managed with varying levels of scrutiny, which can affect data reliability. Some organizations may still use spreadsheets to track leased assets that don't provide any of the management benefits like a software system does. Not only will the transition to a centralized data management system give companies a more accurate picture of leased obligations, it will provide individual departments with better control over procured assets. The ideal software platform includes features such as automated renewal reminders and data change notices and enables departments to manage payment obligations, set approval workflows, and control lease abstracting quality across an entire portfolio of leases.

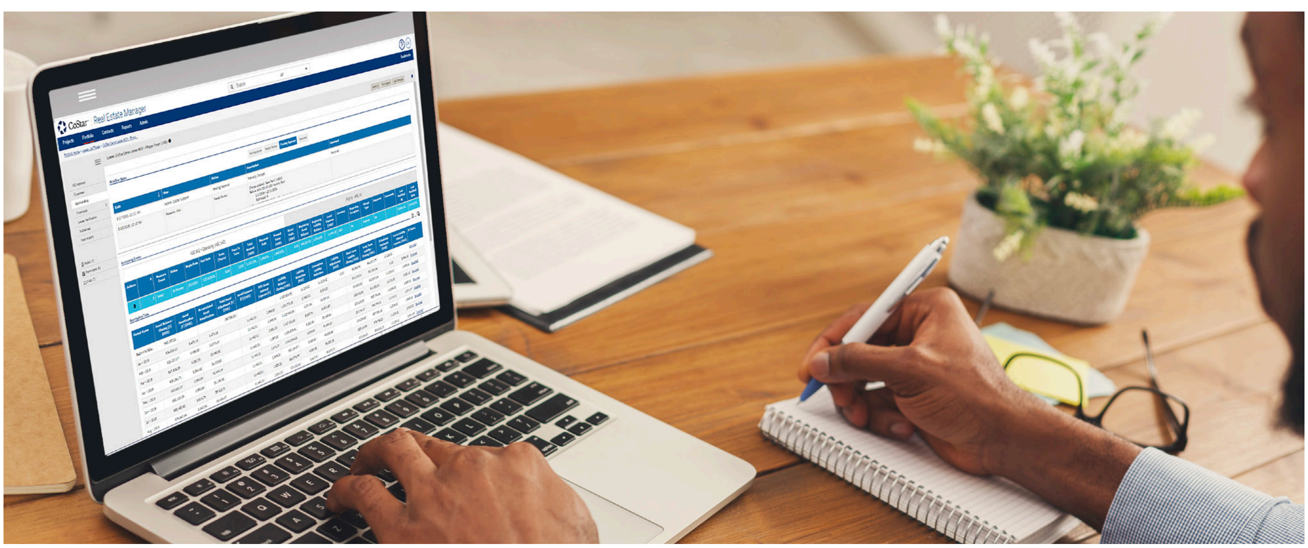
Weaknesses in data management lead to companies overpaying lease obligations. The two most common areas for wasted spending are lack of unbundling and poor end-of-term decision-making, particularly with equipment management. Utilizing one universal software system provides visibility into all organizational lease portfolios, enabling spending patterns to be seen along with opportunities to eliminate unnecessary spending or overpayments on lease obligations. Significant cost savings can result from properly organizing data and enabling company-wide analysis. This also can provide better leverage for negotiations with vendors.

5 Minute Version: Evaluate the process flow for leases and adjust to ensure efficiency

- Consolidating and organizing lease data helps ensure lease data reliability
- Ensure leasing practices are efficient and eliminate waste
- An efficient lease management process can produce cost savings and better negotiating leverage with vendors

11. Review new processes, software, policies and proforma results with the audit team

As companies compile lease information for accounting, it is important to recognize that internal and external auditors play an important role in a company's financial health. Therefore, it makes sense that these teams should be involved in the lease accounting compliance plan.



Internal auditors are typically responsible for ensuring compliance with company policies around procurement, record-keeping, and more. Project leaders should consider involving internal auditors early in the process to obtain buy-in and to ensure decisions are in compliance.

External auditors are responsible for rendering an opinion that the company has presented accurate financial information. These accounting professionals are also among the best resources available to company management on the application of GAAP. Due to independence rules, the external auditor will not take on projects such as selecting a software system or setting accounting policies. However, as companies go through the process, it is a good idea to keep the external auditors in the loop and utilize their expertise to verify the project is on the right track. This will provide assurance as the project progresses and save time in the annual audit process.

5 MINUTES

5 Minute Version: **Review new processes, software, policies, and pro-forma results with the audit team**

- Audit teams can add expertise for project success
- Reviewing early with audit associates can save time during the next annual audit

12. Set up a sustainable process for managing leasing data

The initial push toward compliance with new lease accounting standards is important, but it is equally important to ensure that the software and policies put in place will continue to be a valuable mechanism for acquiring business assets on an ongoing basis. Once a new system is implemented, and processes are established, a company should develop a sustainable environment to monitor, control, and continuously optimize leasing practices.

During this phase of the process, companies should consider how their selected software systems and practices will scale to meet projected demands. Items to evaluate include:

- How will new leases be abstracted into the system, and by which department?
- Will the new system allow for ad hoc reports and if so, do they have to be ordered from the vendor, created by a power user, or can they be created on the fly by any user?
- Which metrics will be important for evaluating leases?
- Who will monitor the ongoing process and ensure compliance with accounting rules?
- What other guidelines are important to ensure efficient leasing practices?

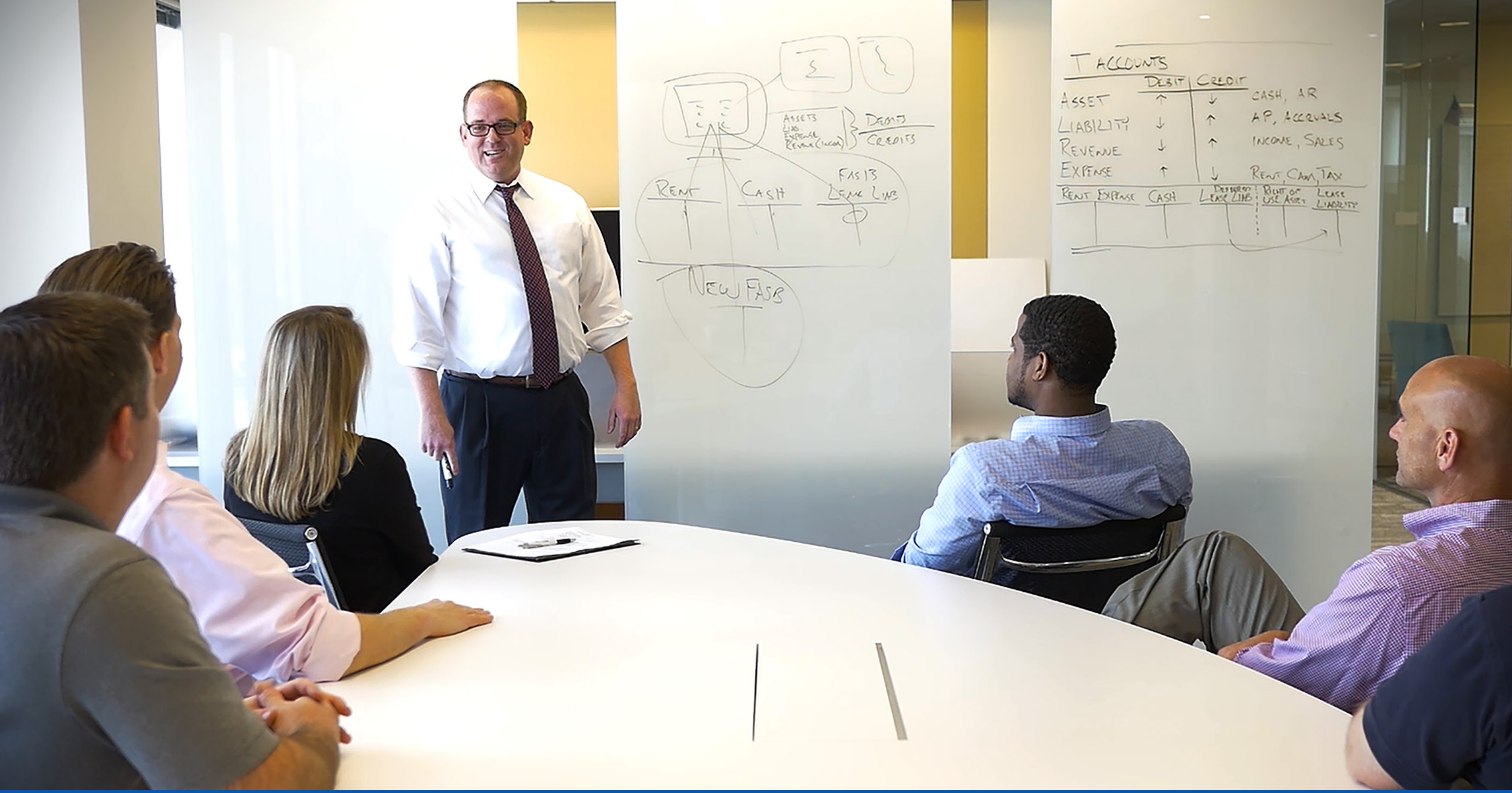
5 MINUTES

5 Minute Version: **Set up a sustainable process for managing leasing data**

- Leasing will continue to be a valuable practice for business operations
- Existing leases will need to be maintained, and new leases will need to be set up
- Give some thought now to a sustainable and efficient process
- “Day 2” is just as important or more important than the initial compliance exercise

Conclusion

The idea of adding virtually all leases to the balance sheet is daunting, but the benefits reach far beyond accounting standards compliance. Gaining operational efficiencies and providing visibility into spending patterns around leases can result in big savings. The keys to success include understanding and developing accounting policy, careful project planning, staff training, and strategic software selection.



Contributing Author Profile:

Matt Waters, CPA, MBA, CGMA

Matt Waters has more than 20 years of experience managing accounting and finance. He has worked with both small organizations and large public companies including The Home Depot and American Tower. His expertise includes process improvements and software evaluation for the new lease accounting guidance issued in early 2016 by the FASB and the IASB.

While at The Home Depot, he led the project to consolidate data for real estate, equipment, and other leased assets into a single department, which increased efficiency in preparing financial reports, 10K footnotes, budgets and forecasts. Organizing lease data in one area allowed the business to see patterns, eliminate waste and make more informed decisions. Ultimately, his project enabled company-wide quality control over leased assets, reducing over-payments and other costs, which added money back to the bottom line.

Mr. Waters has contributed to whitepapers and articles on the topic of lease accounting and has been an invited participant at industry roundtables sponsored by leading accounting firms. He has also led CPE events focused on lease accounting. Since the new lease accounting standards were issued in 2016, Mr. Waters has focused on helping clients prepare for lease accounting changes.

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Lease Accounting

"With CoStar, you can drive business results and meet the new accounting requirements. It's clearly the best all-around choice."

Matt Waters, CPA
Former Lease Accounting Manager with the Nation's Largest Home Improvement Retailer

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