Lease Implementation Update

The new lease standard is here and effective now! This recording will discuss the basics of the new lease standard and the lessons learned through our experience helping various organizations with implementation. Don’t miss the tips and tricks that will help guide you as your organization prepares for implementation.

Find additional resources on our event page: https://www.claconnect.com/events/2022/lease-implementation-update

Here is a transcription of this session:

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Airam Valdez: Good morning and welcome. My name's Airam Valdez, a member of CLA's National Assurance Technical Group. And on behalf of CLA, I want to thank you for taking time out of your busy schedule to attend today's presentation on leasing.

But before we get started, a quick word for my attorneys. As a reminder, this information is for general information purposes only.

We will be providing this presentation at the conclusion of today's webinar so you can refer back to this slide and the rest of the presentation.

So with that out of the way, let's talk about today's learning objectives. Real simple, two learning objectives for today's presentation.

First, recognize the changes associated with the new leasing standard, understand them a little better, and most importantly, understand some helpful tips and tricks on implementation and how CLA can help.

And with me I've got two great presenters that have done this with clients and have been working on this for a number of years.

So great opportunity to introduce Mr. Michael Luff and Sandy Young. Sandy, Michael, why don't you just give a quick shout-out to the audience, tell the group a little bit about yourself before we get started?

Michael Luff: Sure, I'll go. My name is Michael Luff. I work at CLA in the Consulting Group. I'm located in North Carolina, near Raleigh. The reason I'm here, in our consulting group, we've worked with various clients in different industries going back to when the publicly traded companies had to adopt back in 2019.

And so, we do have a lot of good experience we can offer on how to get this done and get it done efficiently and effectively and some ideas of things to think about that may not be quite so obvious until you've been through it.

So happy to be here and offer some experience that we've had. Sandy?

Airam Valdez: Awesome.

Sandy Young: Super. Good morning. I'm Sandy Young. I'm a Client Service Principal here in our Minneapolis office. I work primarily with manufacturers, distributors, retailers.

I'm excited to be here today. I've had a couple of clients that have implemented the lease standard and quite a few that are working through that process right now. So excited to share some of the content we have with you guys today.

Airam Valdez: Awesome. Thanks, Sandy, thanks, Michael, for sharing a little bit about yourself. I've actually had the opportunity to work with both of them in our national group because we work as a team.

And I think that's one of the big things as we go through this lease implementation in tips and tricks is you've got to do this as a team. It's an all-hands-on-deck approach, right?

So you look at it from a client service perspective, you may have outside consultants, and then you have internal specialists, and really working together as a team is really important. I think we'll drive that home a little later on in today's presentation.

So let's just do a real high level overview of the lease standard, and then we'll get into some nuances that Sandy and Michael will drive through.

We call it the new lease standard, but in actuality, the standard's been around since 2016 when it was codified with ASU 2016-02.

Again, why do we call it new lease standard? Well, it's been deferred multiple times, and I think as we get through this presentation a little more, we'll understand why it can be hard to get started, why it's been hard for some of the public companies, as Michael talked about, to implement.

But that train has left the station now, there are no more deferrals. So the standard will be effective for fiscal years beginning on or after December 15th 2021.

So if you're a calendar year end reporter, the standard will be in effect at your 12-31-2022 year end. It will also be in effect for interim periods thereafter.

So you can breathe a little bit of a sigh of relief. There is no requirement right now to early adopt an interim periods, but that doesn't mean you can kick the can down the road. And we'll talk about that here in a little bit more detail.

Why did we implement this new lease standard? Why is it out there? Well, it's really just to provide a better faithful representation of leasing transactions.

We all know capital leases have always been on the financial statement. Really, what's changing is those operating leases which were off balance sheet assets and liabilities, those are coming onto the balance sheet.

Big, big change. Trillions of dollars of assets and liabilities are coming onto the financial statements. Public companies have been doing this for a long time. A lot of work is going into it.

Lessor accounting thankfully has not changed a lot. So we're not going to really spend a lot of time talking about the lease standard from a lessor perspective. With all those new changes, guess what? Enhanced disclosures for lessees and lessors.

Now, from an income tax perspective, no change in how you characterize operating in capital leases for federal income tax purposes, but there will be some nuances and additional changes as a result of bringing those right-of-use assets and liabilities on the financial statements from a book tax difference.

But we won't really go into that a lot of details for today's presentation.

So, now that we have that big picture overview, I'd like to turn it over to Sandy to talk a little bit about just what is a lease. What is a lease? Why does it matter?

Sandy Young: Super. Thanks, Airam. Thanks for going through that and the high level review of where we're at today. Let's maybe start at the beginning.

What is a lease? So you can see on the slide here the definition. It's a contract or a part of a contract that conveys the right to control the use of an identified property, plant, or equipment for a period of time for an exchange for consideration.

The two key components out of that are it's a specifically identified asset and it's the right to control the use of that asset. That sounds pretty simple, right?

But there are some hidden things as part of that as well. There could be some embedded things as part of it, and we'll get into that a little bit more, and Mike's going to share with us what some of those things are. But on the surface, it looks pretty simple.

Let's talk about the classifications. There's really still two classifications of leases. One, is now financing what used to be called capital, and operating is still operating.

What's changed and what's different about that? Well, a financing lease is still an asset and a liability that you book on the balance sheet. Your income statement still has amortization expense, interest expense, and your cash flow has the two components.

Operating leases, however, are now going to come onto the balance sheet. And really, what this is looking at is saying what we used to have buried in the footnotes, it's pulling that information forward and putting it on the balance sheet itself.

So we're going to go through some calculations that are going to show you how do we record that right-to-use asset and a liability for operating leases.

When we get to the P&L, the P&L is still going to be lease expense. It doesn't break it out into operating or, excuse me, amortization and interest expense like a financing lease does, it still is lease expense.

Let's look at a really simple calculation. And so, if we take a look here, so simple lease five years. And just to step back for a second, we're not going to get into the really nitty-gritty of this.

This is really meant to be high level, give you some introductory things as to what this will look like. But for this first part, let's ignore this column that says adjustments.

So really, we have a five year lease, we've got escalating rent payments, so we're going to calculate the present value of those calculations. And that's going to be our lease liability.

Well, if we don't have any adjustments to that, no indirect costs, no lease incentives, we're going to have a right-of-use asset that will be the same as the lease liability.

Where we start getting a little bit more complex is in the adjustment column and what may end up being embedded components of a lease agreement.

So, Mike, maybe you want to jump here and talk about what some of those complexities look like?

Michael Luff: Yeah, absolutely. I'm going to go back to that last slide, I like this slide. It just lays out the idea that we've got these payments, we do the discount calculation, which locks into liability.

But from a ROU asset balance standpoint and maintaining that balance, then we're taking into account initial direct cost. We're taking into account any prepaid lease expense incurred by the lessee. I think we're really looking at this from the lessee's point of view, as Airam mentioned.

Income leases or revenue leases, the accounting hasn't changed. We make the adjustment though for the initial direct cost.

A big one that comes up that always is difficult to get a hold of are the lease incentives. These come up mostly in relation to real property leases where it's very typical for going into a new space, the landlord is going to offer some reimbursement or financing of upgrades and renovations and this type thing.

What used to be book kept in a separate account on the balance sheet under 840 to capture that liability and spread that income over the life of the contract, now that amount is going to be buried, so to speak, in the ROU asset balance.

It has the same effect, but it just tightens up the accounting and bookkeeping, which is particularly important when we think about the time of adoption where we've got outstanding TI, or tenant improvement, liability on our balance sheet. And as part of our initial opening that balance would fold into the ROU assets.

So just something to keep in mind of what are these initial entries that we make once we get all these calculations put together.

Airam Valdez: Michael, that's a great example where the devil's in the details, right? Real simple example, think about your key accounts from college.

But then the nuances, what's that least term, least components, non-lease components? So that's a great segue to the next part of the presentation, right?

Michael Luff: Absolutely. So thinking about what some of the requirements are of how we're going to schedule out payments, and we're going to talk about term and how we measure these liabilities and assets.

One of the first things to think about, which was offered in the standard as an option to consider, right, as an expedient, that we can choose to combine our lease and non-lease components of a lease contract in our tabulation of payments, and ultimately would impact the discounted amounts in the asset liability balance sheet.

In practicality, I'm not sure that this is something that most people will do. The idea or the concept in the standard is that we would have a lease of, let's say, a real property, let's say an office space, we would know what the base rent is.

We need to have the base rent amount, which is in this context a lease component. But there are always, or most times, there are non-lease components also in the contract.

We, as a lessee, in an office building setting, we're expected to pay for common area maintenance and those types of other payments that we make. And those have been termed in the standard as non-lease components.

There is an option to recognize the total amount of the rent, plus let's say a common area of maintenance and we can combine those, or we can split out just the fixed base rent.

In my experience or our experience, typically if we can identify the fixed space rent, it's not combined with other elements, then that is typically what we use.

I've had a few situations where there was a client we were working with and they leased a fleet of rental cars. And as part of the lease agreement, they agreed that they would pay a $50 a month fee to have access to a nationwide chain of repair and maintenance store like Firestone I think it was.

And so they just combined that 50 bucks in payment and did that because it was maybe just a little easier looking at the way the invoices were structured and the contract was structured.

But in the main, typically those non-lease components are slid apart and just period expenses as occurred. And that's how those would roll through our financial statements.

Then there's a third category, which is, it's not a lease component, it's not a non-lease component. It's just another contract element.

Typically, comes up when we maybe think about real property, normally the lessee is going to be on the hook for the property tax or an allocation of property tax. Also, the lessee is going to be on the hook for a fair share allocated of the insurance for the property, right?

And so those elements are never allowed to be combined as part of the 842 calculation. They strictly stand on their own. And so those are always going to be period expenses as incurred for the taxes and insurance.

So again, as Airam pointed out, we pick up a lease contract and all of a sudden we're seeing various things apart from the rent. There may be CAM, there may be taxes new, there may be features in the contract where there are variable amounts that could be payable to a landlord or to a lessor from us.

So just really thinking about things, trying to categorize the elements of the contract, so that we've got a good clear view as to what we are seeing and what is going to help us get compliant with the standard.

So that's a good starting point. Let's think about the two main measurements that we have to consider in the calculations.

The first is the lease term. So we have to understand what is the actual applicable lease term that then determines how far out we would schedule the payment stream.

And obviously the further out the more payments than the discounting the present value of that greater amount's going to be a larger liability and a larger asset.

So what do we look at for lease term? Well, the first thing is easy. It's the non-cancelable period. Typically, let's just say an example, we've got a car lease, a vehicle lease or truck to use in operations.

And we've got a three year lease with an option to extend for another three years. So the initial three year period is a non-cancelable period. Neither side can walk away. We're locked in. Everyone has rights and obligations for that non-cancelable period, that's going to be part of our term.

Then we look at potential renewal options, they don't exist in every lease, but for this purpose, as far as assessing our lease term, then we need to consider these renewal options that we as the lessee can say, "We are reasonably certain to exercise," right?

So if it's a vehicle lease, and let's say we have a three year initial term, we're in year two, we have no reason to trade this particular vehicle in and management believes we're going to extend for an optional additional three years. Then we would include that total of six years of payments in our calculation.

If we can't be reasonably certain then we would not consider those extension periods reasonable certainty, keeping in mind that that is not more likely than not. That's more of a 75 to 80% confidence level, this concept of reasonably certain. So that's the second element.

Airam Valdez: So that's where the judgment comes in, right, Michael? As we're thinking through this lease term, in that real simple example that Sandy referred to of the amounts in that term, this is where it can get a little more complicated, right?

Where on the face it might be a three year lease but all these options you've got to assess. So then that liability may not be over a three year period. It could be six or nine. And there's some judgment as you just pointed out.

So great reminders there, Michael. How about on the consideration side?

Michael Luff: Yeah. So if we look at what the actual payment amount is or what the finances are related to this lease over the term that we've decided is appropriate.

We look at the payments related to the use of the asset. So typical let's say a monthly payment amount over the term. We may have other fixed or any kind of end substance fixed payments.

Typically, we get towards the end of a lease and let's say we've got a residual value guarantee where we've got to ensure that the value of the asset when we turn it back to the owner has a particular value.

And it's typically negotiated but at some point we either decide, yes, we're going to owe something as a residual value guarantee, or we're not going to owe anything. But once that's a known amount then that needs to be factored in.

You've got variable payments that depend on a rate or index. As of the commencement date, those are included. As they change over time one thing to think about is as we have variable payments through time that are related to let's say the consumer price index or any interest rate, those would be considered variable payments and expensed in the period but then also disclosed in our footnote.

But this is referring to the fixed amounts and then we would reduce that consideration, that's the cash that we pay to the lessor.

And then we reduce it by the cash that we receive from our lessor. It's called an incentive, it's TI, tenant improvement funds that we would receive. And that nets out to the total consideration.

Airam Valdez: Yeah. So that really in a nutshell are the two real key components, right? That go into, again, that example that Sandy presented, right?

Which is that initial present value. You've got your lease term and you got your consideration, and then you got to slap on a discount rate.

It can't be really that simple Michael, right? There's probably some nuances when we think about the discount rate, right?

Michael Luff: Oh yeah. There's no accounting standard that they're going to make it easy, right? We need to get things complicated. So one of the first things, again, after we go through the judgements of the term and we go through the judgements of what all the consideration is, we need to take into account, we need to apply a discount rate.

And so what does the standard say about a discount rate? Well, there's a hierarchy. The first option or the first go to is the rate that's implicit in the lease.

That would be ideal. I've only had a few handful of cases where that was even possible for us as a lessee to have a supported calculation to back into what rate was implied by the contract.

So aside from a very minuscule handful of cases, we are left with the option of using the lessees incremental borrowing rate.

So that's the first probably practical option to use an incremental borrowing rate. I won't dwell on it too much, but a lot of folks have read the standard and it's very, very hypothetical.

It's what would a rate be if we were to borrow additional funds today and repay those to a lender over the term of a lease?

And so it's backing into what that amount is that we would receive upfront and that would reflect this discounting for the incremental borrowing rate.

Thankfully for non-public entities, and most of the folks now are getting into this are private companies, non-public entities do have I believe it's an election to be made that they can use a risk free discount rate by class and the risk free discount rate really is applied.

We look at the treasurer department's T-Bill yield curve. We look at the portfolio of leases and the average outstanding term that we have in our portfolio.

And so let's say we have some longer term real estate leases, we have shorter term say vehicles and office equipment and other equipment, we may come up and say, "Well, our average outstanding is seven years." We'd look for the seven year T-Bill rate and we'd apply that.

Obviously, as noted here, the risk free rate's going to be very, very low, obviously lower than our incremental borrowing rate.

And that mathematically, because that's the denominator of the calculation, that ends up generating a higher course up on the balance sheet of an ROU asset and lease liability balance.

But it's very objective. It's something we can replicate. Every year when we have leases we can go back and we can use the same approach. And it just is a stable way to do it.

And most of the folks that we're working with now that are in this 842 standard are using that as their option, just for the ability to replicate and consistency.

Anything else, Airam, that comes up?

Airam Valdez: Yeah, I think it's a real good segue, Michael, we're touching upon as we're going through these examples that Sandy initially again lined up.

There's some accounting policy elections, and then we're starting to pick up and fill taste of that professional judgment, whether it's the lease term, the discount rates, and there's a lot up here folks.

And maybe a couple things to tee in on, Michael, is maybe talking about that least capitalization threshold. It's not necessarily codified in GAP, but I think this might help folks breathe a little easier.

So say I've got a really, really big organization and I've got that small copy machine, few hundred bucks. What would GAP say around how to treat those leases from that perspective? And maybe some tips and tricks around that?

Michael Luff: Yeah. Unfortunately in the standard, there was no specific mention of the application of the materiality concept. I think the board assumes everyone's going to apply that generically.

And what happens, in most cases we start with the capitalization threshold that we use for fixed assets as a starting point, right?

So if we have a lease and it's a small lease, maybe it's 50 bucks a month for a couple of years, maybe two or three years, we discount that back.

And the present value amount that otherwise would be accounted for on the balance sheet is less than our capitalization threshold for fixed assets.

And if we have a large organization, we may have a $10,000 threshold or a $5,000 threshold, compare that to the discounted present value of those future payments over the term and we can easily see that it's not going to be anywhere near that threshold. And we would absolutely apply the concept of materiality to our lease accounting.

Having said that, I think if anything, folks look at capitalization threshold maybe for different reasons and asset security, et cetera, and tracking, they may have a fairly low threshold.

And we've had folks that we've worked with that have actually developed support just conceptually from management standpoint, that they'll set a little bit higher threshold for capitalization of lease related balances as assets and liabilities. So that definitely helps.

Sandy Young: Hey, Mike, question for you, as we're looking at these considerations. One of the things that's scoped out of 842 is short-term leases.

So if you have a lease that's less than 12 months, it doesn't have to be accounted for in this way. Well, why wouldn't we just change all of our leases to 12 months or less than 12 months so that we don't have to worry about this?

Michael Luff: Yes. Okay. We could do that. I think it's something that I've had that question come up-

Sandy Young: I've had that question come up a lot.

Michael Luff: Unfortunately or fortunately, we are left with the portfolio of lease contracts that we have at the date of adoption. And they're definitely not going to all be short term.

There are obviously folks that start to think about this and they look at certain situations and they may be angling to do that.

Maybe take into account if they've got a relationship and they know they need the asset for a number of years, but they feel comfortable with a contract that's for 12 months or less, then that's absolutely.

It's something we need to disclose, that's one thing to think about. That if we want to exercise our accounting policy election to not capitalize any short-term leases that just needs to be disclosed

Sandy Young: And I'm guessing the other component of that, especially with space leases, is that from a GAP perspective, when you capitalize leasehold improvements, for GAP purposes that's over the lease term.

So let's say related party lease or somebody were changing our lease to less than 12 months, we got to follow that same logic with our leasehold improvement capitalization.

So it whipsaws you, if you have a bunch of leasehold improvements and a less than 12 month lease, all of a sudden you have to expense those leasehold improvements.

Michael Luff: Right.

Sandy Young: So it's just to remember to look at the complete picture and not isolate our decisions and things that we're thinking about with these just to avoid doing the balance sheet presentation of the leases.

Airam Valdez: Yeah. No great stuff here, guys. And I think this is a great segue to lease disclosures and hey, there's a lot here, folks. Again, we're going to provide the presentation at the end. So you can refer back to this.

As Michael and Sandy just pointed out, right? As we were talking about those accounting policy elections and that use of professional judgment, guess what the accounting standard setter said, "Okay, great. You can elect certain policy elections. You can use professional judgment, but guess what? You got to disclose it."

So all those existing disclosures we became accustomed to under 840, take those and then layer on those new requirements for additional quantitative and qualitative disclosures. And that's really all that's changing here, right?

You have your old existing disclosure requirements and then the new ones. And again, we'll provide this a little later on. So this is just to illustrate again, you've got the use of professional judgment, you got accounting policies, you got to disclose those.

So that's where the time and effort starts going into this. And on that there's really two different ways to adopt this standard.

And Michael, maybe just provide a little bit of color on both of these methods. I know you've had the opportunity to work with both public companies and private companies alike.

What is some the advice that you could recommend to the audience relative to transition methods available?

Michael Luff: Yeah, so one transition method, the original, it required restatement of any prior period presented, it was the required method for the public companies.

Now we've moved forward and now we have this additional method it's not called prospective. They call it the modified retrospective transition approach, but it's essentially prospective.

And I would say almost all of the clients that we're working with, that's really the approach. Accountants are weird about we get our financial statements and if there's an option not to go backwards and have to make adjustments and track those adjustments, no one really does that. Everyone's really going to adopt this.

And again, as Airam pointed out, 12/31 year end, your adoption date 1/1/22, and just leave 21 alone. And that's appropriate, again, just something that would need to be discussed or disclosed in the footnote, that that's the method that was chosen.

Airam Valdez: Yeah. So surely do you do it twice or you do it once and most clients and businesses are electing to do it once, just for simplicity purposes.

You still have to have the old disclosures under topic 840 that accompany the new disclosures. And again, that requirement to again, bring all those off balance sheet operating assets and liabilities on the balance sheet and disclose it just once.

So again, most folks are doing that additional transition method that Michael mentioned. So Sandy, you've had the opportunity to work with both myself and Michael on preparing for implementation.

We've touched upon some of the different aspects and some of the nuances, again, going back to that simple lease term and that present value calculation.

What are some of your ideas just roadmap to implementation that I've just shared with the audience, the simple ways of looking at.

But how do you engage with your clients and your engagement teams inside with this type of matter when it comes to adopting the standard?

Sandy Young: Yeah, no, implementation obviously is key to all of this, right? And so one is just to start is with a plan. What's the plan?

And to get started with the plan. We can't wait until November, December, and just do this as a year end adjustment, because it's going to take a fair amount of work to work through this.

The first component is finding all of our leases. I've had clients that have had leases that just keep get getting renewed and they don't necessarily have the initial full lease. They just had the renewal addendums.

But we need to identify the full lease to be able to calculate and figure out what bucket does this fit in? And so that has been problematic for some. Some have had to go back to the last OR to get that original copy.

And so that's part of the initial plan is, what is that population of leases? And then to start reading through those to see where are those hidden things that we maybe have just been expensing as we're paying them, that really are embedded components of the lease that need to get built into the calculation of what's going on to the balance sheet.

Airam Valdez: Yeah. And then believe it or not, the lease calculations is actually the easy part, right? What we found with adoption is identifying those leases, reviewing them, interpreting them, some of those nuances Michael talked about, that's actually the hard part.

The calculations is sometimes the easy part. It's arithmetic, right? It's data inputs. And then it's the financial reporting.

But again, if it was so easy, we would've already done this a while ago, so maybe now's a good transition to just continue to talk about some of those tips and tricks and lessons learned from implementation.

Again, thinking about it from that real simple roadmap of adoption, whether it's planning, reviewing. Michael, you've had a lot of opportunities to engage with clients internally and externally on the planning aspects. Any words of wisdom for the audience from that point of view?

Michael Luff: No, absolutely. It's where it all starts. I would say obviously as accountants, we understand how to plan, how to come up with here's who's going to do what.

But one of the things that happens in the planning phase that always pays dividends as the accounting group ultimately works through this.

One of the things that happens is a meeting, maybe have a meeting, maybe have a training session with other people outside the accounting area that are crucial to managing the lease portfolio.

For example, we typically would have included the treasury group. We typically will include the legal group or the contracts group, because they're going to be key in helping us establish the completeness.

But then also we'll have people that are working facilities because they are very tight to the equipment that's used in different locations to maintain the facilities. We'll talk to corporations.

And so the way we've done it is typically we'll offer a training, giving folks an overview, the accountants are going to know. And it's very similar to what we talked about early on, just what's happening and why it's happening. And why is it important that we capture this information.

But typically in the planning phase, if we involve other groups outside of accounting and finance, it's always helpful.

Airam Valdez: Yeah.

Michael Luff: Always helpful to engage those folks, let them know what's happening and just greases things through the process.

Airam Valdez: And my observation from this point of view and Sandy, I'd be interested for your observation as well, is just managing resources, right?

When I think about the privately held businesses at CLA serves, they've got a lot of resource constraints. They run thin and lean. They're working on PPP loans, ERC credits, supply chain management, all those other things that they've got to manage their business.

Then you layer on, hey, we got to adopt this new standard. It's understandable why we're at where we're at. It's June. And then again, that standard's going to be required to be adopted at 12/31, 2022, if you're a calendar year end.

So one of the things I sometimes find is just understanding the standard, finding the resources. It's slow to start, but it has to start at this point. And we'll talk about that here in a little bit more on why it has to start now.

But just getting the planning going has been hard just when we think about human nature, sometimes we're deadline driven. Well, you've got to a deadline here you've got to manage too because it's super important for stakeholders, financial reporting.

If you've got a requirement to present GAP financials, you've really got to take notice and get started. And again, I just want to applaud the audience for leaning and being a part of today's presentation.

Sandy, what are your thoughts? And you've already touched upon identifying leases and reviewing them, but additional thoughts and observations?

Sandy Young: One of the things too that I think I've seen a lot, especially on the retail side of things, is modifications that have been happening to leases.

Through COVID and with all the changes and things that we've been seeing over the last two years, two and a half years, it's a lot of modifications to things like that.

All of that has to be taken into account as part of this as well. Some of it is in rear view mirror, because it's been short term modifications, but some of it isn't. So again, it's looking at that piece of it and making sure we're spending the time to understand what's in there.

One of the things that's not included is variable lease payments. But a escalated stated lease agreement that has stated lease amounts going forward that increase every year or two years, that's not variable. Those are still stated.

And so what happens is historically those would get calculated as part of a deferred rent calculation and booked on the balance sheet as part of that. This incorporates all of that into the same.

So again, it's making sure we understand what are those components within the lease so that we can get to that point where it really is math.

Airam Valdez: Yeah.

Sandy Young: Now, oh, I'm sorry, Airam, go ahead.

Airam Valdez: Oh, I was just going to draw that thread back a little bit more Sandy, that you've done a really good job pointing out is reviewing those leases. It takes expertise. It takes time.

Why does it take expertise? You don't know what you don't know, right? So you have to understand the standard. You've got to read the standard so you can understand what's in those agreements, not just those lease payments and terms. But are there lease incentives that Mike pointed out, other things of that nature.

So it takes expertise. You got to review and know the standards. So when you review those leases, you understand what to look for and then guess what? It takes a lot of time.

What we have found on average is it works out to about three hours per lease and you might say, "Hey Airam, you're crazy. I got a simple car lease here. It's three pages. It won't take me three hours," and that might be true.

But then when you look at the portfolio and the aggregate, you may have some related party leases. You may have an embedded lease that you've touched upon Sandy.

Those may take upwards of eight, nine, 10 hours to review. So you start averaging it out. It works out to about three hours per lease.

So you have five, 10, 20, 30 leases. You do the math. That becomes a considerable undertaking. So again, it takes time and we'll touch upon that here in a moment on why you should start now.

But that review of leases, it takes time. And then managing that data. There can be upwards of 300 inputs into a review of a lease. That's a little on the extreme side, but there's a lot of data that goes into it.

And Michael you've had the opportunity maybe from the least calculation side where clients have had to engage in this process.

And some have maybe tried to put a bandaid on it and use Excel. Some have went to a third party software solution, whether it's something that you buy off the web in real simple web base or something that integrates into existing DRP system.

Maybe talk about the lease calculations and the financial reporting piece, because that's a big deal, right? You got to review the leases, but then you got to do the day one and ongoing accounting. Thoughts on that?

Michael Luff: Yeah, of course. I'm going to go back to one point on the review lease concept. One thing to keep in mind that we found is very, very typical is just as we think we've got the full population of leases and we gather the contracts for all of those leases.

A lot of times there is additional work that has to be done because, again, in the case of a lot of real property leases, or even a case of equipment leases or vehicle leases, the lease contract references a commencement date.

But until we have occupancy of a space or until we have possession of that underlying asset, in the case of equipment or a vehicle, for example, that's what commences the lease.

And so for us as accountants to get that term right and to get the numbers set up in the database correctly, we have to go out and follow up and find out, well, when did we get occupancy? Or when did we have possession of an asset?

So getting all the contracts right but there will be follow up. So just keep in mind that.

Sandy Young: And Mike, that's why it's important, right? To pull in all those other people outside of just the accounting department so that we make sure we do have accurate dates for that.

Michael Luff: No question. We definitely are, as accounting group, we're going to have questions for folks within the organization. However, the organizational structure, whatever the portfolio is, there will be questions that we'll have to get help on from our friends in other areas. So that's a great example of that.

Lease calculations. I'll say it like this, Excel is great as a calculator, but we don't really need a calculator in this case, we need a calculator that's embedded in a database.

Because ultimately the analogy that we use is it's very, very similar to a fixed asset subledger where we're listing out each lease, each lease contract.

We give it the term, we give it the payments. We give it a discount rate. It does the calculations, but also importantly, the database manages the information. All of those records. It creates journal entries that we can use to enter into our ledgers.

It produces the disclosure reports. It can produce other management reports, but it's really because it has that strong software built for this, is going to have that strong database functionality.

So yes, outside of maybe having three, four, five leases that require calculations and require some summarization, we definitely recommend considering as Airam inputted, either a cloud based lease accounting subledger database software, or software tool that integrates our experiences.

NetSuite, some of the Microsoft dynamics platforms, there have been applications that have been developed that work very well and integrate in those environments that are specific to them.

But again, just something to think about, if you've got more than a handful of five leases, say Excel is going to be difficult. It's going to be fraught with issues just because the way that it's structured, it doesn't have that database functionality.

From a reporting standpoint, again, our subledger then feeds into what do we have in our books, ultimately, that we're reporting on.

We have, as we've talked about, our capitalized balances for assets and liabilities, and then we have enhanced quantitative and qualitative disclosures.

And so we've got to get all of that right, we've got to understand how to get that in the books, we've got to understand how to reconcile that back to the subledger, if for any reason we've got other entries that come into play.

One thing to think about from a reporting standpoint, just something to suggest, be considered, is early on in the process scan through the chart of accounts.

Most folks will look at their chart of accounts, understand 100% that we would've never had a reason to have a right-of-use asset account or a short and long-term lease liability account related to operating leases.

But now we need those. We also need, if we take that accounting policy election that everybody does, we're not going to capitalize short-term leases but there is a disclosure requirement to disclose short-term lease expense.

So another chart of accounts consideration, maybe I may want to set up a short-term lease expense account and work through with accounts payable to designate how those expenses are captured in the appropriate account.

The last one is really a variable lease expense account. We've mentioned that a bit. It doesn't come up super often, but to the extent we have a lease where we have variable expenses, then we'd want to capture those perhaps in a separate account for disclosure purposes, just to make it clean at your end.

And so I'm not sure what else. Sandy?

Sandy Young: Oh, sorry. One thing on the balance sheet is classification of that right-to-use asset. It's not part of fixed assets.

Michael Luff: No.

Sandy Young: It's part of intangibles down in the other assets.

Michael Luff: Yeah.

Sandy Young: And we need to separate out that right-to-use asset that's from a financing lease with the right-to-use asset that's an operating lease, I believe.

Michael Luff: Definitely for footnote disclosure and-

Sandy Young: Yeah, one or the other.

Michael Luff: On the face of the balance sheet.

Sandy Young: Yeah.

Michael Luff: Also one thing to keep in mind is that this intangible right-of-use, there is no short term component of that. It's all going to be in the intangible section essentially long term, even though the lease liability needs to be characterized as either short or long term.

So that's just something to keep in mind. We get that question a good bit about the ROU asset side.

Airam Valdez: Awesome. So Sandy and Michael, this great words of wisdoms and tips and tricks. And as you can see, it seems simple enough. Planning, identifying leases, but as you pull that thread back, you start to see some of the hidden complexities and why it takes time.

But I want to go back to why planning is so important and how to get started. Because again, as I've mentioned, that train has left the station.

We need to be working, whether I'm a client or at CLA working with clients, to get started on this standard. So just some real practical tips for getting started, Michael. We've got it all up here. Maybe a couple things you want to grab on here?

Michael Luff: Yeah, sure. So let me go through the first three. So understand and know the standard. I think it's fair to say, and Airam referred to the calculations aren't arithmetically complex, we're not doing astrophysics.

We're discounting and adding and subtracting and maintaining order of our lease contracts and how they relate. But going back to the planning point, having other folks in the organization that understand at least at a surface level what's happening and why accounting is having to work through this and what it means, and the things that we're looking for and will need help on.

So understand and know the standard, but also hopefully communicate some of that internally. I think we've touched on that a few times.

Assessing the situation and resources. And again, I think it's been mentioned, and we have clients all the time and a lot of folks have plenty of resources. They've got folks that can work on this. They've got an eye towards the technology and it's a bit easier for them to get started.

But a lot of folks we talk to, they don't have the time. They don't have excess slack in their people's time to help work through this.

And there's going to be some degree of assistance from the outside, whether it's us or whomever that can help get things going.

Can be also everything from high level offering technical advice, but also down to the point of having folks help go through the leases, help you get your database set up, make a first pass of the accounting judgements, review of management and ensure everyone's accepting all the judgements that are being applied. So every situation's different, but that's definitely something to think through early on.

And then again, just defining the lease implementation project. It's tough to begin with the end in mind when we haven't done it. That's why folks like us will help walk through this.

Because we have seen obviously multiple, I would say hundreds of projects related to this adoption from the start to the finish, and then even as we work through it we get better.

Because we're able to anticipate how this is all going to ultimately result in full compliance, full support, auditability, et cetera of our lease accounting.

But at least at first, just defining that project, assigning the folks to work through it, making decisions on what additional resources you may need.

And talking with folks like us that have that experience and can help frame up what the picture is and where we're headed.

Airam Valdez: Yeah.

Sandy Young: And then it's moving into taking your inventory of your leases, right? And when you're looking at that lease, remember go back to that initial definition of what's a lease?

It's a contract with the right to control the use of a specifically identified asset. And so then from there build, right?

It's the assets, it's the contract and then it's what's deeper into the contract. Is there maintenance? Is there embedded components as part of that? And then from there it's building to the calculations.

Airam Valdez: Yeah. And then from a good auditor standpoint, right? A lot of you have compliance requirements, right? You're likely going to be audited hopefully by CLA or someone else like us.

You have to have a documentation and paper trail. So documenting the processes. How did you assess the completeness of your population? How do you assert that so it can be audited? How did you perform the least calculation?

So those are all just things that go into, how do I start? We're here in June, we've known about this standard for years. We know if you're a calendar year end reporting, you have to get started.

So hopefully we've given you some inspiration to get started, but any other words of wisdom? There's something that resonates with me.

But I would be interested to get your point of view, Sandy and Michael. You've worked with early adopters. Why do the audience need to take notice now to get started?

Sandy Young: Well, I think part of it is just that it's the unknown of how long it's going to take. Like I said earlier, don't wait until December and try to work through this as it's just a normal year end adjustment.

This first year, the clients that I have that have gone through it, have spent hours and hours trying to make sure they've got the right information and involving the right parties as part of it.

Airam Valdez: Got it. So it's like when you're remodeling a house, you're building that new house, whatever you think it's going to take triple it or quadruple it.

Michael, I'm sure you've probably seen that in real life?

Michael Luff: Yeah, no. I think one thing, again, speaking from our experience, one issue that is going to be a problem potentially is once you decide on the fact that, okay, I've got 150 leases, there's no way I'm using Excel.

The next step is then to go through a process to at least have some demos of the various software tools that are available. And then once you demo the tools, you sign a license agreement with the software vendor, then you've got to set that database up.

And that takes time. And it also takes coordination in a lot of cases with folks that work at the software vendor. So that by itself, even if you're in parallel gathering lease contracts, following up, understanding receipt dates, talking to folks that say, "Yes, we're going to probably extend."

You're getting all your data together internally, but at the same time on a parallel track, you can work through getting your database set up.

But I think the issue is why start now is because you can imagine these software companies, they're just people like us and they're going to have resource constraints. I'm already seeing it, frankly, in a few cases.

And so it just elongates the process and the earlier you can get that kicked off and get ahold of the right piece of software for you and to work through that with the vendor, I think that's something I would do if it were me, so.

Airam Valdez: Yeah. And I think the key point that you brought up, Michael and Sandy, is by you managing the process and starting now, you can be in control, right? Versus deadlines managing you.

That, oh, I've got to have financial reporting and financials out by January 15th or February 15th. If you wait till the end, the deadlines will manage you.

But if you start now, you can be a little more in control in that process. It still will take time and effort. And I think that's a really good segue on if you need help, right?

We've thrown out a lot of different nuances and personally it can feel overwhelming, right? But if you have a good understanding of the lease standard you know where to start, but you maybe need that second set of eyes or that confirmation, CLA's always available to assist with consulting.

We can have a conversation with you. We can understand what you're looking for. We can consult on those maybe more complex lease arrangements as Sandy talked about or what's that lease term or consideration.

So CLA's available if you need just some consulting. If you have the resources and time and expertise, you have the software as Michael talked about, we can assist with consulting.

In that middle category, again, say you have the resources, you have the expertise, you have the time, but you don't quite have those resources.

Well, CLA we've got lease calculators. We have enterprise level software solutions that can handle five leases to 1000 leases that are used by public companies. We can assist with that lease calculations.

We also have a proprietary Excel tool that we've created that'll manage five or fewer leases. So again, I only have a handful of leases. I'm a small business. I don't need a huge software solution. Well, we have a solution for you there.

If you're unsure how to adopt the standard, those practical expedience, all those accounting elections that we talked about, we have tools and templates to help you.

And then that third piece, that turnkey solutions, say you don't have the time, say you don't have the resources or the expertise to do that.

Well, we can design a turnkey solution. So folks like Michael, myself, we can come alongside your organization to tailor a solution that works for you. But again, it all starts with having a conversation.

So during this presentation, there will have been a link shown if you would like someone from CLA to contact you, reach out to us, or we will reach out to you and we'd be happy to have that conversation on how we can assist you on implementing the standard.

But the key point on today's whole presentation, right, is you got to start now. CLA again, we're more than willing to help you, but let's start that conversation.

We have a lot of folks in attendance today. We've gotten some really good questions in today's chat and so what we'll do is we'll try to answer a couple really quick with the last two minutes we have.

But we will be reaching out to you for those of you that have left questions in the chat. We may have answered those and we'll follow up with you on those questions.

Michael, one of the general questions that we see from time to time is what's scoped in and scoped out of the lease standard? Is it software? For example, we've got a lot of clients that use things in the cloud. Is software scoped into the standard?

Michael Luff: No. The way we talk about it is tangible property. And so the way they wrote the standard was anything that's intangible is not going to be subject to 842 accounting.

And that as Airam said, that's definitely a question that comes up a good bit because these regular monthly payments for licenses or software subscriptions. But they're not part of this thankfully.

Airam Valdez: Got it, got it. And then related party leases, Sandy's touched upon that already. Any words of wisdom from that point of view, whether it's unwritten leases or, hey, I'm looking for an opportunity to restructure leases.

Any thoughts or observations from a leasing perspective and best practices for related party leases?

Sandy Young: I would say you got to treat related party leases just like unrelated party. I know there's always some flexibility sometimes with related parties, but documentation is going to be your friend on this so that we're staying consistent with how we're managing those.

Airam Valdez: Yeah. Goes back to that opening comment, right, Sandy? Is get everyone in the room, do it as a team. Owners of that property, accounting, finance, maybe even legal, right? To draft up those agreements, so work as a team.

So with that, we're coming to the top of the hour. CLA we always can help. Up here there's several resources you can sign up.

We've got a landing page with additional articles and FAQs on lease accounting. We're going to be sending this presentation. Take some time, look at those and let's have a conversation around leasing.

So with that, I just would like to thank you again on behalf of CLA for giving us the opportunity to spend the hour with you today. Thank you so much.

Sandy Young: Thanks, everybody.

Michael Luff: Thank you.