FloQast

A Pain-Free Process for Adopting ASC 842

The time has come.

With the year-end Close right around the corner, private companies who have yet to adopt ASC 842, the new lease guidance for company lessees, are scrambling to get their ducks in a row.

But before the panic sets in, remember that ASC 842 adoption doesn't have to be a pain. We know how stressful busy season is during a normal year, so for the last several weeks, former accountants who are now at FloQast have been working to develop timely resources to help private companies who need to adopt ASC 842 before it's too late.

Let's start by taking a look at Day 1 accounting* for the standard, and dive into a practical approach and key factors for private company lessees implementing ASC 842.

*Day 1 accounting refers to adoption and initial recognition, NOT to maintenance or long-term recognition and remeasurement of standards

FloQast

Understanding ASC 842's General Business Implications

Ahead of worrying about the perceived lift of adopting ASC 842, it's important to first understand its purpose.

ASC 842 replaces the existing standard ASC 840. The primary difference between ASC 842 and ASC 840 is the capitalization of operating leases onto the balance sheet, in the form of Right-of-Use Assets (ROU) and lease liabilities.

But why?

The new ASC 842 standard was created to give investors a better view of leases' (if there is more than one) impact on a business. Though many businesses have relatively few leases to account for, at least one is generally real estate-related and could have a significant impact on the company's balance sheet for both lease liability and the value of the ROU asset.

While this is indeed a considerable difference between the two standards, most of the inputs are very similar, as well as their scope and classification. However, there is enough difference that you will want to reassess leases and their recognition.

What To Consider When Adopting ASC 842

Now that we understand the purpose of ASC 842, it's time to address the elephant(s) in the room: the myriad of important questions that need to be answered as part of the adoption process. For larger public filers, ASC 842 may have some significant ramifications for business processes, reporting, and covenants down the road. For most private entities, however, the standard may be significantly less impactful. As your organization moves to adopt ASC 842, understanding the ***extent*** of the standard as it ***specifically applies*** to your business and identifying what needs to happen ***today*** can help your team make the transition with relative ease.

First, review the new guidance, the changes in inputs, and the high-risk areas, which we will discuss further below (our webinar also covers this). Most teams will find the high-risk areas are not applicable to their business. If that is the case, expedite the process by focusing solely on Day 1 accounting. This will allow you to focus on and complete what is required for your year-end financials and audit, saving the rest for the following year. This longer runway should allow you ample time to plan the next steps.

Second, focus on practical expedients. These are available for a reason. Standard setters know that implementing and maintaining complex accounting standards is a heavy burden on small and medium-sized private businesses. Their ownership structure is also very different from public entities; therefore, their financial information needs are different. If you are pre-IPO and concerned with switching to a public entity in the future and having to re-measure and restate, don't be. Going public generally requires accounting policies to be restated, and investors and underwriters are used to seeing this. It generally has little to no impact on the IPO, so cross that bridge only if and when you have to.

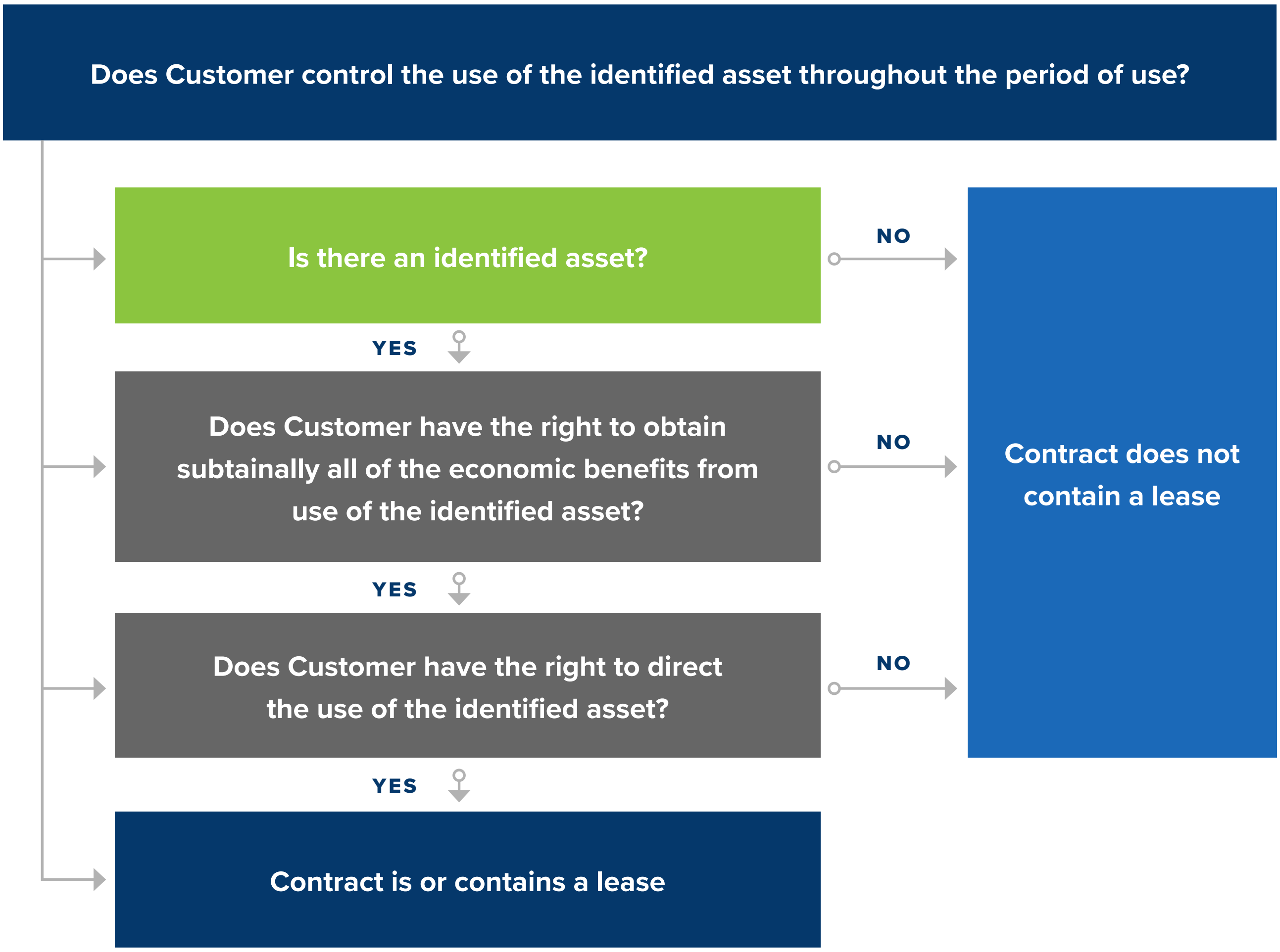
Changes in Lease Recognition and Measurement

Now let's get into the meat of it. What are the ***differences*** between ASC 842 and ASC 840 for lease recognition and measurement? While not so different, there are enough changes that each input should be looked at again. Luckily most of this information should be readily available or easily obtained if you focus on a practical adoption.

STEP 1

Recognition of Lease Contract

Always start at the beginning with scope and establish if you indeed have a lease. The questions to answer in each scenario are:



STEP 2

Lease Classification

Now that you have determined you have a lease contract, the next step is to determine what kind of lease it should be classified as: an operating lease or a finance lease. Note finance leases are a rename of capital leases in ASC 840. The difference between operating versus finance leases (ASC 840 capital leases) is very similar to the old standard.

Does your lease meet 1 (ONE) of the following criteria:

1. **Lease Term:** Does the lease term represent a major part of the remaining economic life of the underlying asset?*
2. **Lease Payments:** Does the present value of lease payments represent substantially of the underlying asset's fair value?**
3. **Alternate Use:** Is the asset so specialized in nature that it provides no alternative use to the lessor after the lease term?
4. **Transfer of Title:** Does ownership of the underlying asset transfer to the lessee at the end of the lease term?
5. **Purchase Option:** Does the lease agreement contain a provision where the lessee has the option to purchase the asset, and that option is reasonably certain to be exercised?

YES → **Classify as a finance lease**

NO → **Classify as an operating lease**

*Include/execute options
**Include executory costs

STEP 2 cont.

Lease Classification

The critical change here is the removal of bright lines* from the old standard. ASC 842 no longer sets bright lines, such as 75% of the asset's remaining economic life, etc. Instead, it broadens the guidance to "significant" remaining economic life, etc. Bright lines are still great practical expedients that are acceptable to use in your analysis. However, the high risk in this change in standard is when leases are close to thresholds. When close to old bright-line thresholds, the lease should be examined carefully to determine what operating or finance classification should be chosen. In addition, it's important to maintain a consistent approach to other leases in your portfolio and/or asset class.

If it's difficult to answer any of these questions on your own, and you're unsure if you should exercise a purchase option, don't overcomplicate the process and ask the appropriate business leader.

Pro-tip:

Ask via email and request an answer with a small summary in order to create an audit trail and save it in your memo or perm file.

STEP 3

Identify Commencement Date

Defined as "the date the lessor makes the underlying asset available to the lessee for its use and the date on which a number of important determinations and measurements are made," the commencement date is important for both initial asset and liability recognition, as well as classification, initial measurement, and term period. ASC 840 had classification and initial measurement based on inception date; however, ASC 842 has all three (classification, recognition, and initial measurement based on the commencement date).

In particular, this portion of the definition – "the date the lessor makes the underlying asset available to the lessee for its use" – is an important distinction that has significant implications. For instance, if the leased asset is an office space that is made available in March in order to make leasehold improvements, but the contract, payments, and plan to move in are in June, the commencement date is still in March. Be careful not to assume your lease term is based on contract dates, or you might have to re-measure during your audit.

*Bright lines, also known as 'cookbooks' are generally accounting rules that have clear quantitative thresholds used to determine the classification or demonstrate how the codification in scenarios should be applied.

STEP 4

Calculate Discount Rate

As noted above, the new ASC 842 includes the recognition of a liability and offsetting right-of-use asset for both operating and finance leases. The discount rate is critical in this measurement. While at the surface level, it can appear a bit tricky, it can be simplified if you take a 'practical' approach and rely on the allowed practical expedients. The guidance allows for two types of discount rates and a third practical expedient for private entities:

Discount Rate Summary		
Rate Type	**Lessee Use?**	**Challenges**
Implicit Rate	Yes*	May be impossible for lessees to determine
Incremental Borrowing Rate	Yes	May be expensive for lessees to determine, includes several variables (increased error risk), and includes significant judgement
Risk-Free Rate	Yes**	Only available to private companies, reguires remeasurement

*Lessee may use the implicit rate, but it is rarely readily available because it requires knowledge of lessor-specific information that the lessee may not have access to
**For non-public entities only

The **implicit rate** is the implied lending rate provided by the lessor and their contract. Though it may be stated in the lease contract, it's relatively rare. If it's not specifically called out, it's difficult to calculate. For example, it would require knowledge of tax credits realized and costs deferred by the lessor which may be impossible for lessees to determine.

The **incremental borrowing rate** is the interest rate a lessee would incur to borrow on a collateralized basis over the same period as the defined lease term (refer to Step 5) in a similar economic environment. The incremental borrowing rate is what most public companies use to calculate their discount rate. Consequently, it is generally expensive to assess, includes several variables (making it prone to error), and requires significant judgment as shown below. Fortunately, the risk-free rate is much simpler to obtain and use.

STEP 4 cont.

Calculate Discount Rate

Incremental Borrowing Rate - Effect of Factors	
Base	**Lessee-specific credit risk - credit worthiness of lessee (over lease term)**
+	Amount of lease payments (impacts lessee's debt obligations)
-	Collateralized nature of IBR (secured vs. unsecured rate)
+/-	Quality of lessee's collateral (lessee's aggregate collateral)
+/-	Alignment of borrowing term and lease term
=	Incremental borrowing rate

The **risk-free rate** is the rate of a zero coupon U.S. Treasury instrument for the same period as the lease term. An easy adoption would rely on using this expedient. It's important to note a couple of things when using the risk-free rate practical expedient:

- **As the rate is generally lower than the other rate options, it will increase the liability and ROU, which may impact certain bank covenants ratios such as liquidity**

It's important to identify the use of expedients early on. If it does affect a covenant, be sure to reach out to your bank and have a proactive discussion on changing covenants if possible. As this standard has had to be adopted by public companies these discussions should not be new to them.

STEP 5

Determine Lease Term

Before diving too deep into your lease term, remember that the new standard includes an election for short-term leases, defined as less than 12 months (including considerations below), that allows companies to apply off-balance sheet accounting. For most leases, the starting point is your non-cancellable lease period, including any rent-free periods. However, there are several other factors to consider such as:

	Noncancellable Lease Term (Including Any Rent-Free Periods)
+	Period(s) covered by any renewal or termination option(s) that rest solely with the lessor
+	Period(s) covered by any renewal options(s) that rest solely with the lessee and that the lessee is reasonably certain to exercise
+	Period(s) covered by any renewal option(s) that rest with both the lessee and lessor
+	Period(s) covered by any termination option(s) that rest with both the lessee and lessor when both: (a) any termination penalty is more than insignificant and (b) the lessee is resonably certain to not exercise the option
=	Lease term (subject to two guardrails)*

*Guardrails the lease term is subject to includes:

- If a lease involves fiscal funding clauses when the likelihood of their exercise is more than remote – in this case, the lease term should only reflect the periods for which the necessary funding is reasonably certain
- If a lease involves purchase options that the lessee is reasonably certain to exercise – when such options exist, the lease term shouldn't extend beyond the date the purchase option becomes exercisable

STEP 5 cont.

Determine Lease Term

Renewal options are a characteristic of leases where the lessee has the option, but not the obligation, to extend or renew a lease agreement at specific terms upon the expiration of the current lease term. If the option to exercise a renewal option rests solely with the lessor, the lease standard indicates lessees should include the renewal option term as part of the lease term. Renewal options that rest either partially or solely with the lessee require judgment on whether or not to include them in the lease term. Below are some examples of factors to consider regarding whether or not to have renewal options in the lease term and indicators a lessee is certain to exercise a renewal option:

Factor	Indicator Lessee is Certain to Exercise a Renewal Option
History related to lessee's exercise of similar options	When similar renewal options have been exercised in the past
Costs to enter in a new lease for a replacement asset	When there is a penalty for not exercising the option and that penalty is substantive compared to the lease payments for the period covered by the option
Degree of specific design and customization of underlying asset	When the underlying asset required a significant degree of design and customization
Importance of underlying asset to lessee's options	When the underlying asset is critical to the lessee's operations
Option's exercise price (or penalty for not exercising the option) compared to the lease payments for the period covered	When there is a penalty for not exercising the option and that penalty is substantive compared to lease payments for the period covered by the option
Contractual rates for the period covered by the option compared to market rates for the same period	When contractual rates are favorable compared to market rates (e.g., contractual rats for the renewal period are less than market rates for that period)

Factor	Indicator Lessee is Certain to Exercise a Renewal Option
Costs to return asset or restore the underlying asset to its prior specified condition	When exercising the option would result in the lessee not incurring significant costs of this nature until after the end of the renewal period
Option's exercise price (or penalty for not exercising the option) compared to the lease payments for the period covered	When there is a penalty for not exercising the option and that penalty is substantive compared to lease payments for the period covered by the option
Guaranteed residual value	When exercising the option reduces, removes or defers payment of a significant guaranteed residual value payment until after the renewal period ends
Lease term compared to the length of time the underlying asset could be used and is expected to be needed by lessee	When not exercising the option would result in a shorter lease term than the period of time the underlying asset could be used and is expected to be needed by lessee

Who knew there could be so much to unpack to determine lease term length? It's important not to get overwhelmed with the above factors, and instead, identify what factors are applicable, then focus on those first. If you're unsure about some of the questions, don't stress – just be sure to arrive at your term length using these applicable factors, then go back and review any remaining questions. Chances are, many of these questions will not be applicable based on the lease terms, and many of the answers should be readily available. Similar to lease classification, if the answer isn't readily available, reach out to the appropriate business leader and get a response.

Along with options to extend the leases, there are several additional factors that could be considered. However, the most critical step in the adoption is to be systematic with the analysis – avoid arbitrarily extending some and not others. Apply a **consistent approach** to lease term decisions to save significant time in adoption, as well as the subsequent reporting and audit.

Pro-tip:

Simplify the wording for your business leader and ask for a binary yes/no answer.

STEP 6

Assess Likelihood of Exercising Purchase Options

Purchase options give the lessee the right to acquire the underlying asset(s) during or at the end of the lease contract, and the accounting treatment of the lease will depend on how likely it is that the lessee will exercise the option. Below are the following factors to consider:

Factors	Indicator Lessee is Certain To Exercise a Purchase Option
History related to the lessee's exercise of similar options	When similar purchase options have been exercised in the past
Option's exercise price compared to the expected market value of the underlying asset on the option's exercise date	When the exercise price is specified and fixed and also less than the expected market value of underlying asset on exercise date
Costs to enter a new lease compared to option exercise price	When exercising the option would eliminate the lessee incurring costs to enter into a new lease and those costs are significant relative to option's exercise price
Degree of specific design and customization of underlying asset	When underlying asset requires a significant degree of design and customization
Importance of underlying asset to lessee's operations	When underlying asset is critical to the lessee's operations

As with lease classification and lease term, it's important not to get lost in the guidance. Focus on what ***IS*** applicable and what ***IS NOT*** based on the lease contract and expectations from management. For any other answers not readily available, don't be afraid to reach out to your appropriate business leader(s). Be consistent with your application of the guidance and you'll avoid many issues.

Pro-tip:

Send the appropriate business leader an easy questionnaire to fill out for ease and audit trail.

STEP 7

Calculate Lease Payment

Perhaps the most critical input as it has such a significant effect on lease liability and ROU. Unfortunately, lease payments come in a lot of flavors.

Nature of Payment	Include/Exclude from Lease Payments
Fixed payments, including payments, insurance, or taxes	Include
Variable payments, including payments for insurance or taxes (ex: the payment amounts are based on lessor's actual cost	Include when they are in-substance fixed payments or when they vary after the commencement date based on an index/rate
Lease incentives	Include when they are paid/payable to lessee and when they are losses incurred by the lessor for assuming lessee's pre-existing lease
Exercise price for purchase option	Include when reasonably certain the lessee will exercise purchase option
	Exclude when it is NOT reasonably certain lessee will exercise purchase option
Renewal Fee	Include when lease term reflects lessee exercising the reneal option and fee is fixed or variable based on an index/rate
	Exclude when lease term reflects lessee exercising the renewal option and the fee is variable based on a factor other than an index or other rate Exclude when lease term does not reflect lessee exercising renewal option

One critical difference in lease payments between ASC 840 and ASC 842 is treatment of fixed payments to the lessor for property taxes and insurance. Under ASC 840, such payments were previously excluded from minimum rental payments for classification and disclosure purposes (accounting for such payments vary depending on whether the lease is classified as a capital or an operating lease).

In addition, with ASC 840, capital lease payments were excluded for the accounting of the lease while operating leases have diversity in practice, with respect to whether to include them or not. Under ASC 842, fixed payments to the lessor for property taxes and insurance are treated the same as any other fixed payments within the lease agreement: included in lease payments and contract consideration as part of the minimum required obligation and included as lease payments.

Practical Expedients and Transition Methods

As noted above, there is a practical expedient for private companies struggling with IBR analysis. However, there are two more practical expedients to use:

Package of Practical Expedients

- No reassessment of lease classification
- No re-evaluation of embedded leases
- No reassessment of initial direct costs

Combining Lease and Non-lease Components

- Eliminates requirement to separate and allocate consideration in a lease contract between lease and non-lease components
- Non-lease components transfers a good/service to lessee that is separate from right to use underlying asset

Risk-free Rate

- Private companies only
- Risk-free rate = rate of a zero coupon U.S. Treasury instrument for the same period as lease term
- Able to elect risk-free rates by class of underlying asset vs. entity-wide level

For a pragmatic and easy adoption of the new guidance, it's highly recommended that you leverage these practical expedients. Utilizing these expedients will significantly reduce the work necessary to recognize and measure leases, as well as reduce the lift in writing up the corresponding memo. The package of practical expedients allows private companies to avoid having to perform reassessments or re-evaluation of current leases assuming such reassessment and re-evaluation was deemed appropriate under ASC 840. Rely on the documentation provided to your auditors in past audits to serve as audit proof for the upcoming audit.

Modified Retrospective Approach

ASC 842 is applied retrospectively to each prior reporting period presented in the financial statements, with a cumulative-effect adjustment as of the beginning of the earliest period presented.

RECOMMENDED:

Alternative Modified Retrospective Approach

ASC 842 is applied retrospectively to the beginning of the period of adoption through a cumulative-effect adjustment (recognized as of the beginning of that period). Most lessees will adopt this methodology for their financial statement presentation.

ASC 842 Disclosure Requirements

The new guidance has a few more disclosure requirements which are to be anticipated with the "capitalization" of operating leases and the creation of ROUs. So while the quantitative schedules have changed in substance, so have the qualitative narrative of the disclosure. An example of the new quantitative schedule would look like this:

	Year Ending	December 31,
	20X2	20X1
Lease cost	$XXX	$XXX
Finance lease cost:	XXX	XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	$XXX	$XXX
Other information		
(Gains) and losses on sale and lease back transactions, net	$(XXX)	$XXX
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term—finance leases	X.X years	X.X years
Weighted-average remaining lease term—operating leases	X.X years	X.X years
Weighted-average discount rate—finance leases	X.X%	X.X%
Weighted-average discount rate—operating leases	X.X%	X.X%

In addition, a general description of leases is required along with basis and conditions on which variable lease payments are determined, the existence and terms of options to extend or terminate the lease, existence, and terms of residual value guarantees in the lease, and any restrictions or covenants imposed by leases. Many of these qualitative requirements are already disclosed depending on the classification and materiality of the lease or asset class. However, it is recommended to work directly with your auditor to proactively identify the disclosure lift early in the audit and gather the information early.

Conclusion

ASC 842 has admittedly lived in an odd and challenging space for many accounting teams. It's an important codification update and a critical project that needs to be implemented, yet isn't as relevant as ASC 606 nor as daunting. Due to the volatility of market conditions in recent years, coupled with exceptional growth during the pandemic, hiring constraints, and the potential for a recession in early 2023, many companies have not had the opportunity to adopt the new guidance.

Many teams have all felt the pressures of trying to adopt guidance late in the game, but it's important to remember that the key to successfully navigating the new guidance is practical adoption of Day 1 accounting and addressing any high-risk areas as soon as possible. If you approach the implementation with that in mind, you and your team will have a surefire route to smooth and pain-free adoption of ASC 842.

Other helpful resources:

- **ASC 842 RESOURCE KIT:** Including Lease Schedule Template and Best Practices Checklist
- **ON-DEMAND WEBINAR:** Late in Adopting ASC 842: A Practical Way to Get Back on Track Before Your Audit
- **BLOG:** Understanding the ASC 842 Adoption Process

About FloQast

FloQast delivers workflow automation software enabling organizations to operationalize accounting excellence. Trusted by more than 2,000+ accounting teams – including Twilio, Los Angeles Lakers, Zoom, and Snowflake – FloQast was built by accountants, for accountants to enhance the way accounting teams work. FloQast enables customers to streamline processes such as automated reconciliations, documentation requests, and other workflows that impact the month-end close, financial reporting, and payroll, and is consistently rated #1 across all user review sites. Learn more at **FloQast.com**.

FloQast