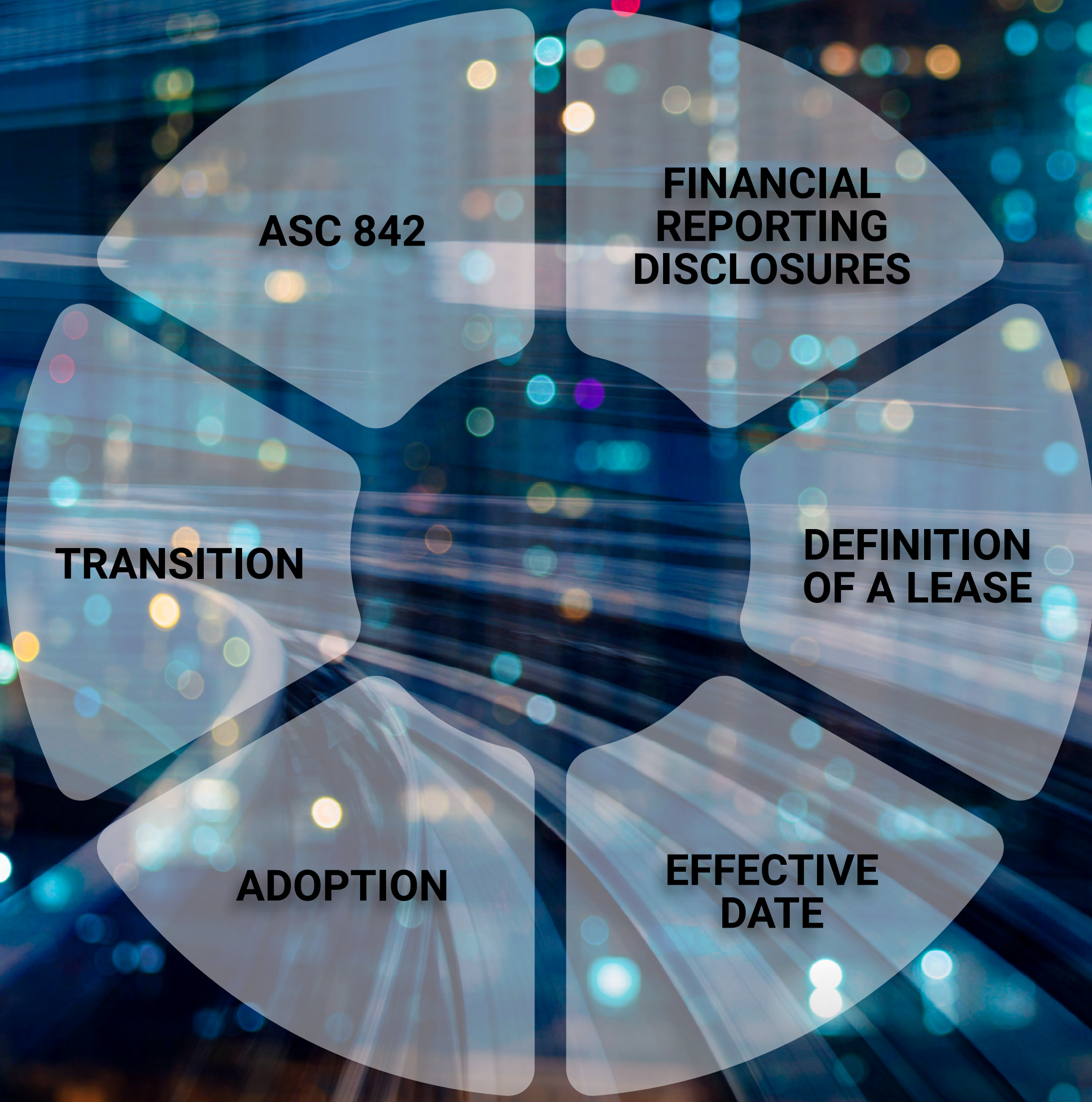
Key Provisions in Transitioning to the New Lease Accounting Standard For Private Companies



TAKING THE FASB ASC 842 LEASE ACCOUNTING STANDARD CHANGES FROM STRATEGY TO EXECUTION

iLeasePro

1 Summary of the New Standard

In February 2016, the FASB issued Accounting Standards Update (ASU) No. 2016-02, Leases (codified as Accounting Standards Codification Topic (ASC) 842). ASC 842 introduces a lessee model that, in most cases, requires a lessee to recognize a lease liability for each lease contract based upon the present value of future lease payments with an offsetting right of use asset. In the calculation of the present value, the lessee will use a discount rate based upon the rate implicit in the lease, or if that rate is not determinable, the lessee's incremental borrowing rate.

ASC 842 retains the two-model approach to classifying leases as operating or finance leases. A lessee may elect, as an accounting policy, not to record leases on the balance sheet with terms of 12 months or less. To qualify for this election, the lessee must be cognizant of the lease term as defined in **ASC 842**; lease term includes any renewal period which the lessee is reasonably certain to exercise.

Although both operating and finance leases will be recorded on the balance sheet, the expense recognition pattern will differ for each. For an operating lease, a lessee would recognize lease expense on a straight-line basis over the lease term. For a finance lease, the lessee would recognize separately both interest expense and amortization expense. Therefore, the lessee would generally recognize greater expense earlier in the life of the lease for a finance lease as compared to an operating lease.

2 Financial Reporting Disclosures

The new standard also significantly expands the required lease financial disclosures, which includes both qualitative and quantitative disclosures. Entities should carefully consider the broad nature of these disclosure requirements early in their implementation efforts.

iLeasePro

3 Definition of a Lease

The provisions of **ASC 842** require the financial statement preparer to determine these most important elements associated with a lease (not meant to be all inclusive):

- Does the contract in question meet the definition of a lease for accounting purposes?
- Does the contract contain any non-lease components?
- What is the lease term?
- What are the lease payments?
- How should a lease be classified?

ASC 842 also incorporates significant changes to the definition of what constitutes a lease. Lessees should carefully consider these changes and ensure that they fully analyze their contracts. The financial statement impact of failing to identify whether a contract is or contains a lease could be much more significant under the new leasing standard.

4 Lease and Non-Lease Components

ASC 842 requires entities to identify the lease and non-lease components of a contract that contains a lease. A contract or lease agreement may contain multiple lease components. When a contract includes both lease and non-lease components, an entity may be required to allocate the consideration in the contract to the various elements.

The consideration allocated to the lease component is accounted for under **ASC 842**, while the consideration allocated to the non-lease component is accounted for under other applicable GAAP.

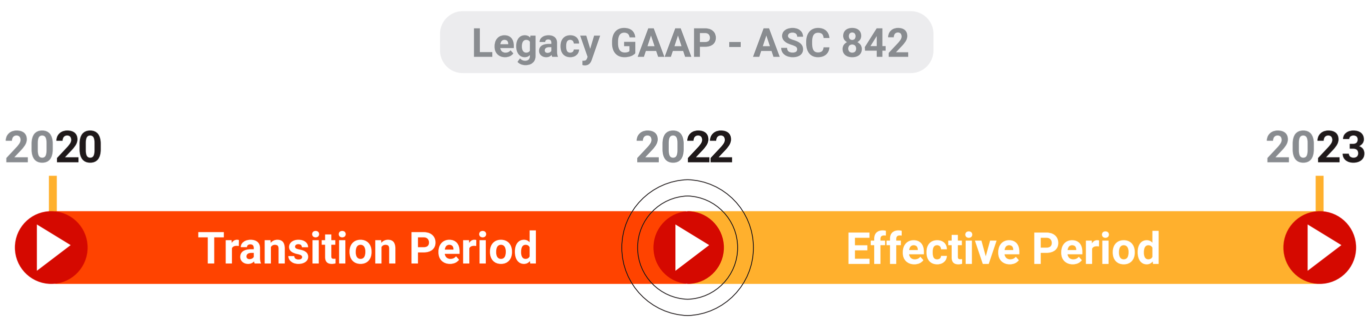
ASC 842 allows lessees to elect, as an accounting policy, not to separate lease and non-lease components. This would result in a larger lease liability on lessees' balance sheets, however, this election eliminates the complexity of valuing the non-lease component.

iLeasePro

5 Transition and Effective Date

The ASC 842 change went into effect for public companies by December 31, 2018. Originally, non-public companies were required to become compliant to the ASC 842 changes by December 31, 2019, but the FASB had moved the compliance for non-public companies out to December 31, 2020 to give these private companies additional time to comply based on the challenges experienced by the public companies. Recently though, due to the Coronavirus situation, the FASB approved the deferral of the effective date for ASC 842 for non-public business entities and private not-for-profit entities for one year until the period beginning after Dec. 15, 2021.

Many public companies under-estimated the effort involved. Private companies should learn from these unsuccessful implementations to take advantage of the extension and begin the transition as soon as possible.



NON-PUBLIC COMPANIES

6 Adoption and Transition

PRACTICAL EXPEDIENTS

There is a package of practical expedients provided in ASC 842 as a means of lessening the burden of transition.

An entity may elect not to reassess:

- Whether expired or existing contracts contain leases under the new definition of a lease;
- Lease classification for expired or existing leases; and
- Whether previously capitalized initial direct costs would qualify for capitalization under **ASC 842**.

Note that **ASC 842** has curtailed what may be considered an initial direct cost when compared with ASC 840.

This list of practical expedients would have to be adopted on an all or nothing basis for the entire portfolio of leases. And note that errors in the application of ASC 840 are not grandfathered as part of this provision. The overall effect of this transition option will be that existing leases will continue to be recognized in accordance with current US GAAP except that entities will have to (1) recognize a lease liability and right of use asset for operating leases and (2) if the lease is modified, account for the lease under **ASC 842** at the date of modification.

We expect that almost all private companies would adopt this option.

iLeasePro

6 Adoption and Transition

USE OF HIND SIGHT

Hindsight is allowed when considering the likelihood that an option to extend or terminate the lease will be exercised or a purchase option will be exercised and assessing the impairment of a right of use asset. This transition option can be elected on its own or in combination with the package of practical expedients noted above.

The main drawback to hindsight is that necessary transition adjustments cannot be finalized prior to the effective date and entities have to evaluate all relevant factors impacting hindsight at the effective date.

6 Adoption and Transition

EMBEDDED LEASES

Embedded leases are a somewhat new concern coming out of adoption of the new standard. Embedded leases are components within contracts that entail the use of a particular asset, where the user has control over that asset. Therefore, they meet the definition of a lease. The language in the contract may not contain the word "lease". These lease arrangements may not have been previously identified and the portion of the contract that meets the definition of a lease may be a relatively small component of the contract. These types of arrangements may be found in IT services contracts and supply contracts to name a few.

Under ASC 840, these lease arrangements may have been accounted for substantially the same as an operating lease with no material financial statement impact.

ASC 842 requires operating leases to be recognized on the balance and thus the importance of identifying these embedded lease arrangements. Consequently, certain contracts may require a fresh look with an evaluation of whether they contain a right to use an identified asset.

6 Adoption and Transition

TRANSITION METHOD

When the FASB originally issued the standard, it set the transition date requirements as the later of:

1. the beginning of the earliest period presented in the financial statements or
2. the commencement date of the lease. In a recently adopted update to the standard, the FASB provided a significant time saving transition option which allows the transition date to be the date of initial application.

As a practical matter, this allows calendar year private companies to apply the standard on January 1, 2020 and not have to restate the prior periods presented in the financial statements. Companies that choose this transition option would be required to provide Topic 840 comparative period disclosures.

We expect that most private companies would avail themselves of this alternate transition approach because leases which expired prior to the transition date would not be included and restating prior period financial statements can be cumbersome and time consuming. Lack of comparability in the prior periods should not be as much of a concern for private companies as compared to public companies.

7 Final Thoughts

Many private companies maintain their lease contract on Excel spreadsheets because ASC 840 GAAP is relatively straight forward, particularly for operating leases. However, **ASC 842** brings many complexities and to comply with all of the new standard's requirements (including those related to disclosures), entities may need to implement new accounting software. It is critical that private companies have a complete understanding of existing lease contracts, assess the requirements necessary to comply with the new standard and decide whether a more sophisticated technology solution is required.

In making that assessment, the focus is necessarily on the accounting capabilities of the technology. But let's consider expanding the requirements with an additional focus on overall lease management. Excel spreadsheets do not provide the capabilities to insert efficiencies into the lease life cycle – efficiencies such as critical date notification, document management and effective tracking of lease option issues. The focus should be on getting the most out of the technology options.

iLease Management LLC **is ready to provide additional information and assistance to help you meet the compliance requirements of the upcoming Lease Accounting changes.**

Contact Us

https://ileasepro.com/contact

TAKING THE FASB ASC 842 LEASE ACCOUNTING STANDARD CHANGES FROM STRATEGY TO EXECUTION

iLeasePro

