

JO Knows Lease Transition Options

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With the implementation of the new lease accounting standard upon us (Accounting Standards Codification 842, *Leases* (ASC 842)), and the impact that this new standard could potentially have on the financial statements for so many entities, we have so far in this series discussed certain technical aspects of the standard, from how to identify a lease, determine the key inputs (i.e. lease term, lease payments and discount rate) necessary to determine the type of lease and ultimately, calculate and account for the right of use asset and lease liability.

With the foundation set, we now look at year 1 implementation of the new lease accounting standard and the options during transition.

The standard requires modified retrospective adoption, meaning that leases are accounted for under this guidance as of the first day of the earliest period presented in the financial statements. For a typical calendar year-end entity presenting a comparative financial statement, this would be January 1, 2021. This will require an adjustment to the prior period(s) in order to record the right of use asset and lease liability, and in certain instances require a cumulative adjustment to retained earnings. There is an alternative election that can be made, known as the “Comparatives Under 840 Option”, whereby the standard can be applied as of the first day of the year of adoption (i.e. January 1, 2022). If this option is selected, prior periods presented are unaffected, and disclosures are carried forward. This option may reduce the time and effort necessary for implementation; conversely, the financial statements – more specifically in most cases, the balance sheet – will not be comparable, as, for example, an operating lease will be accounted for on the balance sheet in the current year but not in the prior year. Management should weigh the costs and benefits of the two options before deciding which is more desirable.

Once such a decision is made, the remaining elections, calculations and adjustments are made as of the date of initial application. The standard provides for certain practical expedients that may be elected, which include lease identification, lease classification and initial direct costs (the so-called “package of three”); the use of hindsight; and land easements. The package of three must be elected collectively or not at all. The use of hindsight and land easements expedients can be elected separately or in combination with the other expedients. The package of three is intended to reduce the time needed for implementation, since, if elected, there is no need to evaluate if an existing contract is or contains a lease, whether an existing lease is an operating lease or finance lease, or whether certain costs should be capitalized. Simply put, the conclusions reached under ASC 840 can be carried forward under ASC 842, and this must be applied to all leases in place as of the date of initial application.

The use of hindsight allows for reassessment of the lease term in light of events and conditions that have taken place since lease inception through the date of initial application. For example, real estate leases commonly have an initial period with one or more renewal options. At lease inception, an entity may have concluded that it was not reasonably certain that the renewal option would be exercised. With the passage of time and fluctuations in market rates, an entity may reach a different conclusion now about whether a renewal option is reasonably assured. If the use of hindsight results in a change in term, this will result in a greater right of use asset and lease liability (longer term, more aggregate payments), but will not impact lease classification unless the package of three was not elected, in which case the term will be one factor evaluated to determine proper classification.

It is widely expected that the package of three will be adopted by many entities. For entities with existing capital leases, the transition adjustment should be less complex as there was an existing leased asset and capital lease obligation recorded on the balance sheet. The carrying value of the leased asset and outstanding capital lease obligation are simply reclassified into a right of use asset and lease liability, respectively, as of the date of initial application. For operating leases, the right of use asset and

lease liability must be calculated. The lease liability is the present value of the future minimum lease payments as of the date of initial application. The selected discount rate should be based on the date of initial application as well. The right of use asset is the sum of the lease liability plus any prepaid rent or unamortized initial direct costs less any accrued rent or unamortized lease incentives.

Lastly, it is during implementation that other accounting policy and practical expedient elections should be made. These elections will impact the ongoing accounting and are required to be disclosed.

Conclusion

Now that we are in the back half of the year, it is time to commence the lease implementation process if not already started. There are elections and practical expedients that can reduce the time needed, but nonetheless, many entities still may face a time-consuming process to implement ASC 842.

Effective Date

ASC 842 is effective for private companies and nonprofit organizations with annual reporting periods beginning after December 15, 2021 and interim periods within fiscal years starting after December 15, 2022.

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