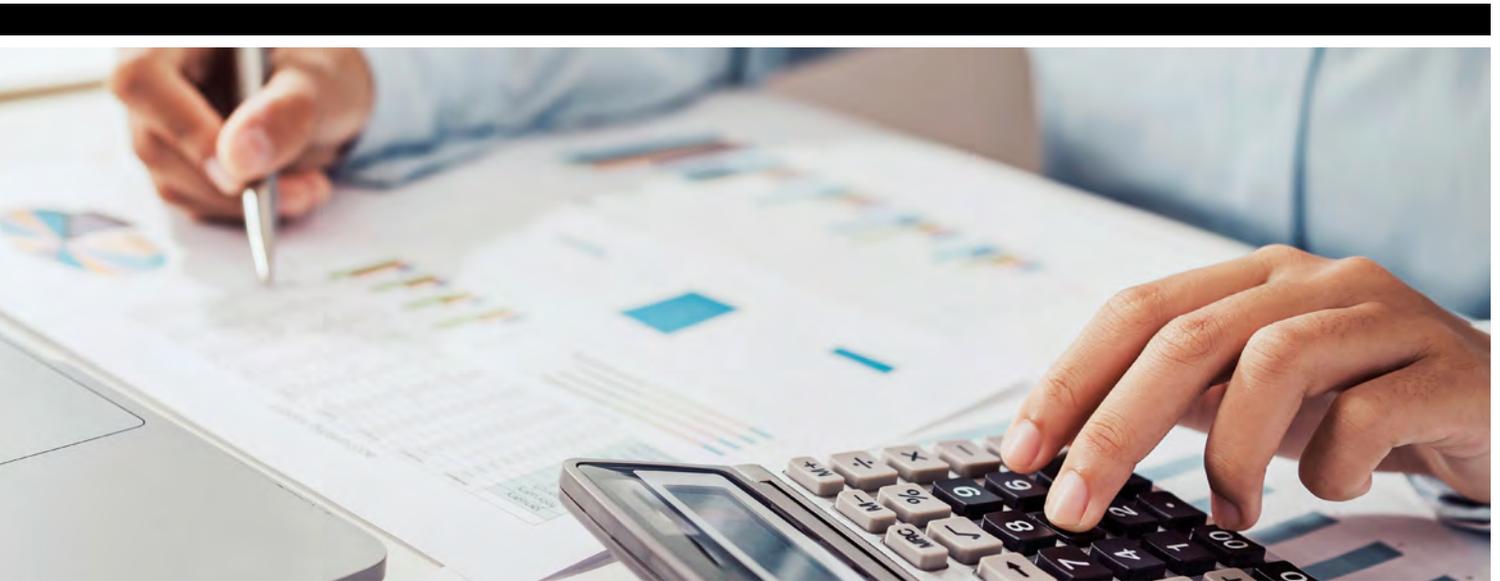


# IMPLEMENTING ASC 842

## What Private Company CFOs Should Know

AN ARMANINO WHITE PAPER





**JANUARY 1  
2019**

The effective date for ASC 842 for public business entities was fiscal years beginning after December 15, 2018 (effective starting January 1, 2019, for calendar year-end public entities).

For non-public business entities, the effective date for ASC 842 is fiscal years beginning after December 15, 2021 (effective starting January 1, 2022, for calendar year-end private companies).

**JANUARY 1  
2022**



## Introduction

**Just like the tax law revamp and the new revenue recognition standard, there's another major new accounting standard that has the potential to disrupt the status quo for accounting departments (and beyond) in public, private and nonprofit entities.**

ASC 842 is the new lease accounting standard, and it represents the most significant change to lease accounting in 30 years. Impacting nearly every company that holds leases — including real estate, vehicles, equipment, furniture and more — the standard aims to bring operating leases onto the balance sheet for the first time.

Among the implementation challenges for organizations of all sizes is the time-consuming effort of collecting and analyzing lease data from contracts across the business. Major changes to lease management processes may be required as well, and new technology could be necessary to handle data management, calculations and compliance reporting.

While the effective date for calendar year-end public companies was January 1, 2019, the standard has been delayed multiple times for private companies, so they have until the fiscal year beginning after December 15, 2021. Essentially, private companies that report on a calendar year will have to adopt ASC 842 effective January 1, 2022. Judging by the numerous reports of public companies struggling to comply, private companies shouldn't waste time getting started.



## Highlights of the New Standard

The overarching intent of the new lease accounting guidance from the Financial Accounting Standards Board (FASB) is to achieve greater transparency and address off-balance-sheet financing concerns related to lessees' operating leases.

According to the FASB, the ASC 842 guidance improves lease accounting by:

- Providing a more faithful representation of a lessee's rights and obligations arising from leases
- Reducing the opportunity for organizations to structure leasing transactions to achieve a particular balance sheet outcome
- Improving understanding and comparability of lessee's financial statements
- Giving users of financial statements additional information about lessors' leasing activities and exposure to credit and asset risks
- Aligning lease accounting more closely with the new revenue recognition standard

Under ASC 842, companies must now recognize the majority of leases as assets and liabilities

on their balance sheet for all financial reporting. The new standard also expands qualitative and quantitative disclosures, including the nature of leases, significant judgments and assumptions, lease expense amounts and maturity tables.

There are no scope exceptions for smaller leases (e.g., leases of low-value assets such as personal computers or copiers). The new standard applies to all identifiable assets, *except*:

- Leases to explore for or use minerals, oil, natural gas and similar nonregenerative resources
- Biological assets, including timber
- Assets under construction
- Intangible assets
- Inventory

## FOR LESSEES

### Major Differences Between Previous GAAP and ASC 842

## FOR LESSORS

Operating leases (for right-of-use assets) now appear on the balance sheet

Fewer leases will be classified as direct financing

Lessees will recognize both operating and finance leases on the balance sheet

Fewer upfront costs (initial direct costs) will qualify for deferral

Organizations will recognize a right-of-use asset and lease liability

Unusual outcomes may result when sales-type leases contain primarily variable consideration

New financial statement disclosures are required

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The new lease accounting guidance aligns certain underlying principles of the new lessor model with those in ASC 606, the new revenue recognition standard. For example, ASC 842 requires lessors to use the guidance in ASC 606-10-32-28 through 32-41 when separating and allocating consideration to the components in a contract. For this reason, some organizations are choosing to adopt both new standards at the same time, rather than implement them sequentially.

### The Definition of a Lease

A contract is (or contains) a lease when two criteria are met:

**1** The contract explicitly or implicitly specifies use of an **identifiable asset**. An example of explicitly specifying an asset is including the type, make and serial number of an industrial machine in the contract versus implicitly stating a name of the type of machine.

**2** The lessee **controls** the use of the asset for that period of use. With the new standard, a customer has control if the customer has the right to both obtain substantially all the economic benefits from the use of the asset and direct the use of the asset.



# The Challenges Companies Face

Along with having more time to comply, private companies also have the advantage of learning from the efforts and mistakes of public companies that have had to move sooner to implement the standard.

Numerous surveys have noted that many public companies underestimated the effort and manpower required to implement the new lease accounting rules.

Whether your company has dozens, hundreds or thousands of leases, your team could face some of the same challenges that affected public companies, including:

## 1 Contract identification and collection

- ▶ **Potential issues.** Even for companies that don't have a high volume of leases, identifying lease contracts can still be very resource intensive. One reason is that leases are often decentralized across the company, making it difficult to identify all leases, including embedded leases, and collect the necessary data.

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**IMPACT.** Not enough resources/time

## 2 Lease determination

- ▶ **Potential issues.** Following the lease decision flowchart (see next section) included in the ASC 842 implementation guidance from FASB requires knowledgeable resources who understand diverse and potentially complex leasing terms.

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**IMPACT.** Lack of skills/knowledge

## 3 Data capture and management

- ▶ **Potential issues.** The new standard requires data points about leases that many companies have not previously tracked in their core systems. Once you've identified leases, how will you collect lease data from across the company, where will you store it and how will you maintain it?

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**IMPACT.** Lack of centralized lease management processes and systems

#### 4 Accounting calculations and lease reporting

► **Potential issues.** How will you calculate and report on the lease data you've captured? Spreadsheets can be inefficient and risky for all but the smallest number of leases. Instead, you'll probably need new software or a software upgrade that helps you effectively support the new standard.

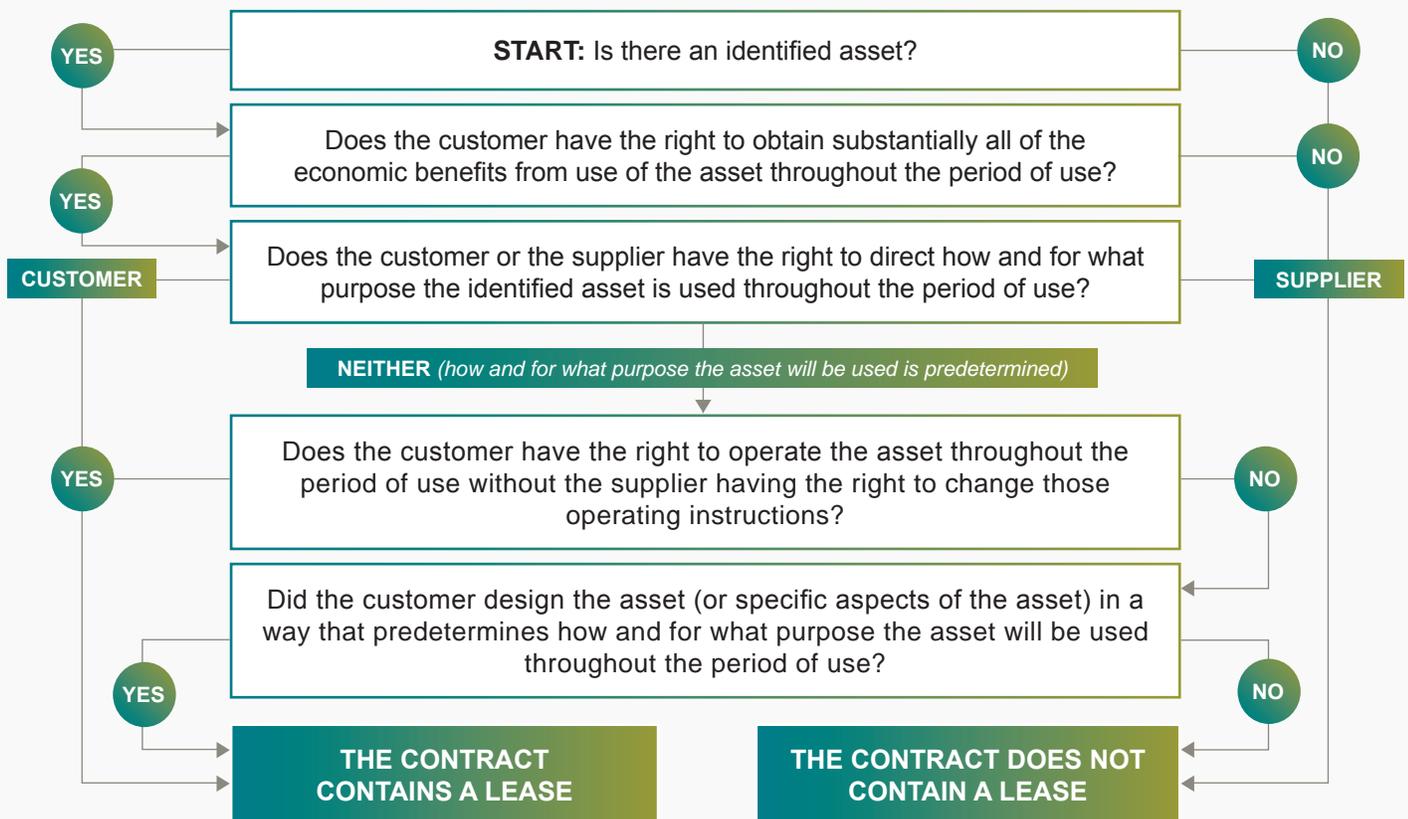
**IMPACT.** New/updated technology required

#### 5 Internal processes

► **Potential issues.** Adopting the standard will likely require creating new internal controls and processes related to leases and maintaining an up-to-date lease inventory. You'll need processes for capturing every new lease that is signed across the company and tracking changes that occur during the life of the lease that may impact value, liability or other aspects.

**IMPACT.** Cross-functional involvement and support needed

### ASC 842 Lease Decision Flowchart





## Renewed Focus

**With all leases now coming onto the balance sheet, there's a renewed impetus and focus on ensuring the completeness and accuracy of your population.**

Under ASC 840, operating leases were relegated to a commitments disclosure that provided the reader of the financial statements the future of lease payments. With the new rules, the aggregate present values of lease payments are now promoted to the face of the financials for everyone to analyze. It'll be imperative that companies look beyond just the accounting silo to effectively adopt the new standard and meet the requirements for financial reporting and disclosures — this will be a cross-functional team effort including finance, legal, facilities and real estate, and operations. The implementation and ongoing efforts will require communication and input from anyone in the organization that may have lease agreements lurking in a filing cabinet.

### **Pending Updates**

As a result of the post-implementation feedback received by the FASB, a new proposal was released on October 20, 2020, that would provide three targeted improvements to the new leasing standard. These improvements would impact everyone, whether you've already adopted ASC 842 or are still going through the process. The comment period for the targeted improvements closed on December 4, 2020. On February 10, 2021, the FASB redeliberated and issued updates on the proposals.

# The three targeted improvements and FASB updates are as follows:

## 1 Lessors would be forced to classify leases with predominantly variable lease payments and not based on an index or rate as operating leases.

- ▶ **What it means:** The last targeted proposal only applies to lessors and requires that leases with lease payments that are predominantly variable and are not based on an index or rate (e.g., a long-term lease of machinery where the consideration in the contract is determined based on hours used by the lessee) be classified as operating leases.
- ▶ **Update.** The FASB decided to consider amendments to the proposal and asked staff to evaluate the impact of alternative amendments. The alternative would require lessors to classify and account for a lease as an operating lease if a lessor (a) meets any of the criteria for sales-type lease classification and (b) would recognize a selling loss at lease commencement as a direct result of variable lease payments that do not depend on an index or a rate.

## 2 Provide lessees with the ability to remeasure lease liabilities for changes in an index or rate.

- ▶ **What it means:** This provides lessees with the option to remeasure variable lease payments based on an index or rate (e.g., the Consumer Price Index or CPI) when there is a change in the index or rate that will affect future lease payments. Under ASC 842, a lessee measures variable lease payments using the prevailing index or rate at the lease commencement date, and changes in variable lease payments result in a remeasurement of the lease liability only when the lease liability is remeasured for another reason (e.g., a change in the lease term). Under the current guidance, any change in the index rate would simply run through the current period P&L. The FASB proposed giving lessees an option to remeasure lease liabilities for changes in a reference index or rate affecting future lease payments on the date that those changes take effect. If this option is selected, lessees would be required to apply it on an entity-wide basis.
- An example:** a lessee that enters into a three-year lease agreement with fixed lease payments in year one and payments that are adjusted at the beginning of years two and three based on CPI changes would be able to remeasure its lease payments each year the change in CPI takes effect.

This change would more closely align IFRS 16 and US GAAP as it relates to lease payments that vary based on an index or rate.
- ▶ **Update.** The FASB decided to not move forward with the proposal and removed this issue from its technical agenda.

### 3 Exempt both lessees and lessors from applying the standard's modification guidance when one or more lease components are terminated before the end of the lease term but the terms relating to the remaining lease components stay the same.

► **What it means:** This would prevent a company — either a lessee or lessor — from having to reassess the lease classification or remeasure the discount rate. Prime examples of these arrangements would include the early termination of vehicles under a fleet agreement or the modification to reduce the number of floors being leased.

Fear not! If you didn't separate the lease components at the commencement of the lease because it would have been inconsequential, you would still be able to take advantage of this improvement.

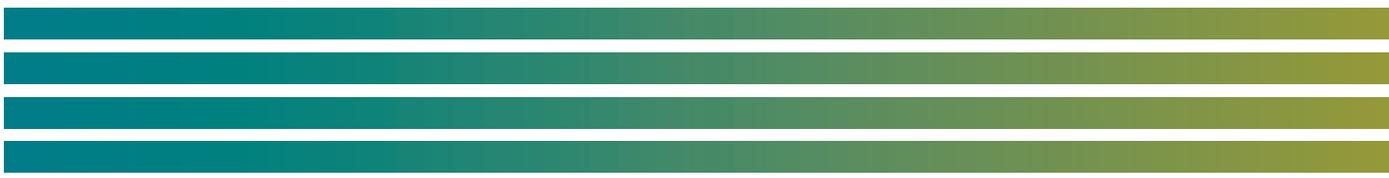
► **Update.** The FASB decided to not move forward with the proposal and instead, asked the staff to identify other potential improvements and solutions for consideration at a future meeting.

#### How does this impact those who have already adopted ASC 842?

As of the effective date, an entity would be permitted to apply the amendments on lease modifications and lessor classification either retrospectively to their date of adoption of ASC 842 or on a prospective basis to new or modified leases.

#### What about those who haven't yet transitioned to ASC 842?

If these targeted improvements become final guidance ahead of the effective date of your implementation, you'd simply incorporate as part of your adoption and then follow the transition requirements under ASC 842.



## Checklist for Implementation

For many companies, the implementation of ASC 842 will not be a trivial matter given the extent of the changes, particularly for lessees. It's imperative to begin implementation planning as early as possible to allow for unforeseen delays and stumbling blocks.

Developed for CFOs and their teams, the following checklist includes actionable steps to help as you begin planning and assessing your organization's compliance efforts. If you have already begun implementing the new standard, the checklist may provide new ideas or approaches to help you avoid common pitfalls and stay on track for meeting the compliance deadline.

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### 1 ASSESS REQUIRED RESOURCES

While some organizations may have enough staff hours available as well as in-house leasing knowledge to undertake the entire compliance initiative, many will not.

Based on a preliminary understanding of the number of existing leases to be collected and analyzed from across the company, CFOs should determine whether external resources need to be obtained to handle all or part of the initiative, particularly the more resource-intensive activities such as lease abstraction and implementing new technology.

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## 2 IDENTIFY EXISTING LEASES

With your project team in place, you'll need to begin by locating all your company's lease documents.

This typically involves working across departments and business units to survey all relevant areas about the existence of leases. As you collect the lease documents, initial analysis of the leases should help you uncover the accounting, operational or data issues you'll need to resolve.

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## 3 EXAMINE FOR EMBEDDED LEASES

Your team also needs to review service contracts, analyze them for embedded or implied leases and document them for your auditors.

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## 4 UPDATE LEASE INVENTORY

Once you've collected all the leases, including embedded leases, create or update a complete lease inventory. This will serve as your starting point for collecting all the relevant data you'll need for ASC 842 compliance.

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## 5 IDENTIFY DATA GAPS

Reconcile the lease data you have in current systems or spreadsheets with the data points that you'll need for compliance.

For many companies, lease data such as the market value of a leased asset or discount rate was not previously tracked or needed for financial reporting in the past. This created a gap in data for existing leases. Your goal is to identify all the missing data types and create a plan for how to obtain the data for current and future leases.

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## 6 EVALUATE THE IMPACT

With lease inventory and information collected, you can begin assessing the impact of the new standards on your company's financial statements, ratios, metrics and debt covenants.

Work with stakeholders, such as investors, banks and external auditors, to disclose the expected impact and mitigate any risk associated with it. For instance, if debt covenants are likely to be affected, work with lenders to avoid violations.

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## 7 ASSESS AND REVISE INTERNAL CONTROLS AND POLICIES

Your company may need to make significant process changes to comply with ASC 842.

From changing the workflow for new contracts so that your accounting team can identify and track leases and lease data, to managing changes to terms in existing lease contracts, you'll need to evaluate and redesign processes across departments. This step is an important part of planning for your future state of compliance after the FASB deadline.

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## 8 IDENTIFY AND DEPLOY SUPPORTING TECHNOLOGY

Relying on manual efforts to collect, manage and track lease data, perform calculations and create reports for compliance can be labor intensive and error prone for any company with more than a handful of leases. For that reason, many organizations are deploying new technology such as lease accounting or lease management software to automate as much of the lease accounting effort as possible.

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## 9 ABSTRACT AND STORE LEASE DATA

This step will likely take place in parallel to some of the other steps, as it's easily one of the most labor-intensive and time-consuming activities.

You'll need to analyze every existing lease contract and extract and store all the relevant data points. For lengthy contracts, such as real estate lease documents, a detailed examination of the document could take two to three hours of effort. Allot time for collecting additional data needed that isn't found in the individual contract, such as the discount rate.

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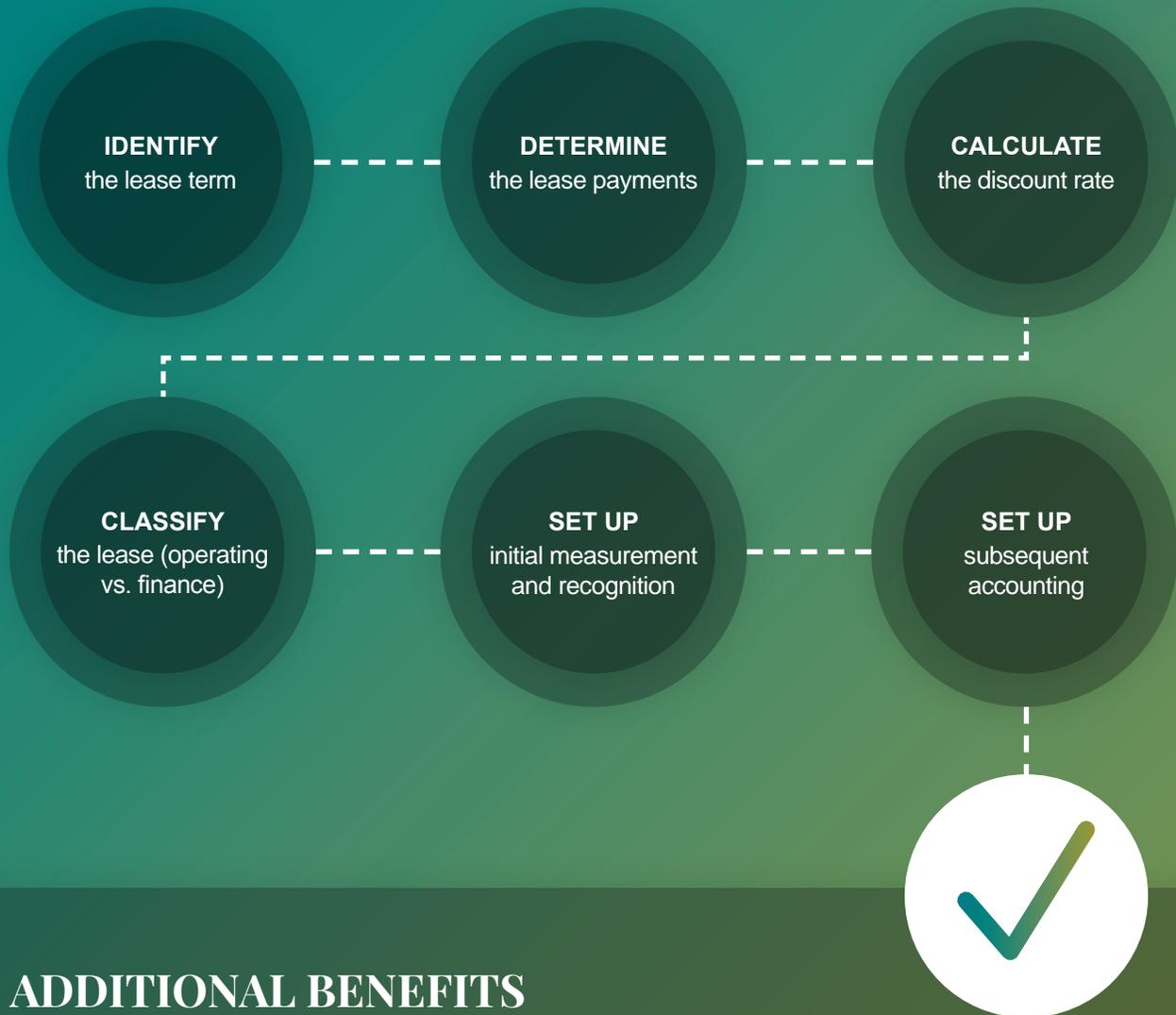
## 10 REVIEW AND REVISE FOR ONGOING COMPLIANCE

Once the implementation project is complete, you'll need to maintain compliance going forward.

Take time to review the effectiveness of your policies and processes around lease management, the accuracy and completeness of the data you're collecting, the effectiveness of the software you've deployed and the impact of the new lease accounting requirements on your staffing levels.

## The New Lease Accounting Process

For each lease your organization identifies, you should:



## ADDITIONAL BENEFITS OF COMPLIANCE

While the new lease accounting standard will probably require significant time and effort to implement for all but the smallest companies, there are benefits in addition to compliance. You may identify unused leases, helping to free up cash. Analysis of lease data could provide the insight you need to improve lease negotiations and outcomes in the future. You could also gain deeper insight into leasing costs to help you make better decisions.



## Conclusion

Private companies are in the enviable position of having not only more time to comply with ASC 842 than public companies, but also being able to learn from the mistakes of their public counterparts and apply proven best practices for expedient, effective compliance. But these advantages only exist for organizations that heed the warnings of the companies who have already achieved compliance. Don't underestimate the effort and time required to adapt to this complex set of accounting and lease management changes.

The clock is ticking for private companies. There's no time to waste in getting started with ASC 842, so you can enjoy the benefits of compliance while mitigating the impact and risk to your business.

*Regardless of where you are in the ASC 842 implementation process, Armanino can help you achieve a smooth transition. Visit us for more information on lease accounting, including our Lease Accounting Gap Assessment.*

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