

ASC 842 – Insights on the Lease Accounting Standard

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Non-public calendar year entities are required to adopt Accounting Standards Codification 842, *Leases* (ASC 842). We have assisted multiple companies in adopting this standard to date and have identified common threads in terms of questions asked by clients, areas of confusion and topics in which management is not prepared. The following is a list of insights gained throughout the implementation process which will assist in ensuring you are ready for ASC 842 required January 1, 2022 and thereafter.

What's Changing for Lessees?

Leases will now be quantified and brought on to the balance sheet as a right of use asset and lease liability. There will still be two types of leases; however, they will be classified as operating and finance leases as opposed to operating and capital leases as previously required. There is also a noteworthy number of policy elections available to non-public entities which can significantly impact the value of the right of use asset and lease liability. Navigating ASC 842 and tracking leases offers a new challenge for organizations as this area may not have been a focus of the internal control environment in the past.

Common Threads

While the idea of adding an asset and liability for your leases may sound simple, there are multiple areas in which clients have been unprepared. Below is a list of common threads we see in practice including recommendations for how to increase efficiencies and lessen the time it takes to adopt the new lease standard:

- **Definition of a Lease** – We have identified numerous instances of embedded or unknown leases while performing preliminary lease reviews for clients. A lease is defined as a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration. By interviewing different members of management, reviewing service contracts and searching for recurring payments in the general ledger, we have identified leases which were previously not known or not considered leases by management. Performing these functions before your annual audit or review can assist in having a complete list of leases.
- **Internal Control Environment** – Who approves new contracts that may include leases? How is that information communicated to the accounting department? Does your team know of the key terms and provisions in all lease contracts? Where is this information tracked? These are new questions that you will encounter this year which may not have necessarily been asked in prior years. It is extremely important under ASC 842 to have an understanding of the key stakeholders involved in the lease contract process and a responsible accounting individual must be informed of all decisions. It is also very difficult and often not feasible to calculate the right of use asset and lease liability in an Excel file alone – meaning your firm may need a software solution to assist in the calculation. Preparing to answer these questions and deciding on a software solution will help in being better prepared to adopt this standard.
- **Renewal Options** – The lease term should include any periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option as well as any options to extend that would be controlled by the lessor. Two issues commonly arise in this area including a lack of awareness that certain renewal options exist and lack of documentation surrounding whether it is reasonably certain a renewal option will be exercised. A simple *yes* or *no* may not suffice. Consideration of all economic factors relevant to the assessment should be documented in order to support management's conclusions. Some examples of considerations could include history of extending the lease, a renewal option at a significant discount compared to market, importance of the underlying asset to the lessee and significant costs to enter into a new lease for a replacement asset.

- **Discount Rate** – This is a new concept in regard to leases as this is often the only information needed for the calculation that is not included in the lease contract. There are also multiple options that can be used within ASC 842 to add complexity to the discount rate. First, the rate implicit in the lease is to be used if readily determinable which is often not the case for operating leases. If not readily determinable, the incremental borrowing rate is used which is the interest rate the lessee would be charged for a loan that is collateralized, has a similar lease term, for an amount equal to the lease payments and occurs in a similar environment. This rate is often difficult to ascertain. Fortunately, for non-public business entities there is a policy election to use the risk-free discount rate for the same period of time as the lease term instead of the incremental borrowing rate. Understanding this policy election and deciding internally if you wish to elect will help streamline the adoption of this standard.
- **Practical Expedients and Policy Elections** – There are numerous practical expedients and policy elections that may need to be assessed by management and decisions on elections should be documented. During practice, we noted seven elections are relevant to most firms which take time and multiple discussions to fully understand and adopt. These elections include (1) the presentation transition method, (2) a package of three practical expedients providing transition relief, (3) hindsight transition relief, (4) short-term leases, (5) combining lease and non-lease components, (6) risk-free discount rate and (7) variable lease payments. The shortfall we are seeing is a lack of understanding and preparedness by management relating to these policy elections. Reaching out to your auditors or other professionals as soon as possible to discuss your options will help ease the burden during adoption.
- **Time Commitment** – During our lease implementation projects to date, clients noted the time commitment needed from their team was greater than they initially anticipated. This is not a simple standard and will take time in order to work through the process. Getting started as soon as possible will help ease the burden.

How We Can Help

PKF O'Connor Davies can assist with your ASC 842 implementation needs. The Firm has partnered with a leading lease accounting software company in order to help track necessary lease information and be able to assist clients with this complex implementation. We can provide consulting services on an as needed basis to help you understand this complex standard. You can utilize the software on your own if you wish to handle the implementation yourself, or you can outsource the lease accounting to our team and we will assist you in providing your journal entries, amortization schedules and footnote disclosure information.

Contact Us

If you would like to discuss how we can assist you with accounting for leases, contact a member of your client service team or:

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