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Companies

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By Michael Stevenson.

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new standard's implications for their entire organization and take steps for compliance.

Best practices for meeting the ASC 842 lease accounting standard

Understand complexities and specific changes in ASC 842. It is crucial for in-scope companies to understand the factors that set ASC 842 apart from prior lease accounting standards and ensure they are on track for compliance. Ultimately, ASC 842 aims to enhance the transparency of lease obligations by including those obligations on the balance sheet while also streamlining the reporting process under Generally Accepted Accounting Principles (GAAP). Previously, under ASC 840, operating leases were not recorded on the balance sheet, but now those future lease payments must be recognized. The definition of a lease under ASC 842 is similar to that under ASC 840; however, there are some important nuances to be aware of that can change the outcome.

ASC 842's approach to the identified asset sets it apart from previous determinations under ASC 840. As in traditional lease accounting standards, ASC 842 requires an identified asset to be either explicitly or implicitly specified in the contract, and it does not consider the asset specified if the supplier could substitute similar assets. However, ASC 842 only considers substitution rights substantive if the supplier meets both of the following criteria:

1. Possesses the practical ability to substitute alternative assets throughout the period of use.
2. Would economically benefit from the substitution.

The new standard determines whether a supplier's substitution right is substantive based on facts and circumstances at the time of contract inception. If the right to substitute is substantive, then there is no identified asset, and the contract does not

contain a lease. This guidance may deem more contracts to include a lease than

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(i.e., the customer directs the relevant decisions during the period of use).

- When the relevant decisions are predetermined:
 - The customer designed the asset in a way that predetermined the relevant decisions; or
 - The customer has the right to operate (or direct others in operating) the asset throughout the period of use.

Prepare for compliance as soon as possible. The changes outlined above go into effect for periods beginning after December 15, 2021, and should be reflected in lease portfolios filed for fiscal years beginning after that date. Entering the fiscal year in accordance with the new standard is far superior to playing compliance catch-up down the road. A proactive approach to implementation can save internal teams the stress of tackling a major lease accounting revamp on a time crunch. Hiring outside assistance will likely become more costly as the effective date draws closer as well.

Anticipate bumps in the road. Preparing sooner leaves private companies, particularly those with an elaborate lease portfolio, plenty of time to clear hurdles on the track to compliance. Under ASC 842, leases will now be recognized on the balance sheet, so there is an increased focus on whether a contract is or contains a lease. It is important that private companies have a clear view of their complete lease population, including short-term leases.

Lease population completeness can prove challenging for companies with large lease portfolios. The sheer volume of lease agreements makes it easy for companies to overlook leases, especially those embedded in broader agreements. In the past, companies may have been less likely to identify a lease that was part of a broader transaction or arrangement because it was absent from the balance sheet.

Companies with an international presence may have had added difficulty identifying leases written in other languages and based on foreign legal frameworks. Data silos,

perhaps exacerbated by a company's recent work-from-home policy, can also

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companies handle complexity in pricing and contract structures, track lease events, and report requirements and accounting variables. Most importantly, lease management software builds a comprehensive portfolio that allows companies to monitor leases more easily moving forward.

An experienced third-party advisor can serve as a sounding board and subject matter specialist on the accounting provisions of ASC 842 to determine whether compliance is being properly achieved. Outsourcing can also help companies look beyond the new standard's effective date to ascertain which departments are impacted by ASC 842 in the long term. Existing systems or processes might require modification to meet the updated reporting and disclosure requirements.

The lasting impacts of the new standard

It is too early to tell what influence ASC 842 will have on leasing as the new standard's legacy depends on larger market and societal trends. The introduction of the new standard coincides with other lease-related changes private companies are experiencing. For example, the pandemic may have inspired some to cut down on office space in favor of a permanent hybrid or work-from-home environment. Others may have renewed their leases to encourage employees to return to the office. Conditions in the post-pandemic economy — such as interest rate levels — will also influence leasing trends.

One thing is for certain: Private companies should begin preparing financial statements in accordance with the new standard as soon as they are able. They're encouraged to consider the long-term implications ASC 842 might have on operations and leverage the tools and resources at their disposal for sustained compliance.

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