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The Technical Guide to ASC 842 Adoption

Introduction

As with any new accounting standard that's released by the FASB, ASC 842 has become a focus area for auditors, analysts, and other key stakeholders – both internal and external.

With the adoption of ASC 842 becoming mandatory for all companies, we've identified some key areas of the standard that are worth exploring further.

After the success of The Ultimate Guide to Implementing ASC 842, in this guide we focus on the areas of ASC 842 generating the most questions – and the most concern. The goal being to put your mind at ease by providing practical advice and actionable steps to comply with ASC 842.

ASC 842 so far

ASC 842 has created a seismic shift in the way that organizations view and account for leases. Coinciding with the after effects of the COVID-19 pandemic, this topic has had a tremendous impact on many organizations.

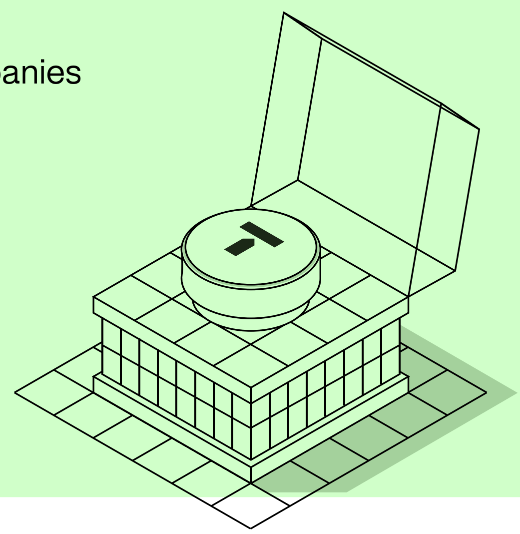
For example, one of the areas we'll look at is lease modifications. These are often related to real estate leases, such as office space. In a recent Deloitte survey, 28.8% of respondents planned to reduce or are reducing their real estate footprint by eliminating owned and leased space – which would require lease modifications per ASC 842 – showing just how pervasive ASC 842 related issues are.

At this point, ASC 842 adoption is required for all public and private companies. Public companies were required to implement the standard before private companies (although the private companies could have voluntarily chosen early adoption.)

This also means that by now we have more data related to where companies are struggling, where opportunities lie, and how best to ensure ASC 842 compliance.

In this guide, we'll look at four challenges that companies face when it comes to ASC 842:

- Disclosures
- Embedded leases
- Lease modifications
- The Incremental Borrowing Rate (IBR)



Disclosures

One of the key objectives of ASC 842 is to promote transparency and comparability. This means, of course, that the disclosure requirements around ASC 842 are a critical part of the standard. These disclosures ensure that key information is presented clearly to the user of the financial statements and allows such users to assess the amount, timing, and uncertainty of cash flows arising from leases.

With so much focus on the balance sheet changes in ASC 842, the enhanced disclosure requirements tend to be forgotten.

What are the key ASC 842 disclosure requirements?

ASC 842 mandates what should be included in the Statement of Financial Position, or balance sheet, of a lessee [842-20-45-1]. This includes:

- Finance lease right-of-use assets and operating lease right-of-use assets should be presented separately from each other and from other assets
- Similarly, finance lease liabilities and operating lease liabilities should also be presented separately from each other and from other liabilities

In the income statement, or Statement of Comprehensive Income, a lessee must show the following [842-20-45-4]:

- For finance leases: interest expense on the lease liability and amortization of the right-of-use asset: this can be presented however the entity presents other interest expense and depreciation or amortization of similar assets
- For operating leases, the lease expense must be included in the lessee's income from continuing operations

General disclosure requirements

According to ASC 842, a company must disclose both qualitative and quantitative information about the following [842-20-50-1]:

- Its leases, including a general description to provide more information to user
- The significant judgments made in applying the requirements of ASC 842 to these lease
- The amounts recognized in the financial statements relating to these lease

Qualitative and quantitative disclosures

Examples of qualitative disclosures mentioned in the Topic include:

- A general description of an entity’s leases
- The basis, terms and conditions according to which variable lease payments ar determined
- Information regarding the option to extend or terminate leases
- Restrictions or covenants imposed by lease agreements
- Information about leases that have not yet commenced but that create significant rights and obligations for the lessee
- Significant assumptions and judgments made in applying the requirements of this standard, including:
  - Determining whether a contract contains a lease
  - Allocation of the consideration between lease and non-lease components
  - How discount rates were determined

While examples of quantitative disclosures are:

- Finance lease cost, segregated between the amortization of the right of use assets and interest on the lease liabilities
- Net gain or loss recognized from sale and leaseback transactions
- Weighted average remaining lease term
- Weighted average discount rate

Additionally, lessees are required to disclose:

- Separate maturity analyses of both finance lease liabilities and operating lease liabilities including undiscounted cash flows on an annual basis
- For a minimum of each of the first five years and the total of the amounts for the remaining years
- A reconciliation of the undiscounted cash flows to the finance and operating lease liabilities as shown on the face of the balance sheet
- Lease transactions with related parties
- The accounting treatment of short-term leases

In summary, disclosures are a key part of ASC 842, and understanding the overall picture of what's required from a disclosure perspective, can go a long way towards ensuring you're on top of all ASC 842 disclosure requirements.

Embedded Leases

Beware of embedded leases

Much has been written about embedded leases, but why are these so top of mind right now? ASC 842 defines what a lease is and how it should be treated from an accounting perspective. As with the general "substance over form" principle in accounting, these definitions are less concerned with specific wording of a lease contract, and more with whether an arrangement or contract is (or contains) a lease.

For example, a contract might have all the elements of a lease in place, but might not actually call this a "lease" or mention the word lease anywhere in the contract. According to ASC 842, this agreement is nevertheless a lease and it needs to be accounted for as such. This is an example of an embedded lease.

What criteria need to be met?

ASC 842 notes that "a contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration."

When assessing whether an arrangement contains an embedded lease, multiple arrangements may be considered to be a single transaction. If two or more arrangements are entered into at the same time with the same counterparty (or related parties), a reporting entity should consider whether the analysis should be performed on each contract or the combination of contracts.

This definition noted previously is crucial in understanding whether a contract contains an embedded lease. Let's look at this definition in more detail:

The right to control

In order to test whether an entity has the right to control an asset, the following two questions must be addressed:

Does the party in question have the right to obtain substantially all of the economic benefits from the use of the asset?

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Both of these questions have to be answered "yes" in order for the right to control to be in place. Additionally, the customer (and potentially lessee) must

Have the right to obtain the economic benefits from the use of the identified asset

Have the right to direct the use of the identified asset

The identified asset

ASC 842 stipulates that the identified asset in question can be explicitly or implicitly identified. This is an area that has a significant impact for embedded leases, as sometimes the identified asset isn't explicitly mentioned and so it could be assumed that no lease can exist – however by stating that the asset can be implicitly identified, ASC 842 opens up many more contracts to the possibility of an embedded lease existing.

What's an example of an explicitly or implicitly identified asset? An explicitly identified asset might have a unique identifying number or name. An implicitly identified asset might be the delivery of an asset to a specific location. The name of the asset is not specified, but it's clear that the asset in question is implicitly identified. When a supplier must use an asset to fulfill the obligations in the contract, then there might be an implicitly specified asset (subject to determining whether there are substantive substitution rights).

No substitution

In addition to the “identified asset” test is the “no asset substitution” principle. This means that the asset is not considered “identified” – whether explicitly or implicitly – if the asset can be easily substituted for another by the provider of that asset.

A provider’s right to substitute an asset is substantive if both of the following criteria are met:

1. The provider has the practical ability to substitute alternative
2. The provider would benefit economically from the exercise of its right to substitute the asset. A provider’s right to replace a specified asset during the term of an arrangement if it is not working properly or becomes defective is not considered a substantive substitution right and would not by itself preclude the arrangement from being considered a lease.

Example of an embedded lease

Here’s an example of an embedded lease to illustrate the principles involved:

Jaws Inc manufactures specialized equipment for use in underwater exploration. The equipment requires a specialized waterproof widget that is manufactured for the company by Big Boat Ltd , on a 5-year deal. In order to provide the specialized part, Jaws insists on Big Boat setting aside a specific dedicated production line for their widgets. Based on Jaws’ needs, they instruct Big Boat as to when, and how much, to produce.

Here, an embedded lease is in place. There is control of the asset – Jaws dictates when and how it is used; and there is an identifiable asset, in this case the production line.

What should you look out for?

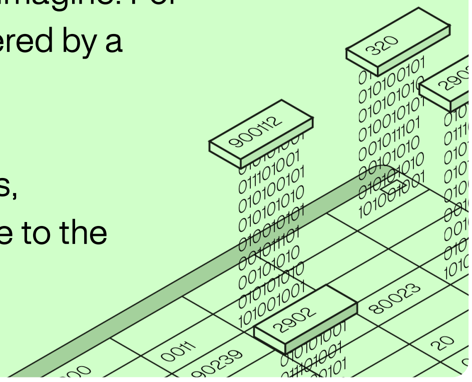
In terms of best practice, you should take the following steps to ensure no embedded leases have been missed:

1. Go through all contracts – not just obvious leases – to look for signs of an embedded lease that might have been overlooked
2. Look at any physical evidence that might point to a lease, such as new machinery
3. Inspect expense accounts for regular payments that might indicate the existence of a lease
4. Discuss the issue with department heads or other relevant members of the organization to get input into the potential existence of embedded leases

Lease Modifications

Under ASC 842, dealing with lease modifications can be complex. And lease modifications are more common than many people imagine. For example, the shortening of a lease term, or a discount offered by a lessor, are two examples of a lease modification.

The central question when it comes to lease modifications, and how to account for them, is as follows: is this a change to the existing lease, or a separate lease?



Finding the way forward with lease modifications

Start by asking two key questions:

1. Has this modification granted an additional right of use asset to the lessee that was not included in the original lease?
2. Have the lease payments increased in line with the value of a standalone asset of this type?

If the answer to both of these questions is "yes" then a separate lease exists.

You will thus have two leases: the original lease, and the new lease that has come about as a result of this change.

Lease modification: an example

A water delivery company leases 10 delivery vehicles. Due to the weather, demand for water has increased, and the company calls up its leasing partner and orders 10 more vehicles, with the corresponding increase in lease payments.

One might assume that the existing lease can just be amended. But from an ASC 842 standpoint, this passes the test set out above and this should be accounted for as a new, separate lease from the original.

The initial lease is left as is, while the new lease is accounted for as with any new lease, according to the requirements set out in the standard.

What if the answers were not “yes”?

If the answer to both of the key questions asked previously was not “yes” then there is no separate lease contract and the following steps should be followed

1. Reassess lease classification and lease term at the effective date of the lease modification
2. Account for initial direct costs, incentives, and any other lease modification-related payment
3. Remeasure the lease liabilit
4. Adjust the right of use asset

For any of the following, there is no separate lease, and the lease modifications will be accounted for as above

- A change in the lease term (increase or decrease
- A change in the consideration per the leas
- The partial or complete termination of a leas
- A change in scope caused by the addition or removal of assets

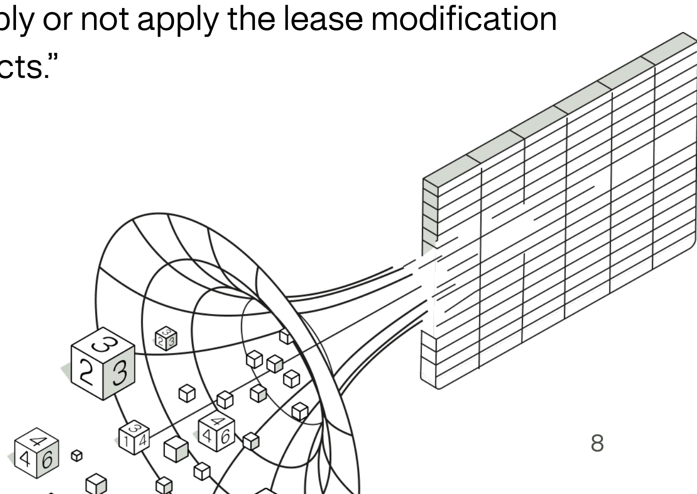
Are there any exceptions?

There are two major exclusions, or areas of relief available for organizations.

COVID-19 exemption for lease modifications

The FASB released a Staff Q&A that noted that “absent interpretive guidance, applying the lease modification requirements in Topic 842 (or Topic 840) to each contract for which concessions related to the effects of the COVID-19 pandemic are made could be costly and complex for both lessees and lessors.

“The FASB staff believes that it would be acceptable for entities to make an election to account for lease concessions related to the effects of the COVID-19 pandemic consistent with how those concessions would be accounted for under Topic 842 and Topic 840… Consequently, for concessions related to the effects of the COVID-19 pandemic, an entity will not have to analyze each contract to determine whether enforceable rights and obligations for concessions exist in the contract and can elect to apply or not apply the lease modification guidance in Topic 842 and Topic 840 to those contracts.”



Short Term Lease Exemption

For a lease with a term of under 12 months, and one that doesn't include a purchase option that the lessee is reasonably certain to exercise, then the lessee may elect not to apply the recognition requirements to this short-term lease. The lessee will account for the lease payments in the income statement on a straight-line basis over the term of the lease.

The Incremental Borrowing Rate (IBR)

The IBR is a central, critical calculation for ASC 842 compliance. What rate should you use? Should it be based on the standard borrowing rate, risk curves, asset classes, lease lengths, countries and so on?

The crucial number

When it comes to the discount rate to be used, ASC 842 states that a lessee "should use the rate implicit in the lease" if that is readily determinable. If not readily determinable, then the incremental borrowing rate should be used.

The IBR is further defined as the "rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment."

Multiple factors can impact this rate, ranging from the specific company's credit risk, to the general economic environment.

With leases having such a big impact on the balance sheet, much revolves around the discount rate used in calculating the present value of lease payments. From the lease liability, to the right of use asset, and through the income statement, getting this figure right is key – as it impacts so many different aspects of the financial statements.

Getting the IBR right

Accurately calculating your IBR, so that external auditors and internal stakeholders are satisfied with your calculation, is a challenge. In this case, technology should be leveraged to ensure that your calculations are data-backed and unimpeachable.

Leading AI-powered automated lease accounting solutions have core features which help underpin this calculation. These include:

IBR Sensitivity Analysis Report

This allows you to simulate different IBR percentages, to confidently determine the best IBR to use for your ASC 842 lease compliance. By having access to this sensitivity report, you can readily determine the impact that the chosen IBR will have across your results.

Your auditor will want you to demonstrate how you arrived at your IBR. With this feature you can do scenario modeling around different IBRs (for example, performing a sensitivity analysis by increasing or decreasing the figure by 1%) and you can see how this impacts the right of use asset and other entries – and demonstrate it to your auditors.

IBR & Interest Rate Rules and Schemes

This offers the ability to input complex, rule or scheme-based interest rates, which in turn can increase accuracy and accelerate ASC 842 compliance. By extension, this empowers you to be confident that your IBR is highly accurate, and enables stakeholders such as auditors, for example, to view your calculations down to a granular level.

ASC 842 should not cause undue stress or tension

Hopefully we've succeeded in shining the spotlight on the areas of ASC 842 that require the most focus, or present the highest areas of risk.

To further reduce risk, accelerate compliance, and let go of the headaches of ASC 842 compliance, we strongly recommend adopting a technology solution to support your ASC 842 compliance efforts.

With that, we'll say "good luck," and if you have any questions, the Trullion team would be more than happy to talk through them with you.

About Trullion

Trullion is an AI-powered accounting platform that automates financial workflows for CFOs, Accountants, and Auditors to increase efficiency, prevent costly oversights, and drive collaboration. Our Platform unifies the unstructured and structured worlds of accounting, translating them into financial workflows and giving you back your time, with confidence.