

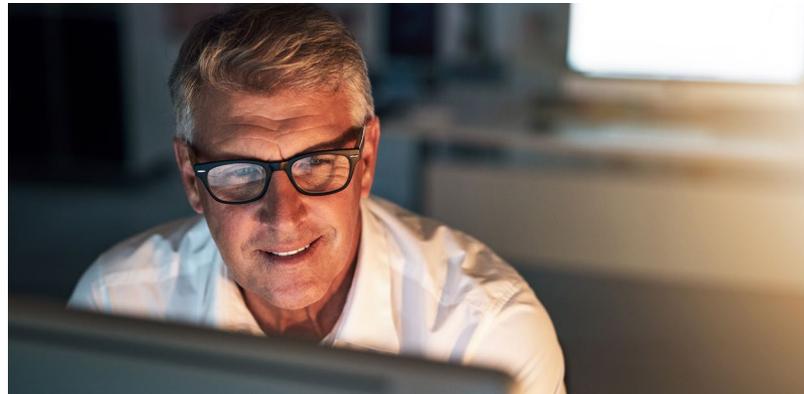
# 7 FAQ'S: IMPLEMENTING THE NEW LEASE ACCOUNTING STANDARD

It has been nine years since FASB and IASB released their first exposure draft on the new lease accounting standard, and three years since they finalized the new standard. Throughout this time, software providers, accounting advisors and end-user corporations have been working tirelessly in preparation for this massive change in accounting for leases.

We have now reached the finish line, or starting line depending on how you look at it, with many public companies having completed their initial software implementation and transition on January 1, 2019. Over the past two years, we have worked with hundreds of companies on their software implementations to support compliance. These companies have posed countless questions regarding the guidance, but some stand out as recurring themes. The intention of this whitepaper is to provide a detailed response to these common questions.

We have enlisted our technical accounting team at ProLease to gather this list of questions and provide thoughtful, detailed responses. As always, our interpretation should not replace discussions with your auditor who should guide you in making any final determinations.

Without further ado, here are the top 7 lease accounting implementation questions asked by ProLease customers over the past year:



## 1 | HOW DO WE BREAK OUT LEASE AND NON-LEASE COMPONENTS OF A LEASE?

Understanding the difference between a Lease Component versus Non-Lease Component versus other Provisions may seem straightforward on the surface, but many companies have discovered through implementation that these components do not always appear so black-and-white in practice. So, how do we break out the service portion of rent?

Once a contractual arrangement is determined to meet the definition of a lease, the total consideration to be paid by the lessee in the contract (as defined) would be allocated to the *Lease Components* and *Non-Lease Components* based upon relative standalone prices for these components. None of the consideration is allocated to *Other Provisions*.



### LEASE COMPONENTS

A leased asset can only be PP&E (Property, Plant & Equipment). Examples include, but are not limited to buildings, office space, vehicles and office equipment. Each PP&E asset would be considered a separate Lease Component only if both of the following criteria are met. If these criteria are not met for an individual asset, then the assets will be combined until the criteria is met, and the combined asset would represent the Lease Component.

**A.** The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee, and

**B.** The right of use is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract.



### NON-LEASE COMPONENTS

Many contracts that contain a lease also include the provision for other goods or services. Examples include maintenance of equipment, operating the equipment, and providing common area maintenance for an office building. Since these elements are not PP&E, they cannot be considered a Lease Component, but since they still transfer a good or service to the lessee they are considered to be a Non-Lease Component of the contract.



### OTHER PROVISIONS

Other provisions that do not transfer a good or service to the lessee is neither a Lease Component or a Non-Lease Component. Examples include (a) A lessee's reimbursement or payment of a lessor's cost such as property taxes and insurance, (b) Administrative tasks to set up the contract or initiate the lease.

## 2 | HOW DO WE KNOW WHICH EXPENSE ITEMS IN A LEASE SHOULD BE CAPITALIZED?

As a general rule, only the amounts allocated to the **Lease Components** (as described in Q1) would be capitalized. However, the amounts allocated to the **Non-Lease Components** (as described in Q1) would also be capitalized if the practical expedient were elected to not separate the Lease and Non-Lease Components.

The treatment of **Other Provisions** (e.g. property taxes and insurance) depends in large part as to whether the lease is a gross or net lease. In a gross lease the fixed lease payment may be intended to cover the lessor's cost for property taxes and insurance, but the lessee has no separate obligation outside of the fixed lease payment to pay for property taxes and insurance. In this instance the property taxes and insurance effectively become part of the Lease Component (i.e. assuming the practical expedient is elected to not separate Lease and Non-Lease Components). On the other hand, in a net lease the lessee will, in addition to the fixed lease payment, reimburse the

lessor (or pay a 3rd party directly) the actual costs associated with property taxes and insurance. In this instance the property taxes and insurance would be considered a **Variable Lease Payment** that would be expensed as incurred.

A Variable Lease Payment is defined as a payment made by a lessee to a lessor for the right to use an underlying asset that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time. Examples include, but are not limited to, lease payments that are based upon an index or rate (e.g. CPI or an interest rate) and lease payments that are based upon usage or performance (e.g. machine hours or sales). As a general rule Variable Lease Payments that are not considered to be an In-Substance Fixed Payment (as defined) are expensed as incurred or when accruable.

Following are instances when a Variable Lease Payment would be capitalized:

At lease commencement, Variable Lease Payments that depend on an index or a rate are included in the lease payments and are hence capitalized using the index or rate at the lease commencement date. However, the entity should not attempt to forecast future changes in the index or rate.

Subsequent to lease commencement a FASB company would remeasure the ROU Asset and Lease Liability for changes in an index/rate only if the lease had to be remeasured for other reasons. However, an IASB company would remeasure the ROU Asset and Lease Liability each time an index/rate change resulted in a change to a lease payment.

## 3 | HOW DO WE PROPERLY ACCOUNT FOR PREPAID RENT?

A Prepaid expense is generally defined as an amount paid in advance to secure the use of assets or the receipt of services at a future date. As it relates to lease accounting, Prepaid Rent represents rent paid in a month that pertains to future month(s) rent. Under the new lease accounting standards, rent paid early is excluded from the measurement of the Lease Liability but is included in the measurement of the ROU Asset. How to measure rents paid just before month-end is a company by-company decision.

## 4 HOW ARE DEFERRED RENT BALANCES IN AN EXISTING OPERATING LEASE HANDLED AT TRANSITION WHEN EMPLOYING A “PROSPECTIVE” TRANSITION APPROACH?

When an existing operating lease is being transitioned, all balances on the books as of the company's effective date must be derecognized with the offset being an adjustment to the opening ROU Asset balance. Your lease accounting software solution should provide a mechanism for achieving this result.

The balances to be derecognized include the following:

### FASB

- Unamortized Prepaid Rent
- Accrued Lease Liability, difference between S/L & cash rent
- Unamortized Lessor Allowance
- Unamortized Initial Direct Cost
- Exit Cost Liability, per ASC-420
- Intangible Lease Asset or Liability acquired in conjunction with a business combination

### IASB (assuming practical expedient to exclude IDC is elected)

- Unamortized Prepaid Rent
- Accrued Lease Liability, difference between S/L & cash rent
- Unamortized Lessor Allowance
- Onerous Lease Liability, per IAS-37
- Intangible Lease Asset or Liability acquired in conjunction with a business combination

## 5 WHEN, WHY, AND HOW DO WE UPDATE OR REASSESS A LEASE UNDER THE NEW GUIDANCE?

Under the previous guidance, lease standards were handled in a “set-it & forget-it” process. The new lease standards have created the concept of ongoing assessment. After lease commencement, lessees must monitor leases for certain changes. A lessee must update the capitalized lease in the following circumstances:

**A.** The lease is modified and that modification is not accounted for as a separate lease (i.e. does not grant an additional right of use).

Examples include, but are not limited to, a change in the scheduled base rent or a change in the lease term that is not the result of an option within the lease.

**B.** There is a change in the lease term (e.g. reasonably certain assessment of exercising a renewal or termination option) or whether the lessee is reasonably certain to exercise a purchase option. *This reassessment must be precipitated by a significant/specific event or change in circumstances (as defined).*

**C.** There is a change in the amount probable of being owed by the lessee under a Residual Value Guarantee.

**D.** A contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments now meet the definition of lease payments. For example, upon attaining a specified number of cumulative copies, a printer lease whose lease payments were variable based upon a per copy charge now changes to a straight fixed lease payment.

**E.** There is a change in future lease payments resulting from a change in an index or rate used to determine those payments, for IFRS-16 only. An ASC-842 capitalized lease would be updated for a change in an index or rate only if that lease had to also be updated for one of the other reasons.

**Notes:** *Items A and B also require that the discount rate and lease classification (ASC-842) be reassessed and updated, as appropriate. Item A also requires the lease to be reassessed to determine if it still meets the definition of a lease.*

## 6 | HOW DO WE CORRECT A JOURNAL ENTRY ERROR/OMISSION THAT WAS DISCOVERED IN THE CURRENT MONTH BUT APPLIES TO A PRIOR MONTH THAT HAS ALREADY BEEN CLOSED?

An accounting error is the result of mathematical mistakes, mistakes in the application of an accounting standard, oversight or misuse of the facts, or a change from an unacceptable to an acceptable accounting principle. Within lease accounting, a couple examples of accounting errors include, but are not limited to: a) capitalizing certain costs, such as a variable lease cost, that are not eligible to be capitalized, and b) discovery that a lease had commenced in a prior month but was not recorded in that prior month.

ASC-250, *Accounting Changes and Error Correction* and IAS-8, *Accounting Policies, Changes in Accounting Estimates and Errors* govern the accounting for error corrections for FASB and IASB, respectively. If based upon the required analyses of these standards it is concluded that the error was immaterial to prior periods and correcting the impact of the error all within the current period (i.e. period that the error is discovered) would also be immaterial, then the cumulative correcting adjustment for the effect of that error would generally be recorded in that current period.

## 7 | HOW SHOULD WE SET UP OUR TEAM TO MAINTAIN LEASE ACCOUNTING DATA POST IMPLEMENTATION?

The new standards will impact many departments throughout your company, including, but not limited to: Real Estate, IT, Accounting, Financial Reporting, Treasury, Procurement, Tax, & Internal Audit. Since so many groups in a company are impacted, it is important to establish a cross functional lease accounting team to make sure everyone is on the same page. It is also critical that your lease accounting software solution include role-based security and access levels to facilitate the interaction between departments. Working together as a team in one integrated system will eliminate duplication of work efforts and help ensure accuracy in your reporting.



## ABOUT PROLEASE

Founded in 1992, ProLease is a leading SaaS provider of integrated Lease Administration and Lease Accounting software, supporting Real Estate and Equipment leases. Over the past eight years, ProLease has developed comprehensive functionality for its customers to comply with the new FASB / IASB lease accounting standards ASC-842 / IFRS 16. Today, ProLease has over 700 active customers globally, including many Fortune 500 corporations.

To learn more, please visit our website or contact us directly:

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