WHITEPAPER

fidato partners

ASC 842 Leases – Navigating the Noise

Overview

On February 25, 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update 2016-02 - Leases ("ASU 2016-02") that was codified in Accounting Standards Codification 842 – Leases ("ASC 842"). From a lessee perspective, ASC 842 lets companies recognize expenses on their income statement in a manner consistent with previous guidance. However, operating leases must now be recorded on the balance sheet as a right-of-use ("ROU") asset with an associated lease liability, which are measured at the present value of remaining lease payments.

As a result of the challenges associated with COVID-19, the FASB issued Accounting Standards Update 2020-05 – Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842) ("ASU 2020-05") which allowed private companies to defer once again implementing ASC 842 until fiscal years beginning after December 15, 2021. While this creates a delay in having to adopt the standard, the importance of developing an implementation strategy sooner rather than later cannot be understated. As public companies and early adopters have emerged from the many challenges associated with adopting the new lease standard, along with the introduction of leasing software to improve contract management in addition to driving compliance efficiently, they have provided a roadmap to help private companies ease their transition.

Setting the Stage for a Smooth Implementation

<u>Develop an action plan to determine the scope and extent of the lease population</u>

Companies should designate individuals to plan and navigate the process of obtaining relevant lease information. These individuals should serve as vital resources in the lease data accumulation process. Facilities/Operations, Legal, Accounts Payable, Accounting, and other related departments should be consulted to gain insights to a company's lease portfolio. These departments will serve as important resources when determining the completeness of a company's lease population. Key dates and deadlines should be established to ensure all required leases are captured prior to the implementation date of January 1, 2022. While many private companies may not have external reporting requirements until after year end, implementing proper lease accounting procedures as soon as possible will ensure a smooth and even paced transition.

A review of the most recent lease commitment footnote is key to developing a baseline expectation of the existing lease population. The footnote will have many important data points, such as expiration dates and rent payments, all of which will be used in the calculation of the ROU asset and lease liability. Lease agreements should be obtained when readily available. At a minimum, a company should be able to support basic operating lease accounting items such as the date of lease inception and termination; rent amounts and timing of payments; and the existence of any explicit options to renew or terminate. These items are necessary in the calculation of the new lease standard.

A review of recurring payments to vendors should occur to determine if any additional leases may exist. These leases can be easy to identify through a review of routine disbursements to identify frequently occurring vendors. A review of selling, general, and administrative expense details such as office expenses, auto expenses, facility costs and other similar expense lines could also assist with identifying additional leases previously unaccounted for or managed.

While the concept of embedded leases has existed under previous lease guidance, the new lease standard reemphasizes the need to identify and disclose these items. An embedded lease is an arrangement in which a vendor allows a customer the use of a particular asset as part of the overall agreement. Companies can identify the existence of a potential embedded lease by reviewing existing contracts, including sales, for the following:

1. The asset is explicitly specified in the contract
2. The asset is physically distinct
3. The customer can direct the use of the asset while in possession
4. The supplier cannot substitute the asset and
5. The company has the right to obtain substantially all the economic benefits.

If any of the above are potentially true, companies should further investigate if an embedded lease exists to determine if a carve out of the lease components is required.

<u>Research options to track and monitor the lease population</u>

Companies should gain an understanding of their expected lease population to determine the type of software that will need to adopt the new lease standard and to maintain compliance in an effective and efficient way. Companies with a low volume of leases, we would recommend only if population is less than 40 leases, may elect to utilize Excel in creation of the lease calculation. While this may be a convenient option for some, those with a large and diverse lease population may want to explore lease specific software to assist with the adoption and maintaining compliance.

While this may at first appear to be costly, the time saved that would have otherwise been occupied by a company's accounting team can help quickly offset the software costs. Compared to Excel, a lease software package can handle a wide variety of lease types and terms that a spreadsheet would struggle to compute. Complexities such as renewals, rent escalations, and rent abatements can create challenges. For example, many leases have a rent due on the first of the month and using Excel's present value function to calculate the ROU asset and lease liability amortization tables can be a challenge, as Excel has difficulty accounting for the timing of a payment. These differences extrapolated across an entire lease population could result in material variances and challenges in future audits.

In addition to driving compliance with the accounting standard, a lease software can provide real time operational and financial insights to a user. Companies can better analyze lease matters such as payments, upcoming expirations and needed renewals, and square footage and headcount by location. Lease populations are typically localized, and company-wide insights can be difficult to obtain using Excel. Switching to a lease software centralizes all data but allows for local input, which is ideal for both corporate management and local accounting teams.

Data integrity and internal controls are becoming increasingly more vital to many private companies. Tracking and approving changes can be difficult in an Excel based environment. A lease software can help manage the tracking and approval process, as all lease data will be recorded with workflow approval process to provide control for any required changes. Auditors will be able to review all changes and data through a lease software history, and lease documentation can be uploaded to a central repository in the system to help save time at year-end.

Many companies are required to report on both a GAAP and IFRS basis. GAAP and IFRS have key differences in the calculation of the ROU asset that with an Excel based approach, would require two sets of lease schedules. A lease software will allow for simultaneous calculation of both GAAP and IFRS all while using a single input of data which over an entire lease population can require significant resource and time commitments.

Please refer to Fidato's whitepaper entitled *Leases – Using a Tailored Software and Approach Versus Manually-Oriented Methods* for more information.

Understand the complexities of the new lease standard

The standard reemphasizes previous ASC 840 guidance regarding leases which include options to renew after the initial term. If a lease has such an option – and management is "reasonably certain" to exercise this option – the renewal term will be included in the asset and liability calculations. From a management standpoint, practical considerations such as economic (the cost of moving the lease, investment in the current lease, etc.), historical (the company has historically renewed the lease) and physical (a unique lease that is difficult to replicate, a lease that is strategically placed, etc.) should serve as a benchmark when determining whether a renewal option is reasonably certain to be exercised.

Companies should determine the applicable incremental borrowing rate for the lease. An incremental borrowing rate is the equivalent rate a lessee would be required to pay to borrow an amount equal to the lease payments under current operating conditions, in a similar economic environment, and for the same duration. Companies should factor in the length of the lease term, the type of the asset, foreign currencies as well other borrowing factors under similar borrowing arrangements. Companies should be ready to apply an incremental borrowing rate in advance of implementation.

Finance leases (previously referred to as capital leases) do not materially change in ASC 842 compared to previous ASC 840 Lease guidance. The guidance tinkers the 75% economic life and 90% fair value rule to allow greater judgement, but for practical purposes, many companies have not materially altered their measurement metrics. A new finance lease criteria states if a leased Asset is specialized in a manner that no alternative use is likely it is considered a Finance lease. Accounting treatment of Finance leases does not change compared to the previous ASC 840 guidance.

Prepare the books for ASC 842

Companies should review their current lease accounting process to determine if they are ready for implementation. Companies will need to identify an action plan to ensure the accounts payable and lease expense processes are set up to reflect the new accounting treatment.

Many companies may find themselves in a situation where they have not historically recorded rent on a straight-line basis as required under previous ASC 840 guidance. While this may have been immaterial in years past, these companies will experience challenges upon implementation, as they will identify variances between their previous rent recording process and the new ROU asset calculation. Companies should be proactive and review potential straight-line rent adjustments in advance as the new ASC 842 standard requires straight line expensing. Prepaid lease expense and deferred rent account balances under ASC 840 will be eliminated with the implementation of ASC 842. Existing balances prior to implementation date will be factored into the calculation of the ROU Asset.

Companies will have to alter the chart of accounts to include the new ROU Asset and Lease Liability which is to include the short-term Lease Liability (measured at the subsequent twelve months of payments due at date of measurement) and long-term lease Liability (measured as the remaining payments after the subsequent twelve months).

Finance leases will continue to be amortized under the new ASC 842 standard consistent with previous ASC 840 Lease guidance. A key departure from ASC 840 is the previous finance lease asset will now be classified as a ROU asset. Accounting treatment will remain the same.

Monitor lease activity

Upon implementation, companies should develop a process to actively monitor existing and new leases as well modifications. Companies may find themselves in a situation where lease activity is decentralized and not aligned with the accounting department. Active reviewing of routine disbursements by vendor name and amounts are efficient ways to identify lease activity. Tailored lease software solutions are a great way to keep track of upcoming lease expirations, terminations, and modifications, as notifications can be sent to each responsible party.

New leases and modifications require a company to remeasure their ROU asset and lease liability. New leases should be measured at the date of lease commencement and amortized over the applicable period while lease modifications require a remeasurement on the date of modification. A modification is when the existing contract is edited from its original form and while not comprehensive list, can include such changes as contract dates, payment terms and amounts, square footage and/ or asset(s) in use.

Communicate with external parties

While many companies have completed their annual audits, the discussion regarding the new lease standard should occur sooner rather than later. Companies and their auditors should work together in advance of implementation to discuss key points mentioned above. A conversation with auditors during the implementation period can reduce confusion and help prioritize implementation efforts.

The introduction of the ROU asset and lease liability to the balance sheet are likely to have material impacts on the financial statements. Certain balance sheet covenants – such as the current ratio, debt to equity, and other covenants may require a change in measurement to ensure compliance in the future. Companies should review their debt covenants and communicate anticipated changes with their lenders in advance of implementation to ensure compliance. In addition, sale-leaseback transactions have lost most of their off-balance sheet financing benefits, as the resulting lease asset and liability will need to be recorded. With these changes in mind, lease software solutions can help with the calculation of balance sheet items and disclosures, saving time and providing more clarity during the transition process.

fidato partners

Final Thoughts

The implementation of ASC 842 can pose many challenges. They can vary depending upon the nature of the company and complexity/volume of lease activity. To be successful in the implementation, it is important to be proactive when communicating expectations and establishing deadlines and to obtain support, both internally and via external consulting firms, to ensure a smooth implementation process which aligns with companies short- and long-term goals.

****

Please look for future updates on other technical accounting matters at www.fidatopartners.com

Contact
Jason C. Evans | Managing Principal, Accounting & Finance

1001 Old Cassatt Road | Suite 200 | Berwyn, PA 19312
Two Commerce Square | 2001 Market Street | Suite 3230 | Philadelphia, PA 19103
jevans@fidatopartners.com | 610 246 7091 (c)

www.fidatopartners.com
https://www.linkedin.com/in/jason-evans-36059628/

About Fidato Partners, LLC

Fidato Partners is the leading service provider of consulting and recruiting in accounting, risk management, and information technology in the Mid-Atlantic region, enabling companies to achieve greater growth and performance by filling critical resource and knowledge gaps. From emerging growth to global organizations, we provide the highest level of service to our clients. For more information, visit: www.fidatopartners.com.