



Bring on the LEASES!

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For many private companies, fully understanding the new lease accounting standards (ASC 842, IFRS 16 and GASB 87) has been an immediate source of frustration. Gaining lease compliance by the beginning of 2022 seems daunting and complicated. This paper summarizes the changes in the accounting standard for lessees and steps to take to ensure a smooth transition.

Why the shift from ASC 840 to ASC 842?

Imagine a company that is in business of making airplanes and has no airplanes recorded on the balance sheet. Instead, the company records the airplanes all as operating leases and the leases hit the disclosures of the financial statements and not on the balance sheet. Well, ASC 842 closes this lease accounting off-balance sheet loophole, which allows corporations to report their operating leases, often a major portion of the lease portfolio, in the footnotes of financial statements. Under the new standard, companies are required to capitalize operating leases on the balance sheet as right-of-use assets and lease liabilities except if they are short-term leases. As a result of the shift, operating lease obligations face increased auditor scrutiny, pushing companies to focus on ensuring accuracy and completeness of what they report as well as leading to greater comparability of financial statements.

What is the timeline?

The final standard was issued in 2016 and public companies began transitioning to the standard January 1, 2019. The impact was estimated to be \$3 trillion in liabilities recorded to corporate balance sheets. All private business entities are required to be FASB ASC 842 compliant by December 15, 2021 (Fiscal Year), and December 15, 2022 (Interim Period within).

What are the changes to lease accounting for the lessee?

- Leases Capitalized:
 - When lessee effectively obtains control of the underlying asset and meets **any** of the following criteria:
 - Transfer of ownership at end of lease term.
 - Lease grants lessee an option to purchase the underlying asset.
 - The lease term is substantially all (75% or more) of the remaining economic life of the underlying asset.
 - The sum of PV of minimum lease payments amounts to substantially all (90% or more) of the FV of the underlying asset.
 - The underlying asset is of such specialized nature that it is expected to have no alternative use to the lessor at end of lease term.
- Estimates of lease term and lease payments:
 - For purchase and renewal options, a lessee should reassess whether the exercise of an option is “reasonably certain” and thus must be recognized only upon the occurrence of a significant change in circumstances that is within the lessee’s control.
- Transition: Existing capital leases are grandfathered under ASC 842. For the FASB, lessees may choose between two available transition methods.
 - Modified Retrospective

- All operating leases existing at or entered into after the date of initial application are booked on a prospective basis, but those that expire in the periods of comparative statement will not have to be rebooked. The asset and obligation are booked at the PV of remaining rents at the earliest date presented in the financial statements.
- Practical Expedient
 - Allows companies to “recognize a cumulative-effect adjustment to the opening balance of retained earnings” at their adoption date.
- Present Value Calculation
 - The lessee calculates the PV of the estimated lease payments using the implicit rate in the lease, if it is known to the lessee, or the company’s incremental borrowing rate (the interest rate the lessee would incur to borrow under a secured loan with terms similar to those of the lease)
 - The PV is considered to be both (1) the value of the right to use the leased asset (ROU asset), and (2) the “principal” balance of the obligation to pay rent (lease liability). This amount is recorded as both an asset and a liability.
- Profit & Loss Statement
 - Finance leases:
 - The asset is amortized as an expense in the P&L over the estimated lease term on a straight-line basis (SL).
 - Interest expense is imputed on the lease liability.
 - The sum of the interest and amortization creates a front-loaded lease expense pattern.
 - Capitalized operating leases:
 - Continue to use the straight-line average rent as the expense, and operating lease assets and liabilities are reported separately from capital lease assets and liabilities.
- Lease Payment Breakdown
 - Under the standard, the lease payment for a finance lease is broken down into:
 - An interest component (charged to P&L)
 - A principal component

In addition, lessees can elect not to recognize short-term leases on their balance sheet under ASC Topic 842 and instead account for them as executory contracts, which is like the accounting for operating leases under legacy GAAP. A short-term lease is one with a maximum lease term of 12 months or fewer that does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

What are some pitfalls identified from public companies’ implementation?

- Gathering leases is a difficult task.
 - Leases may be tracked in many different places and ways.
 - Not every lease is labeled as one. Leases embedded into many types of contracts.
- Required lease data must be abstracted and then maintained.
- Determining the incremental borrowing rate (IBR) is complicated.



- Starting too late will cause many headaches as this implementation requires several departments to work together.

How can Mohr Partners help?

Mohr Partners Global Lease Service is a one stop shop for all your leases needs. We provide lease administration, lease accounting, and rent payment services. We can assist your business entity by providing the following to get you compliant to ASC 842, IFRS 16 or GASB 87.

1. Abstract and compile all executed leases in a database system of your choice.
2. Review all lease agreements for key reporting characteristics based on the new guidance.
3. Create and upload appropriate entries/reports such as SLR & FASB 842 entries, occupancy related accrual entries, and post-close activities/account reconciliations for complete and accurate financial reporting.
4. Provide top-level quality assurance by commercial real estate professionals and CPA's focused on lease abstraction, lease administration, lease accounting and financial analysis /due diligence services.
5. Work with your current software to track leases or migrate you into a software where to manage your leases.

If your business entity would like to receive a free consultation or demo about Mohr Partners Lease Accounting services, please feel free to reach out to our Head of Global Lease Services, Sohail Hamirani at Sohail.hamirani@mohrpartners.com.