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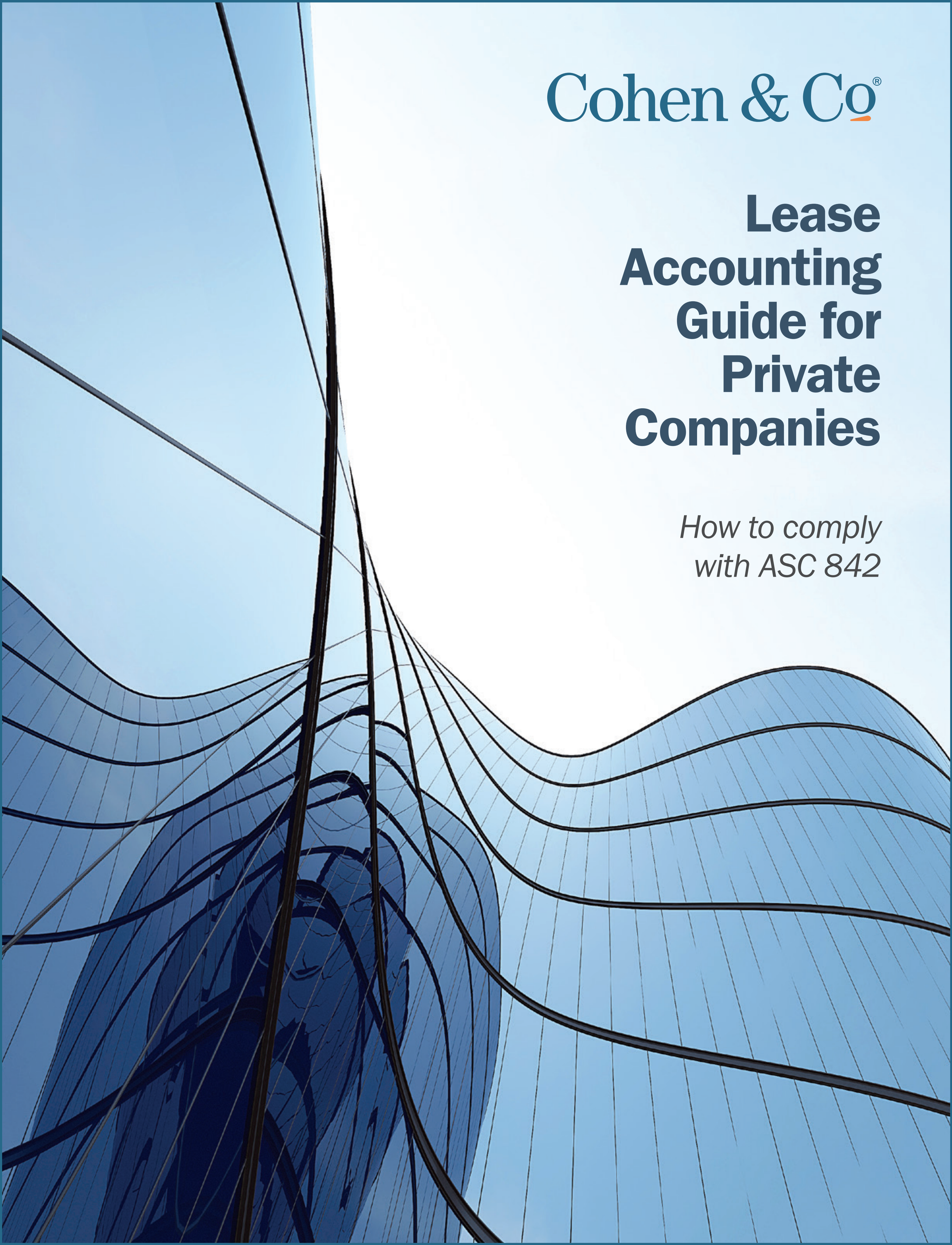
Lease Accounting Guide for Private Companies

How to comply with ASC 842



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A lot has changed in the world since 2016 when the FASB approved and released the new standard on lease accounting, now codified as ASC 842. However, because of the complexity, time and cost of adoption requirements, not to mention a worldwide pandemic, the FASB delayed the standard.

Finally, effective for periods beginning after December 15, 2021, private companies and not-for-profits are required to adopt the new leases standard. All companies must record on the balance sheet both a right-of-use asset and a lease liability for substantially all leases, instead of the previous off-balance sheet accounting used for operating leases. To prepare for the transition to ASC 842, there are numerous steps an organization must go through, including:

- Identifying leases within your organization,
- Accounting for, both initially and subsequently, the leases, and
- Presenting and disclosing related lease information.

While adopting the standard is a complex initiative, the bright side is private companies have real world guidance to forge a path forward. Since public companies were required to adopt the standard effective for calendar year 2019, there is a significant amount of information and numerous examples readily available from which private companies can draw — helping them deal with challenges such as grossing up balance sheets and addressing the impact on debt covenants.

This guide will help finance and accounting executives and their staff better understand the adoption and impact of ASC 842.

Early adoption [of the lease standard] is permitted, yet a July 2021 survey of a portion of Cohen & Co's private company clients showed that approximately 95% had not implemented the new standard. Roughly 85% had either not begun thinking about, or were in the very early stages of thinking through, the process.

How to Identify Leases

One of the primary challenges you must first face is identifying whether or not your company even has a lease.

Under the new standard, a lease is defined as a contract that 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.

A contract is defined as an agreement between two or more parties that creates enforceable rights and obligations. With this definition of a contract, it is important to consider that leases may not always be explicitly identified as a lease agreement.

The standard also explicitly ***excludes*** the following assets and leases from its scope:

- Leases of intangible assets, i.e., licensing arrangements, such as those involving software
- Leases to explore for or use minerals, oil, natural gas and similar nonregenerative resources, including the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained (unless those rights of use include more than the right to explore for natural resources), but not equipment used to explore for the natural resources
- Leases of biological assets, including timber
- Leases of inventory, i.e., the future right through a contract to use or consume a supplier's asset, including precious metals
- Leases of assets under construction

Once you've determined your contract is within the scope of ASC 842, you must then begin to evaluate whether the contract contains a lease as defined above. Although available guidance references a step-by-step process to help in understanding, it's not always necessary to use that formal process. For example, if the "right to control" the property, plant or equipment (PP&E) is clearly maintained by the supplier, then there would be no need to spend time determining if there is an identified asset.

Below is an example to illustrate a contract that does not contain a lease.

Company A enters into a contract with a Supplier for internet services for two years. The contract requires the Supplier to perform at specified performance levels, such as speed and bandwidth. To provide the services, the Supplier installs and configures routers, cables and modems (collectively the "equipment") at Company A's premises; the Supplier determines the performance levels of the internet services using the equipment. The Supplier can reconfigure or replace the equipment when needed to continuously provide the quality of services defined in the contract. Company A does not operate the equipment or make any significant decisions about its use.

The contract does not contain a lease. Instead, the contract is a service contract in which the Supplier uses the equipment to meet the level of internet services determined by Company A.

Company A does not control the use of the equipment because its only decision-making rights relate to the level of internet services (the output of the equipment) for the period of use — the level of internet services cannot be changed during the period of use without modifying the contract. For example, even though Company A receives the benefit of using the internet services, that activity does not directly affect the configuration of the internet services and, thus, it does not affect how and for what purpose the equipment is used. The Supplier is the only party that can make decisions about the use of the equipment during the period of use. The Supplier has the right to decide how internet services are provided using the equipment, whether to reconfigure the equipment and whether to use the equipment for another purpose. Accordingly, the Supplier controls the use of the equipment in providing internet services to Company A.

How to Identify an Asset
(Property, Plant and Equipment)

The next critical step is to determine whether there is a specific asset, or PP&E, identified in the contract. Under the new standard, the asset must be identified either explicitly or implicitly. Explicit identification of an asset could be as simple as an address of a building or a VIN for a vehicle. There are times, however, in which the contract may not explicitly identify the asset being leased, or the contract may be silent to the asset altogether. If a supplier/lessor can only provide one specific asset to satisfy a contract, then this is an implicitly identified asset — such as a cargo container that can only transport certain types of material, whereby the customer is aware the supplier only has one container that can transport that certain type of material.

One exception to this standard, different from the prior rules, relates to substantive substitution rights for the PP&E under consideration. If a supplier/lessor has both the practical ability to substitute alternative assets during the period of use and would economically benefit from doing so, substantive substitution rights would exist and the agreement would not be considered a lease.

A common example is if you entered into a contract with a supplier for a certain amount of space within a warehouse. If the contract allows the supplier to place you in various locations throughout the warehouse, and they could benefit from moving you and giving your space to a new customer, that would be considered a substantive substitution and, therefore, your contract does not qualify as a lease.

Control Determination Analysis

The FASB carried forward into ASC 842 the control concepts from other areas of U.S. GAAP, such as ASC 810 and ASC 606. Accordingly, to have the right to control the use of the PP&E in a contract in which the PP&E is an identified asset, the customer must have both of the following:

- The right to obtain substantially all of the economic benefits from the use of the PP&E
- The right to direct the use of the PP&E

Right to Obtain Substantially all the Economic Benefits

As you work on identifying whether a specific contract contains a lease, you must evaluate whether you have the right to obtain substantially all of the economic benefits from the use of the identified asset.

For example, the economic benefits from using solar equipment include the power generated by the equipment and any renewable energy credits obtained from the power generated. If the supplier retains or controls the renewable energy credits and those credits have a more than minor value, i.e., 10% of cash flows, then you may not have an identified asset in the arrangement because you don't have the right to obtain substantially all the economic benefits of the asset.

You may obtain economic benefit from the asset by using, holding or subleasing that particular asset. When considering this, you should consider the primary outputs, cash flows and by-products from this contract. In other words, a company must assess all of its potential cash flows and benefits from the use of assets derived from a commercial transaction with a third party. As noted in the solar equipment example, the primary contractual obligation is to use the equipment to generate electricity for consumption. However, a company must evaluate whether they can obtain and use the associated renewable energy credits.

Right to Direct the Use

You also must consider if your entity has the right to direct how and for what purpose the asset is used throughout the designated period. If you can direct the use, then you have a lease. If this condition is not met, meaning how the asset is used is predetermined, you must meet one of the following lease criteria to treat this as a lease:

- You have the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use without the supplier having the right to change those operating instructions
- You designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use

One important item to note is that protective rights of an asset do not, in isolation, prevent customers from directing the use of an asset. Protective rights include terms and conditions to protect a supplier's interest in an asset, including maintenance requirements, limitations on usage, and compliance with laws and regulations.

Be Aware of Embedded Leases

Be mindful that the definition of a lease under ASC 842 may result in new, "embedded" leases contained in complex contracts that did not meet the previous criteria of a lease. Common examples of embedded leases include IT service contracts, supply, sales and manufacturing contracts.

Embedded Leases

Common Types

- Contract manufacturing arrangements that grant exclusive use of equipment or space in a manufacturer's facility
- IT arrangements that provide exclusive use of assets (data management and cloud services)
- Transportation
- Inventory management and warehousing
- Cable and satellite
- Advertising (billboards)
- Sale of consumables with "free" equipment
- Arrangements that bundle a service with a device
- Other contracts for which assets are used to provide items or services

Below are examples of contracts with embedded leases.

A contract for data center services with the following terms and conditions:

- The customer's data is stored on a dedicated piece of equipment, and the customer is able to direct the use of the equipment (customer has control of the asset).
- The equipment to be used by the service provider is specified by the customer and cannot generally be substituted (identification of the asset).
- A five-year data center term is contractually agreed upon (period of time is known).
- The agreement specifies a monthly fee the customer will pay the supplier (exchange of consideration).

A contract manufacturing agreement with the following terms and conditions:

- The customer specifies that due to the proprietary and highly customized nature of products to be manufactured, the supplier must use a dedicated production line. The manufacturer uses its employees to produce the units. The customer controls the periods the production equipment is idle or operational (customer has control of the asset).
- The customer specifies which production line is used by the manufacturer. The manufacturer is unable to change production to another line (identification of the asset).
- A three-year contract manufacturing term is agreed upon (period of time is known).
- The agreement specifies payments to the supplier (exchange of consideration).

Implementation Challenges

Determining if you actually have a lease may not be straightforward. It's critically important to consider the following factors when reviewing all of your contracts.

- Known leases may not be maintained centrally in one data listing
- Embedded leases, or leases not specifically labeled as such, can be difficult to identify
  - Remember that a lease under ASC 842 is an agreement that conveys the right to control the use of a specified asset over a period in exchange for consideration
  - Make sure you understand the type of service contracts that exist; for example, look for or inquire whether any service contracts involve the use of specific assets as part of the service
- A key step is to communicate with all key operational management to identify any atypical arrangements that may qualify as leases under ASC 842

A Closer Look at Lease Classification and Measurements

Once you have identified a lease, lessees are required to recognize a right-of-use (ROU) asset and lease liability on the balance sheet for most leases. There is a short-term lease exemption available (learn more about short-term leases in "Ways to Efficiently and Effectively Transition to the New Standard"). The initial measurement of the lease liability and ROU asset on the commencement date is the same for both operating and finance leases.

The difference in accounting for an operating lease and finance lease is in the subsequent measurement. The example below illustrates a lessee's recognition and measurement of a lease, in the context of both a finance lease and an operating lease. The example also highlights implementation considerations regarding whether to elect the practical expedient available to private companies surrounding the use of a risk-free rate.

Example: Measurement of a Lease

Assume the lessee enters into a 10-year lease of an asset. Lease payments are $25,000 per year during the initial term, payable at the beginning of each year. The lessee incurs initial direct costs of $5,000.

The rate implicit in the lease is not readily determinable. The lessee's incremental borrowing rate is 6%, which reflects the fixed rate at which the lessee could borrow a similar amount in the same currency, for the same term and with similar collateral as in the lease at the commencement date.

At the commencement date, the lessee makes the lease payment for the first year, incurs initial direct costs, and measures the lease liability at the present value of the remaining nine payments of $25,000 — discounted at the rate of 6%, which is $170,042. The lessee also measures an ROU asset of $200,042 (the initial measurement of the lease liability plus the initial direct costs and the lease payment for the first year).

During the first year of the lease, the lessee recognizes lease expense depending on how the lease is classified — whether as a finance or operating lease. See the example below.

Scenario 1	Operating Lease	Finance Lease
Lease liability at commencement	$170,042	$170,042
ROU asset at commencement	$200,042	$200,042
Interest expense (Year 1)	N/A	$10,203 (6.00% × $170,042)
Amortization expense (Year 1)	N/A	$20,004 ($200,042 ÷ 10)
Straight-line expense (Year 1)	$25,500 ($255,000 ÷ 10 years)	N/A
Total expense (Year 1)	$25,500	$30,207
Lease liability at end of Year 1	$180,245 ($170,042 + $10,203)	$180,245 ($170,042 + $10,203)
ROU asset at end of Year 1	$184,745	$180,038 ($200,042 – $20,004)

While operating leases are generally recognizing straight-line expense, finance leases typically “front-load” the expense. A higher liability corresponds to higher interest in earlier periods of the lease, coupled with a straight-line amortization of the ROU asset.

Assume all else equal in the above scenario, except the company elects to use the practical expedient available for private companies to use the risk-free rate versus the incremental borrowing rate. At the lease commencement, the risk-free rate was 1%, which changes the related balances to the following:

Scenario 2	Operating Lease	Finance Lease
Lease liability at commencement	$214,150	$214,150
ROU asset at commencement	$244,150	$244,150
Interest expense (Year 1)	N/A	$2,142 (1.00% x $214,150)
Amortization expense (Year 1)	N/A	$24,415 ($244,150 ÷ 10)
Straight-line expense (Year 1)	$25,500 ($255,000 ÷ 10 years)	N/A
Total expense (Year 1)	**$25,500**	**$26,557**
Lease liability at end of Year 1	$216,292 ($214,150 + $2,142)	$216,292 ($214,150 + $2,142)
ROU asset at end of Year 1	$220,792	$219,735 ($244,150 - $24,415)

When comparing Scenario 1 to Scenario 2, the material impact on the value of ROU asset/liability and related interest when electing the expedient for private companies is clear. Prior to making this election, it’s important to consider the following:

- The lessee must apply the risk-free rate, once elected, to all future leases in that class of underlying assets
- Since the risk-free rate will generally be lower than the lessee’s incremental borrowing rate, the resulting lease liability and ROU asset will likely have higher values at inception, as noted in Scenario 2; this has an inherent negative impact on working capital since there is no current portion of the ROU asset
- Using the risk-free rate will make it more likely that the lease is classified as a finance lease, since the fair value of future lease payments is more likely to equal, or exceed, substantially all the fair value of the underlying asset

What is the Impact on Lessors?

The new standard is complex, but there's good news for lessors. The changes they will experience are not as impactful as they are for lessees, although still important to address by the deadline.

For lessors, ASC 842 represents more of a refinement rather than a remake when it comes to the treatment of leases. To begin with, wording in financial statements should now generally replace the word "rent" with "lease" — meaning rent revenue becomes lease revenue, rent term becomes lease term and rent receivable becomes net investment in lease.

Additionally, lessors should be cognizant that the new standard slightly refines the definition of a lease. What previously may have been one lease agreement may now be multiple lease agreements, or, perhaps, not a lease at all. Outside of a few rare exceptions, however, lessors should not anticipate significant changes when it comes to the determination of a lease.

Exceptions to the Rule

Of course, with every new standard's rules also comes exceptions to those rules. For lessors, there are a handful of such exceptions to be cognizant of, as well as a few specialized revisions, summarized below. If any of these are present in a lease, know that you may need to give additional consideration:

- Real estate leases no longer have unique guidance and follow the same guidance as any other lease
- ASC 842 does not include guidance on leveraged lease accounting, a special type of accounting a lessor applies to certain direct financing leases because of its unique economic effect on the lessor
- Leases with predominantly variable lease payments may be classified as sales-type or direct financing leases under ASC 842
- Lease modifications have more guidance on how they are to be treated to better align with ASC 606
- Initial direct costs, such as legal fees incurred to execute a lease, are generally now expensed under ASC 842 rather than capitalizede

Lease Classification Considerations

The next step for lessors after determining that a lease is present is to determine the type of lease, which then dictates how to further account for (and disclose) the lease.

Under ASC 840, leases were generally categorized as operating or capital leases, with capital leases further considered either sales-type or direct financing leases. While this hasn't changed dramatically for lessors, the qualifications have changed somewhat. Gone are the bright line tests involving 75% of economic life and 90% of fair value, and instead more general judgment-based criteria have been introduced, mostly based on the concept of transfer of control rather than risk versus reward.

Sales-type Lease

Under ASC 842, lessors are required to classify a lease as a sales-type lease if any of these criteria are met:

- Lease transfers ownership of the underlying asset to the lessee by the end of the lease term
- Lease grants the lessee the option to purchase the underlying asset that the lessee is reasonably certain to exercise
- Lease term is for a major part of the remaining economic life of the underlying asset
- Present value of the sum of the lease payments and any residual value guaranteed by the lessee (not already reflected in lease payments) is greater than or equal to substantially all fair value of the underlying asset

- Leased asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term

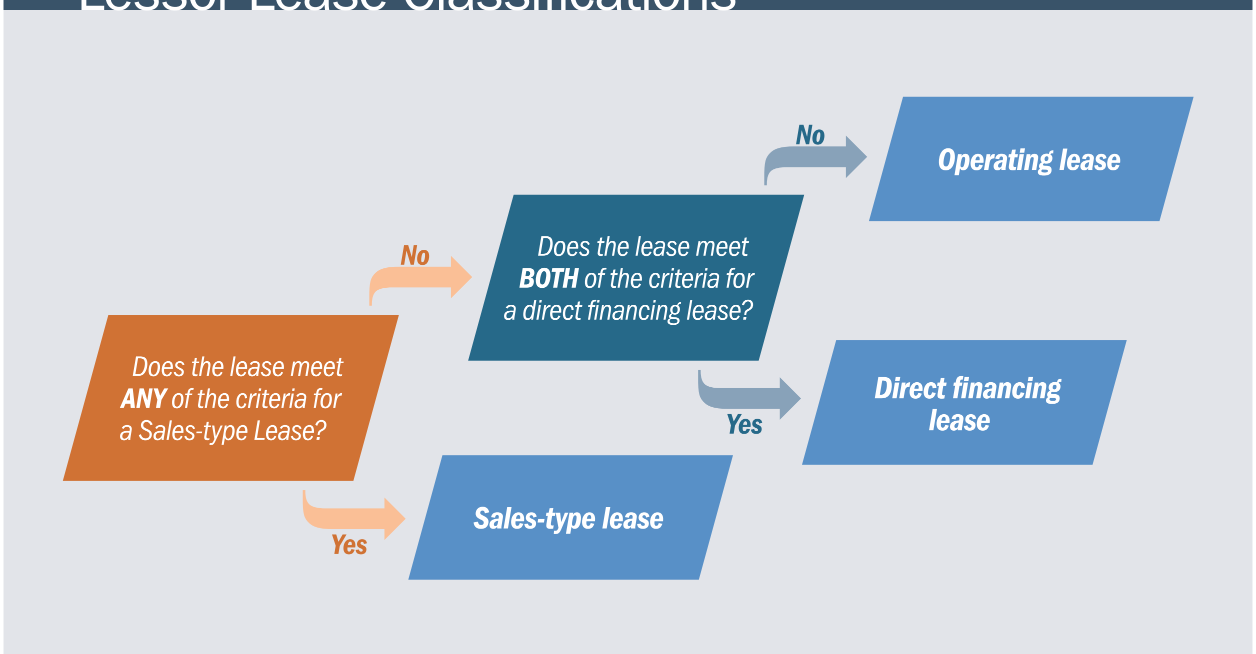
Direct Financing Lease

Under ASC 842, lessors are required to classify a lease as a direct financing lease if sales-type lease criteria are not met and when both of the following conditions are met:

- Present value of the sum of lease payments and any residual value guaranteed by the lessee (not already reflected in lease payments) and/or any other third-party payments unrelated to the lessor are greater than or equal to substantially all of the fair value (which is generally cost basis) of the underlying asset
- Probable that the lessor will collect the lease payments plus any amounts necessary to satisfy a residual value guarantee

If the lease doesn't meet the conditions of either a sales-type lease or a direct financing lease, then that lease is an operating lease. Below is a simple decision tree to help lessors classify their leases.

Lessor Lease Classifications

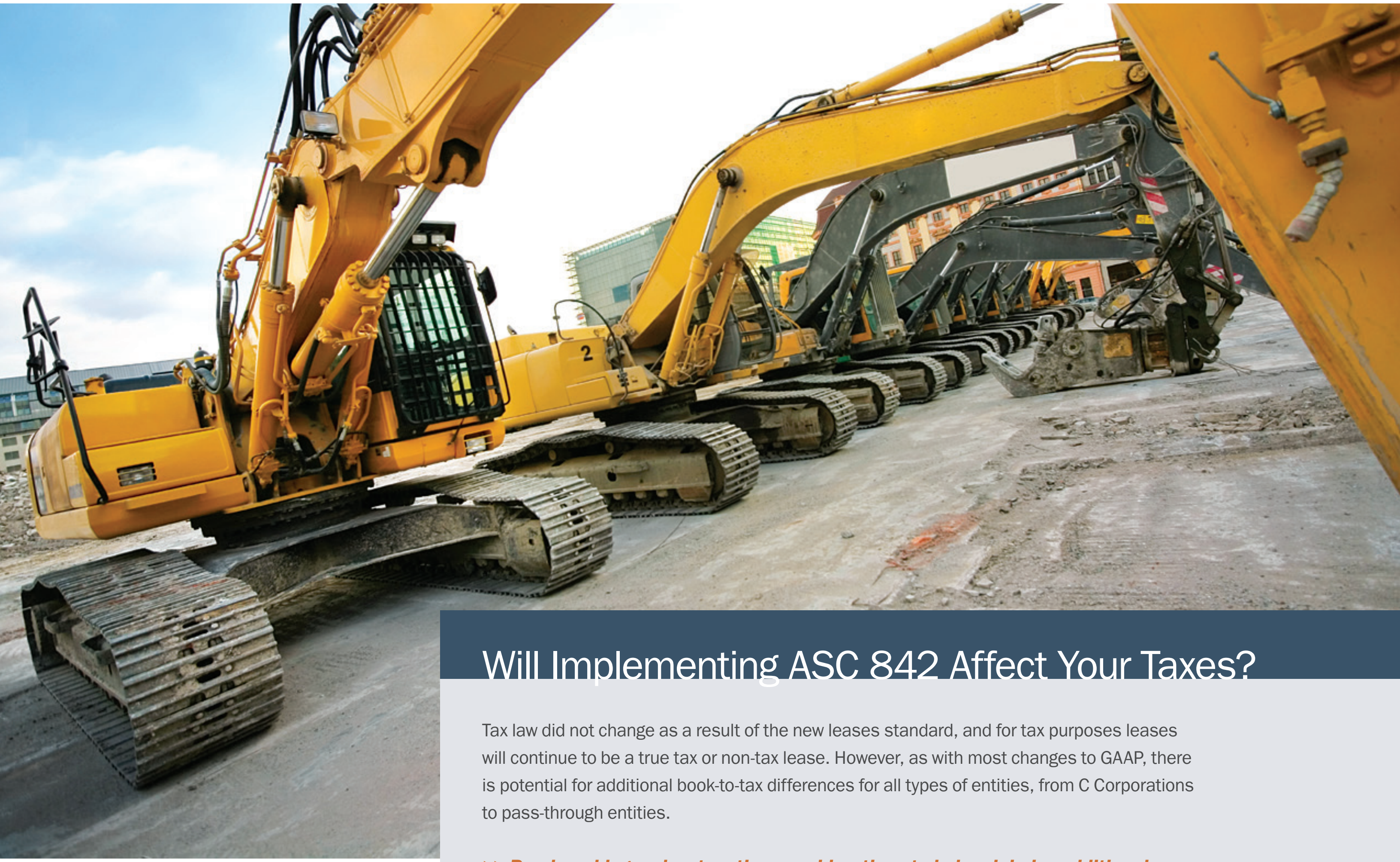


Lessor Lease Accounting

You've determined you have a lease and what kind of a lease it is. What next? In general, the same thing as before, albeit with slightly different wording as discussed above. Operating leases will see virtually no accounting changes for lessors, a stark contrast to the impact to lessees.

Lessors with sales-type leases will record any selling/leasing profit at lease commencement, whereas those with direct financing leases will gradually recognize this same profit over the course of the lease term.

Just as under the previous standard, both sales-type leases and direct financing leases will derecognize the underlying asset and record a "net investment in lease" representing the present value of lease payments and any guarantees of estimated asset residual value, as well as the present value of the remaining unguaranteed portion of estimated residual value.



Will Implementing ASC 842 Affect Your Taxes?

Tax law did not change as a result of the new leases standard, and for tax purposes leases will continue to be a true tax or non-tax lease. However, as with most changes to GAAP, there is potential for additional book-to-tax differences for all types of entities, from C Corporations to pass-through entities.

>> Read our blog on key taxation considerations to help minimize additional surprises after fully implementing the new standard.

Real World Impact: Initial Direct Costs

ASC 842 defines initial direct costs as incremental costs of a lease, for both lessees and lessors, that would not have been incurred if the lease had not been obtained. Common examples are commissions and payments made to an existing tenant to incentivize them to terminate a lease. This differs from ASC 840's guidance for initial direct costs, which did not require the costs to be incremental.

ASC 842 requires lessors to recognize initial direct costs for operating leases as expenses over the lease term on the same basis as lease income. Lessors include initial direct costs in the initial measurement of their net investments in direct financing leases and sales-type leases with no selling profit or loss.

However, initial direct costs related to sales-type leases with selling profit or loss are expensed at the start of a lease.

Scenario: A lessee and lessor enter into an operating lease and, as a result, incur the following costs:

Travel costs related to lease proposal	$	3,000
External legal fees		15,000
Allocation of employee costs for time negotiating lease terms and conditions		4,500
Commissions to brokers		7,000
Total costs incurred by lessor	$	29,500
External legal fees	$	10,000
Allocation of employee costs for time negotiating leases terms and conditions		3,500
Payments made to existing tenant to obtain the lease		12,000
Total costs incurred by lessee	$	25,500

The lessor capitalizes initial direct costs of $7,000, which it recognizes ratably over the lease term consistent with its recognition of lease income. The $7,000 in broker commissions is an initial direct cost because it was incurred only as a direct result of obtaining the lease (that is, only as a direct result of the lease being executed). None of the other costs incurred by the lessor meet the definition of initial direct costs, because they would have been incurred even if the lease had not been executed. For example, the employee salaries are paid regardless of whether the lease is obtained, and the lessor would be required to pay its attorneys for negotiating and drafting the lease even if the lessee did not execute it.

The lessee includes $12,000 of initial direct costs in the initial measurement of the ROU asset. The lessee will also amortize those costs ratably over the lease term as part of its total lease cost. Throughout the lease term, any unamortized amounts from the original $12,000 are included in the measurement of the ROU asset. The $12,000 payment to the existing tenant is an initial direct cost, as that cost is only incurred upon obtaining the lease. None of the other costs incurred by the lessee meet the definition of initial direct costs, since they would have been incurred even if the lease had not been executed.

Impact: This scenario illustrates the changes many real estate lessors must make, as fewer costs qualify as initial direct costs.

Under ASC 842, companies can no longer include allocated costs for compensation and costs for services, such as certain legal advice, incurred even if the lease is not obtained. The definition of initial direct costs under ASC 842 is considerably more restrictive than the definition under ASC 840. Companies should consider how this can affect key financial metrics.

Understanding the Impact on Common Debt Covenants

With the complexities and time commitment of creating and executing a lease implementation plan, there is one important consideration that may be overlooked, or considered after adoption is complete: Will there be any potential impact on your debt covenants? The answer is, likely, yes. It is critical for companies to closely read their debt covenants, determine the impact of adopting ASC 842 and begin talking with their lenders now.

The following balance sheet illustrates the potential impact on some of the most common debt covenants. At the date of adoption, in this example, the company will record an ROU, which is a noncurrent asset, and a lease liability, which has both current and noncurrent classifications, for one operating lease. While the balance sheet was created for illustrative purposes, the covenant descriptions were taken directly from common definitions often found in debt agreements.

	BEFORE ASC 842		AFTER ASC 842	
ASSETS				
CURRENT ASSETS				
Cash	$	1,000	$	1,000
Accounts receivable - Net		3,000		3,000
Inventories - Net		4,000		4,000
Total current assets		8,000		8,000
Property, plant and equipment		25,000		25,000
ROU asset				6,000
		25,000		31,000
Total assets	**$**	**33,000**	**$**	**39,000**
LIABILITIES				
CURRENT LIABILITIES				
Current portion of long-term debt	$	2,000	$	2,000
Accounts payable		4,000		4,000
Current portion of lease liability				1,000
Total current liabilities		6,000		7,000
Long-term debt		10,000		10,000
Long-term portion of lease liability		-		5,000
		10,000		15,000
SHAREHOLDER'S EQUITY				
Shareholder's equity		17,000		17,000
Total liabilities and shareholder's equity	**$**	**33,000**	**$**	**39,000**

Adoption Impact		
Right-of-use asset	$	6,000
Current portion of lease liability		(1,000)
Long-term portion of lease liability		(5,000)

Below are examples of the impact to four common debt covenants related to the sample balance sheet.

1. Current Ratio

Covenant Description: *Borrower shall maintain a ratio of current assets to current liabilities of not less than 1.20 to 1.00, as of the end of each fiscal quarter.*

	BEFORE ASC 842	AFTER ASC 842
Total current assets	$ 8,000	$ 8,000
Total current liabilities	6,000	7,000
Current ratio	1.33	1.14
Minimum current ratio required	1.20	1.20
In compliance	Yes	No

If your company is adopting ASC 842 and you currently have long-term operating leases, there will be an adverse effect on your current ratio upon adoption, as you will be recording a noncurrent asset and a current and noncurrent liability.

2. Debt to Tangible Net Worth Ratio

Covenant Description: *Borrower shall maintain a ratio of debt to tangible net worth of not more than 1.00 to 1.00 as of the end of each fiscal quarter. As used herein, "debt to tangible net worth ratio" means the ratio of the borrower's total liabilities to the borrower's total tangible net worth. As used herein, "tangible net worth" shall mean the borrower's net worth, less all intangible assets, such as goodwill, trade names and other similar intangible amounts.*

	BEFORE ASC 842	AFTER ASC 842
Total liabilities	$ 16,000	$ 22,000
Total equity	17,000	17,000
Debt to tangible net worth ratio	0.94	1.29
Maximum debt to tangible net worth ratio required	1.00	1.00
In compliance	Yes	No

It is important to look at the definitions within your debt agreements. Simply looking at the name of this ratio might imply that the input is only debt or loans payable. However, upon review of the definition of the ratio within this debt agreement, debt is defined as the borrower's total liabilities. In situations where debt is defined as total liabilities, there will most likely be an adverse effect upon adoption of ASC 842 if your company currently has long-term operating leases. You will be recording lease liabilities that were not previously recorded on the balance sheet and will increase total liabilities. While there are situations where an adjustment to opening retained earnings will be made, this illustration does not affect equity.

3. Fixed Charge Ratio

Covenant Description: *Borrower shall not suffer or permit the fixed charge coverage ratio, for the most recently completed trailing 12 months, to be less than 2.25 to 1.00. Fixed charge coverage ratio shall mean, for any period, as calculated in accordance with GAAP, the ratio of EBITDA to total fixed charges. Total fixed charges shall mean interest expense paid in cash and regular scheduled principal payments on funded indebtedness. Included within the definition of funded indebtedness is capitalized lease obligations.*

	BEFORE ASC 842		AFTER ASC 842	
EBITDA	$	7,000	$	7,000
Total fixed charges		3,000		3,000
Principal payments made on capitalized lease obligations				1,000
Total updated fixed charges	$	3,000	$	4,000
Fixed charge coverage ratio		2.33		1.75
Minimum fixed charge coverage ratio required		2.25		2.25
In compliance		Yes		No

The above illustration assumes the company's performance is "all else equal" before and after the adoption of ASC 842. The definition of funded indebtedness includes capitalized lease obligations. It is important to note that the difference between capitalized lease obligations, as stated in the definition, and capital lease obligations. Under the new standard, companies are required to capitalize lease obligations that were not previously recorded on the balance sheet. Assuming all else equal, after the first year of adoption, included within fixed charges would be the $1,000 of regularly scheduled principal payments on the capitalized lease obligations.

In addition, EBITDA is not a GAAP definition. You will need to consider what is included within the definition of EBITDA per your debt agreement. If you have similar wording written into your debt agreements, you need to know how your lender will treat the scheduled principal payments on the newly recorded lease obligations.

4. Leverage Ratio

Covenant Description: *Borrower shall not suffer or permit the leverage ratio, for the most recently completed trailing 12 months, to exceed 2.00 to 1.00. Leverage ratio shall mean the ratio of funded indebtedness, minus cash on hand, to EBITDA. Included within the definition of funded indebtedness is capitalized lease obligations.*

	BEFORE ASC 842	AFTER ASC 842
Funded indebtedness	$ 12,000	$ 18,000
Less: Cash	1,000	1,000
	$ 11,000	$ 17,000
EBITDA	7,000	7,000
Leverage ratio	1.57	2.43
Maximum leverage ratio required	2.00	2.00
In compliance	Yes	No

Similar to the fixed charge coverage example above, the definition of funded indebtedness includes capitalized lease obligations.

As shown in all the examples above, the adoption of ASC 842 determined whether or not the company was in compliance with or in default of their debt covenants. Some loan agreements establish whether the borrower must prepare their debt covenants using flexible or frozen GAAP. Using flexible GAAP, a borrower calculates debt covenants according to current GAAP, including any changes. Under frozen GAAP, the borrower's covenants are in accordance with GAAP that applies at the time a loan agreement is executed.

If you have lease agreements in place and you are unsure how your lender will interpret the newly presented financial statements, the communications need to begin now. While your accountant can typically provide clarification when debt terms say, "in accordance with GAAP," you will need clarification from your lender if there are ambiguous terms within the agreements.

Below are some examples of next steps your management should be taking in terms of common debt covenants:

- Read through your current debt terms and covenant requirements
- Talk with your lender about what they are doing for ASC 842 to determine how they are changing agreements, if at all; it is important to know and understand these effects now, so you can plan and communicate with your lender regarding the potential impact
- Determine if/how the standard will impact your covenant agreements currently in place
- Ask for clarification or covenant term changes now, prior to the adoption of ASC 842

Ways to Efficiently and Effectively Transition to ASC 842

A key consideration to implementing the new standard is how to efficiently and effectively transition from ASC 840. Below are available transition methods, practical expedients and policy elections to consider to make the process smoother.

2 Ways to Apply the Modified Retrospective Transition Approach

The new standard requires a modified retrospective transition approach but has two options for how you apply it, which are commonly referred to as the effective date method and the comparative method.

Companies electing the effective date method record any cumulative adjustment needed related to the implementation of ASC 842 as of the date of implementation, with no adjustment to any prior year information presented in the financial statements. For calendar year companies adopting as of January 1, 2022, this means 2022 will be presented under ASC 842 and any prior years presented in the financial statements will be presented under ASC 840. For this reason, this approach is often referred to as the “non-comparative” approach.

Companies electing the comparative method record any cumulative adjustment needed related to the implementation of ASC 842 as of the opening date of the earliest comparative period presented in the financial statements. For calendar year companies with comparative statements adopting as of January 1, 2022, this means both 2022 and 2021 (assuming a comparative presentation) will be presented under ASC 842.

Which method is best? The short answer is, it depends. However, there are some factors you should consider when weighing which is best for your company.

1. Effective Date Method

The effective date method is generally the simpler, less time consuming and less expensive transition method of the two, due to the fact that it does not require the restatement of any prior periods presented in the financial statements.

On the flip side, this method may not be the best choice for companies with comparative financial statements, as prior periods included in the financial statements are not restated. This reduces comparability between periods, which could cause confusion for some financial statement users. In addition, comparative financial statements would need to include two sets of lease disclosures: ASC 842 disclosures for the period of implementation and ASC 840 disclosures for any prior periods presented. One option to not have to include both disclosures is to only present a single year statement in the year of implementation. However, be sure to consult your financial statement users before deciding to present single year financial statements, including your bank as your loan documents may not permit this presentation.

The new standard requires a modified retrospective transition approach but has two options for how you apply it, which are referred to as the effective date method and the comparative method.

2. Comparative Method

The comparative method is generally the more complex transition method of the two, since it requires the restatement of any prior periods presented in the financial statements. For this reason, it generally requires more time and expense to implement.

On the positive side, this method allows for the greatest comparability in the financial statements when presenting more than one period.

3 Transition Practical Expedients

Practical expedients are options companies can adopt that are meant to ease the process of implementing a new accounting standard. Those implementing ASC 842 have three such expedients available to them: the package of three, hindsight and land easements.

1. Package of Three

The package of three allows the conclusions made under ASC 840 to be maintained until the lease is modified or replaced with a new lease, at which time reassessment under ASC 842 would occur. So, if this option is adopted, management does not have to reassess:

- Whether any expired or existing contract is or contains a lease,
- The lease classification of any expired or existing lease and
- Initial direct costs for any existing lease.

However, this does not grandfather in errors made under ASC 840, as errors must be corrected prior to implementing ASC 842. This practical expedient is an all or nothing “package” deal — these three options must all be adopted or none, and, if adopted, they must be applied to all leases.

Adopting this package of practical expedients can reduce the time and expense involved in implementing ASC 842, and, therefore, it is widely accepted that this will be a popular practical expedient. However, not adopting may be a better fit if management has the time and feels reassessment may lead to more favorable lease outcomes, such as more leases having a preferred classification or the booking of additional right-of-use assets related to initial direct costs.

2. Hindsight

If this option is adopted, management may use hindsight when evaluating the lease term and impairment of ROU assets. This simply means management should consider all changes in facts and circumstances through adoption of ASC 842 when assessing lease terms and ROU asset impairment. Similar to the package of three, this must be adopted for all or none of the leases at your company.

Adopting this practical expedient can lead to more accurate lease accounting as it requires management to consider a greater range of information when implementing ASC 842. This is especially true if facts and circumstances have changed significantly since lease commencement. However, adoption of this practical expedient generally requires additional time and expense to implement. That is, not adopting this practical expedient allows management to carry over the remaining lease term as determined under ASC 840 when implementing ASC 842.

3. Land Easements

A land easement consists of a right to use and/or enter land owned by another party. If a company adopts the land easement practical expedient, management does not have to reassess whether or not any existing or expired land easements at the time of implementation of ASC 842 meet the definition of a lease. This practical expedient was offered since companies may not have previously accounted for such agreements as leases.

Adopting this practical expedient can reduce the time and expense involved in implementing ASC 842.

However, your lease accounting may be more accurate if you do not adopt this expedient, as reassessing land easements under ASC 842 could lead to different, and more on point, lease accounting conclusions.

4 Additional Practical Expedients and Accounting Policy Elections

The practical expedients discussed so far specifically relate to the implementation of ASC 842. However, there are additional ASC 842 practical expedients and accounting policy elections that apply after implementation, including short-term leases, lease and non-lease components, discount rate and portfolio approach.

1. Short-Term Leases

Under this accounting policy election, management may elect not to apply the usual recognition requirements of ASC 842 to leases deemed short-term. In other words, management would not record an ROU asset or lease liability. This election applies to short-term leases only, which are leases that at their commencement date includes periods before implementation of ASC 842 and:

- Have lease terms of 12 months or less, and
- Do not include options to purchase the underlying asset or extend the lease beyond 12 months, that the lessee is reasonably certain to exercise.

This policy election is elected by class of underlying asset, such as office equipment and vehicles.

Adopting this accounting policy election can reduce the time and expense involved in implementing ASC 842. However, this exemption should not be used as a means to structure long-term leases as short-term leases to avoid ASC 842 consideration. Attempting to structure long-term leases as short-term leases could lead to unintended consequences, including having to write off related leasehold improvements over that short period, increased legal costs to write frequent lease agreements, and concerns from lenders regarding the viability of short-term leases.

2. Lease and Non-Lease Components

A lease agreement may include both lease and non-lease components. Non-lease components consist of other goods or services offered to the lessee. Common examples of non-lease components include providing supplies for leased equipment or common area maintenance for a building. Under this practical expedient, management may elect not to separate payments made for non-lease components from those made for the related lease components. That is, these components would all be accounted for together as a single lease component. This expedient is elected by class of underlying asset and can be applied regardless of the dollar value of the non-lease components.

Adopting this practical expedient can reduce the time and expense involved in implementing ASC 842, as management would not be required to evaluate all the lease and non-lease components in every agreement. This is particularly helpful when the lease agreements do not clearly define the standalone selling prices of the non-lease components. However, adopting this expedient may not be beneficial for companies with leases that contain material non-lease components, as it could lead to higher valued lease liabilities and could impact the classification of leases (i.e., leases are more likely to be classified as finance leases if non-lease components are material and included in the valuation).

3. Discount Rate

The calculation of ROU assets and lease liabilities under ASC 842 requires the use of a discount rate. ASC 842 requires management to use the rate implicit in the lease; if not specified in the lease, then the incremental borrowing rate must be used. Under this accounting policy election, management may elect to instead use a risk-free rate, such as the U.S. Treasury rate. This accounting policy election is only available for private companies. Private companies are also able to make the risk-free rate election by class of underlying asset, rather than at the entity-wide level. However, when the rate implicit in the lease is readily determinable for any individual lease, a lessee should use that rate (rather than a risk-free rate or an incremental borrowing rate), regardless of whether it has made the risk-free rate election.

Adopting this accounting policy election can reduce the time and expense involved in implementing ASC 842, as many lease agreements do not include an implicit rate and the incremental borrowing rate may be difficult to determine (i.e., the incremental borrowing rate needs to be for borrowings collateralized by similar assets as those being leased and for a similar term as the lease). However, the risk-free rate is historically very low and likely to be lower than the one implicit in the lease or the incremental borrowing rate. As a result, using a risk-free rate generally results in the recognition of larger ROU assets and lease liabilities, and can also lead to more leases being considered finance leases (i.e., due to the present value of lease payments being more likely to meet or exceed the fair value of the underlying asset). *See an example in Scenario 2 on "A Closer Look at Lease Classification and Measurements."*

4. Portfolio Approach

ASC 842 requires the calculation of ROU assets and lease liabilities for all lease components. For companies with many leases, this may lead to significant calculations, and the tracking of a large number of ROU assets and lease liabilities. Under this accounting policy election, management may elect to apply the recognition requirements of ASC 842 to leases at a portfolio (or combined) level. For example, the lessee may combine several similar vehicle leases into one ROU asset and lease liability. This election is permitted if the leases being recognized together have similar characteristics, such as length, extension provisions and purchase options, and the portfolio level accounting is not expected to differ materially from accounting for these leases at the individual level.

Adopting this accounting policy election can reduce the time and expense involved in implementing ASC 842, as similar leases would not require the calculation and tracking of separate ROU assets and lease liabilities. Instead, these similar leases could be combined in a single portfolio with one related ROU asset and lease liability. This election would be most beneficial when a company has low-dollar, high-volume leasing arrangements often seen with copiers, vehicles or phone systems. However, adopting this accounting policy election may not be feasible if there is variation in the leases, and may not be beneficial for companies that want greater visibility into their business operations provided by accounting for leases individually.

The implementation of ASC 842 requires the management of your company to review and choose between various transition methods, practical expedients and accounting policy elections. Each of these has unique advantages and disadvantages you must carefully consider. As a result, discuss these factors with your financial statement users to decide which fit best with your specific circumstances and reporting requirements.

Next Steps

Private companies and not-for-profits with any type of lease agreement must comply with ASC 842 for periods beginning after December 15, 2021. Financial leaders in every company need to take the time now to become intimately familiar with the standard, examine current leases and determine what resources will be needed to comply, and begin talking with lenders regarding potential impact on debt covenants. Don't forget to consider how the new standard may impact anticipated leases in the near future.

Lean on lessons learned from public companies who have already implemented the standard, as well as the advice and knowledge of your advisers to help guide you through a successful implementation.

Contact Us for Help

With a focus on private companies and a technical group within our Assurance Practice dedicated to the implementation of ASC 842, we offer tools and resources tailored toward helping private companies prepare and implement the standard.

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Appendix 1

25 Key Changes as a Result of ASC 842

	Provision	ASC 842
1	**Build-to-Suit Lease Arrangements**	The accounting for a build-to-suit arrangement depends on whether the lessee controls the underlying asset during the construction period.
2	**Classification Criteria**	A lease should be classified as a finance lease if it meets one of the following criteria: ◆ Transfer of ownership ◆ Bargain purchase option ◆ Lease term is for a major part of the estimated economic life of the leased property ◆ Present value of the lease payments is substantially all of the fair value of the leased property ◆ The leased asset is specialized with no alternative use to the lessor at the end of the term The FASB noted that an entity may still use the bright lines established under ASC 840 as a reasonable approach when evaluating the classification under ASC 842.
3	**Collectability**	Lessors should consider collectability in accounting for their leases; collectability will differ depending on whether the lease is classified as a sales-type, direct financing or operating lease. A lease can still be classified as a sales-type lease if there are collectability concerns. For a sales-type lease to be recognized, collectability of the lease payments must be probable (in a manner consistent with ASC 606). The collectability guidance for direct financing and operating leases is aligned with ASC 840. If the lease is not a sales-type lease, the lease should be classified as an operating lease if collectability of the lease payments and any residual value guarantee is not probable at lease commencement.
4	**Disclosures**	An entity must disclose significantly more quantitative and qualitative information than under ASC 840.
5	**Discount Rate**	A lessee should use the rate implicit in the lease if it is readily determinable, regardless of whether it is higher than the lessee's incremental borrowing rate. The rate implicit in the lease considers the lessor's initial direct costs. The discount rate used must reflect a secured borrowing rate. A practical expedient is available for private companies to use a risk-free rate instead of the incremental borrowing rate.
6	**Executory Costs**	Executory costs, such as reimbursement for a lessor's property taxes and insurance, are allocated to both lease and non-lease components in the contract on the same basis as the other consideration in the contract. The portion of executory costs allocated to the lease component(s) in the contract is considered part of the lease payments (to the extent that the payments are fixed).
7	**Inception Date vs. Commencement Date**	A lease is classified and initially measured on the lease commencement date, which is when a lessor makes an underlying asset available for use by a lessee. Under the previous standard, ASC 840, leases were classified on the lease inception date.
8	**Initial Direct Costs**	Initial direct costs include only those costs that are incremental to the arrangement and that would not have been incurred if the lease had not been obtained.
9	**Lease Modifications**	Lease modification guidance is more extensive under ASC 842, and the two-step model from ASC 840 is not carried forward. The changes are primarily related to aligning the modification guidance with the guidance in ASC 606.
10	**Leases Involving Real Estate**	There is no unique guidance on classifying and accounting for leases involving real estate. Leases involving real estate are subject to the same general classification and measurement guidance as leases involving other property, plant and equipment.

11	**Lessee Accounting**	Finance and operating leases, other than those that qualify for the short-term scope exception, must be recognized on the lessee's balance sheet. A lessee recognizes a liability for its lease obligation and corresponding asset representing its right to use the underlying asset over the lease term.
12	**Lessor's Accounting for Direct Financing Leases**	A lessor must defer selling profit for a direct financing lease and recognize the deferred amount over the lease term.
13	**Leveraged Lease Accounting**	ASC 842 does not include guidance on leveraged leases. Entities are not permitted to account for any new lease arrangements, except for those that are grandfathered in, as leveraged leases after the effective date of ASC 842.
14	**Maintenance**	Maintenance services represent a non-lease component that must be separated from the lease component(s) in the contract, if the option to separate is not elected.
15	**Practical Expedient for Separating Lease and Non-lease Components**	A lessee may elect not to separate lease and non-lease components in the contract. If elected, the lessee must account for the combined components as a single lease component.
16	**Reassessment** (identifying a lease)	An entity should only reassess whether the contract is or contains a lease if the terms and conditions of the contract are changed.
17	**Reassessment** (lessee measurement)	Upon a reassessment event, a lessee should remeasure its ROU asset and lease liability on its balance sheet. A lessee should use the discount rate that applies as of the date of the reassessment event to remeasure its ROU asset and lease liability.
18	**Related-party Leases**	Entities should account for related-party leasing arrangements on the basis of the legally enforceable terms and conditions of the lease rather than the substance of the arrangement.
19	**Residual Value Guarantees**	A lessee should include in the lease payments only the amount of the residual value guarantee the lessee will likely owe at the end of the lease term.
20	**Right to Control the Use of the Asset**	The customer must have the right to substantially all of the economic benefits from using the asset and must be able to direct how the asset is used.
21	**Sale-and-leaseback Arrangements**	All assets are subject to the same sale-and-leaseback guidance. There is no unique guidance on sale-and-leaseback arrangements involving real estate. An entity should assess the criteria in ASC 606 to determine whether a sale has occurred. A repurchase option precludes sale accounting unless the option is priced at the fair value of the asset on the date of exercise and alternative assets exist that are substantially the same as the transferred asset and are readily available in the marketplace. Leasebacks classified as a finance lease are not considered a sale. Leasebacks not classified as a finance lease require other considerations to determine if a sale has occurred.
22	**Sales-type vs. Direct Financing Lease**	The distinction between a sales-type lease and a direct financing lease is based on whether the lessee obtains control of the underlying asset. This assessment is not affected by the relationship of the fair value to the carrying amount of the underlying asset. If the lessee obtains control of the underlying asset, the lease is classified as a sales-type lease. If the lessee does not obtain control of the underlying asset (but the lessor relinquishes control), the lease is classified as a direct financing lease.
23	**Separating Land and Other Lease Components**	A lessee should account for land and buildings as separate lease components, unless doing so would result in an insignificant impact on accounting.
24	**Statement of Cash Flows** (lessor)	A lessor must classify cash received from leases in the operating activities section of its statement of cash flows.
25	**Substantive Substitution Rights**	For a substitution right to be substantive, meaning it will not be subject to lease accounting, the supplier must have the practical ability to substitute the asset and must economically benefit from the substitution, which is new under ASC 842.

Appendix 2

What You Need to Know About Your Leases

The information below presents some of the key data to extract from your lease agreements when considering the impact of ASC 842 and subsequent accounting treatments.

ALL TYPES OF LEASES		
	Type of Information	**What To Know**
1	**Commencement Date**	The date an asset is available to a lessee for use (see paragraphs 842-10-55-19 through 55-21 for more implementation guidance)
2	**Identified Asset**	The asset identified, either explicitly or implicitly, in the contract
3	**Substitution Rights**	Any substantive rights the lessor has to substitute alternative assets throughout the period of use, resulting in economic benefits to the lessor
4	**Fixed Payments**	Comprised of the stated lease payments per the lease agreement, plus in-substance lease payments, less lease incentives paid or payable to the lessee.
5	**In-Substance Fixed Payments**	Amount of in-substance fixed payments paid each period — in-substance fixed payments may appear to contain variability but are, in effect, unavoidable, such as when a lessee has the “choice” about which set of payments to make even though it must make at least one set of payments
6	**Index-Based Payments**	Amount of variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date
7	**Payment Frequency**	How often lease payments are made
8	**Payment Duration**	Number of payments made during the life of the lease
9	**Usage-Based Payments**	If a payment varies based on usage of the underlying asset
10	**Performance-Based Payments**	If a payment is based on performance
11	**Escalating Payments**	Payment amounts, payment frequency or payment schedule increase over time
12	**Incremental Borrowing Rate**	Rate of interest a lessee would have to pay to borrow on a collateralized basis over a similar term, for an amount equal to the lease payments, and in a similar economic environment
13	**Prepaid Rent**	Payment made to the lessor before or at the commencement date
14	**Lease Incentives**	Any incentives associated with a lease, including payments made to, or on behalf of, the lessee as well as losses incurred by the lessor as a result of assuming a lessee’s preexisting lease with a third party (in which case the lessor and the lessee should independently estimate any loss attributable to that assumption)
15	**Initial Direct Costs**	Incremental costs of a lease that would not have been incurred if the lease had not been obtained (commissions or payments made to an existing tenant to terminate its lease)
16	**Taxes**	Real estate or property taxes related to the leased asset

17	**Insurance**	Insurance that covers the lessor's interest in the asset
18	**Other Expenses**	Commitment fees or other administrative changes
19	**Penalties**	Any requirement associated with or outside of a lease agreement that could adversely impact a lessee financially, such as requiring disbursement of cash, performance of service, surrendering of an asset, etc.
20	**Deposits**	Payment amount made, including whether refundable or nonrefundable
21	**Purchase Option**	The option at the commencement date to purchase the underlying asset on the same basis as an option to extend or to not terminate a lease, as described in paragraph 842-10-30-2
22	**Renewal Option**	Options to extend or renew the lease; must document the renewal period, how many payments will be made and payment amount for renewal term
23	**Termination Option**	Options to terminate the lease; must document the contractual details surrounding early termination and any associated fees
24	**Purchase Option**	Option to purchase the asset at the end of the lease
25	**Residual Value Guarantee**	Guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount

REAL ESTATE LEASES		
	Type of Information	**What To Know**
1	**Floor Space**	Total space leased and amount of usable leased space
2	**Obligations to Return an Underlying Asset to Its Original Condition**	The requirement to return an underlying asset to its original condition if the lessee has modified it
3	**Costs Imposed to Dismantle and Remove an Underlying Asset at End of Lease Term**	Costs incurred to remove lessee installations, such as leasehold improvements, so the lessee may restore the underlying asset to its original condition
4	**Common Area Maintenance Charges**	Charges for landscaping, janitorial services, repairs, snow removal and other maintenance of common areas

EQUIPMENT LEASES		
	Type of Information	**What To Know**
1	**Quantity of Units**	Number of units of each type of equipment asset being leased (trucking leases typically consist of several assets)
2	**Original Cost**	Original equipment cost being financed
3	**Obligations to Return an Underlying Asset to Its Original Condition**	The requirement to return an underlying asset to its original condition if it was modified by the lessee

Appendix 3

ASC 842 Checklist

The following checklist is a summary of steps to help your company be prepared to implement ASC 842.

1	Identify all leases, including checking for embedded leases.
2	Obtain all lease documents and retain them in one central location. Read and summarize each lease, pulling out all the important information needed for calculations (see Appendix 2 list).
3	Review and discuss elections and practical expedients (see "Ways to Efficiently and Effectively Transition to ASC 842" section) available in the standard, considering their impact on your company. Make informed decisions, then document them.
4	Calculate the ROU assets and liabilities that will be added on the balance sheet.
5	Identify your company's current covenants (and the date they expire) and review all loan documents. Calculate the impact of the new standard; hold discussions with your lender, if needed.
6	Establish policies/procedures/controls for reviewing, classifying and accounting for leases. Document them in a formal written policy.

The above checklist may not include all considerations your company may need to make based on the specific facts and circumstances surrounding your leases. Always consult with your professional advisers.

Thank You

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