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ASC 842

The Risks of ASC 842:

What to Know and How to Avoid Them

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Over 99% of senior finance and accounting professionals have real fears when it comes to misrepresenting company lease information to comply with ASC 842.

Among those fears:

- Increased audit fees and fines
- Damage to company reputation
- Risk of legal action
- Damage to own professional reputation

In this document, we are going to address the potential risks associated with the new lease accounting standard, ASC 842, and what contributes to them. While discussing the potential consequences of these risks, we will also take a look at ways they can be mitigated.

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The risks associated with ASC 842

Misrepresented recorded balances or inaccurate disclosures within financial statements put your business at risk. These risks are associated with damage to company reputation, individual reputation, increased audit fees and potential legal action.

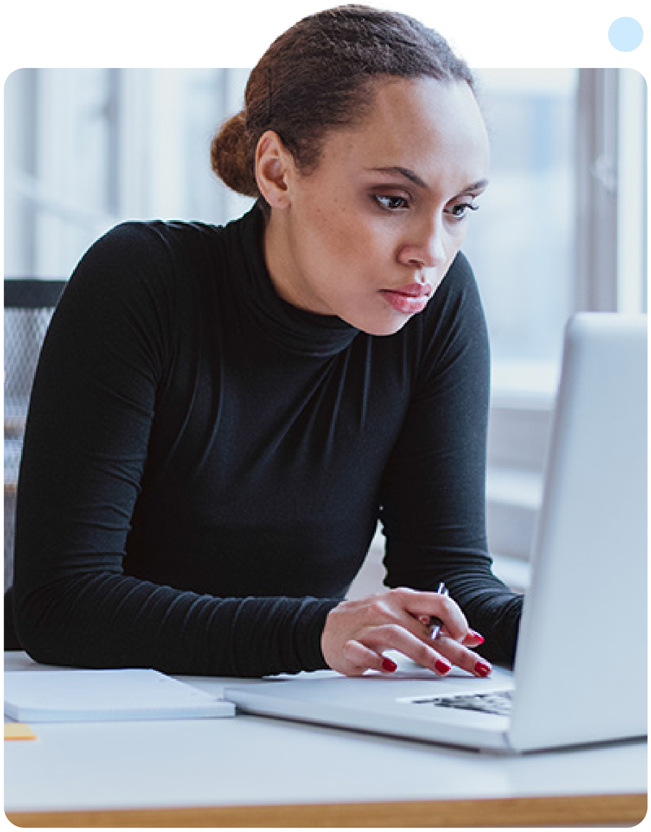
Under ASC 842, leases have moved from a disclosure matter to a reporting matter. This shift in reporting raises the stakes for accounting and finance.

Internal controls over leases need to be reexamined or, perhaps, addressed for the first time. A deficiency in the management of leases could lead to a misstatement in the financial statements and result in a material weakness. Because financial statements include a statement detailing material weakness, this can damage a company's reputation.

Below is a deeper dive into some of the risks of ASC 842.

Do you have all the leases you should include?

For companies implementing ASC 842, one of the biggest risks is failing to include every lease for reporting and disclosure.



In particular, organizations that managed leases on a decentralized basis may not have an adequate picture of the number of leases their organization currently holds.

Lacking a complete lease population leads to an understatement upon adoption. And adjusting amounts in a subsequent period when leases are "found" could result in restatements or the dreaded material weakness mentioned earlier. At the very minimum, this will cause more work for a company's auditors and more expense for the company.

What happens if you classify a lease incorrectly?

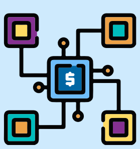
Companies are required to determine whether leases should be classified as operating or finance leases at lease inception. Similar to ASC 840, there are criteria that must be considered as part of this analysis. While it may be easy to think that the difference in classification is not that important because all leases are now included on the balance sheet, the distinction is extremely important.

The impacts of lease misclassification:

While the total expense over time will be the same, the operating lease expense is recognized evenly. The finance lease expense is front-loaded because of the interest expense component associated with the liability.

The expenses recognized under both operating and finance leases have different impacts within the financial statements. For example, depreciation expense for finance leases will be added back to operating activities in the statement of cash flows, while the payments on the liability are shown in the financing section. Conversely, operating lease expense is included within the net income figure, and the cash impact of changes in asset and liability balances are included as part of the changes in the operating activities of the cash flow statement.

Credit agreements may contain covenants that limit the number of finance leases because they are considered debt and/or treat the new operating lease assets and liabilities differently.



The “geography” of the respective accounts in the balance sheet could also impact company metrics, bonuses or incentive plans.

What if you make a mistake in the key inputs used for lease accounting and reporting?

Under the previous lease guidance, certain assumptions – such as the discount rate to use in computing the net present value of lease payments and the lease term – were used simply for the classification of the lease. These were documented and had no further impact on the financial statements, outside of the disclosure of future minimum lease payments.

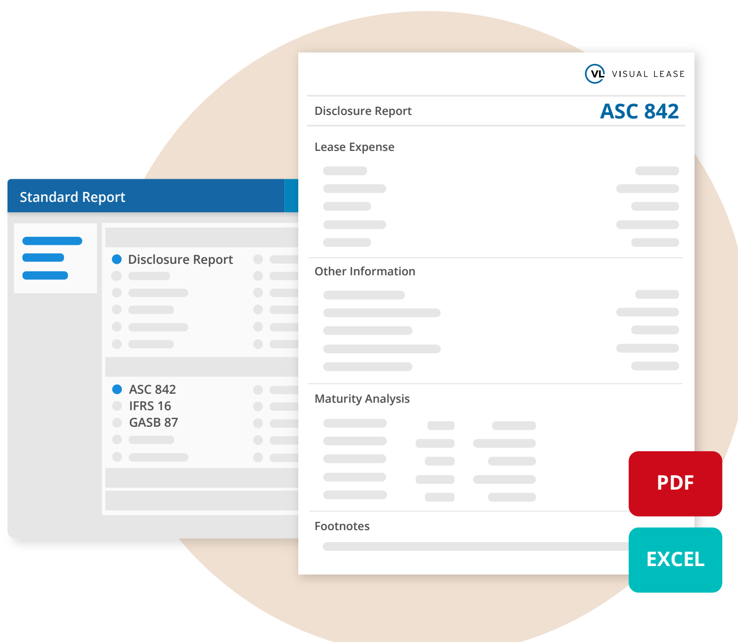
> Under ASC 842, however, these key inputs not only impact the classification, but also the initial recognition and subsequent measurement of the leases. A mistake in one of these assumptions can have material consequences on operating results.

Not using the appropriate discount rate or lease term could be the difference between whether a lease is an operating lease or finance lease. As noted above, each type of lease has pronounced differences in its financial statement impact.

To illustrate the impact of lease terms, note that under the new lease standard, the lease term takes into account a number of factors that must be considered at lease inception. This includes whether a company will exercise renewal or termination options. Like the discount rate, using an inappropriate lease term could result in improperly classifying a lease.

Additionally, under ASC 842, operating lease assets are subject to impairment. An incorrect assumption in a lease term could lead to an unexpected loss being recorded in the financial statements, similar to the impairment of fixed assets or intangible assets.

These are not the sort of "surprises" that companies want to discuss in financial statements. No one wants to record or disclose an impairment loss related to a lease, particularly if it was due to an ill-informed decision by management.



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How do you handle changes in leases in mid-stream?

Lease reassessment is a new concept introduced by ASC 842. Changes in circumstances or the occurrence of significant events can impact whether a lease is going to be renewed, terminated or otherwise modified.

Gone are the days when a change to a lease agreement meant potentially updating the lease expense recorded in the income statement and adjusting minimum lease payment disclosures

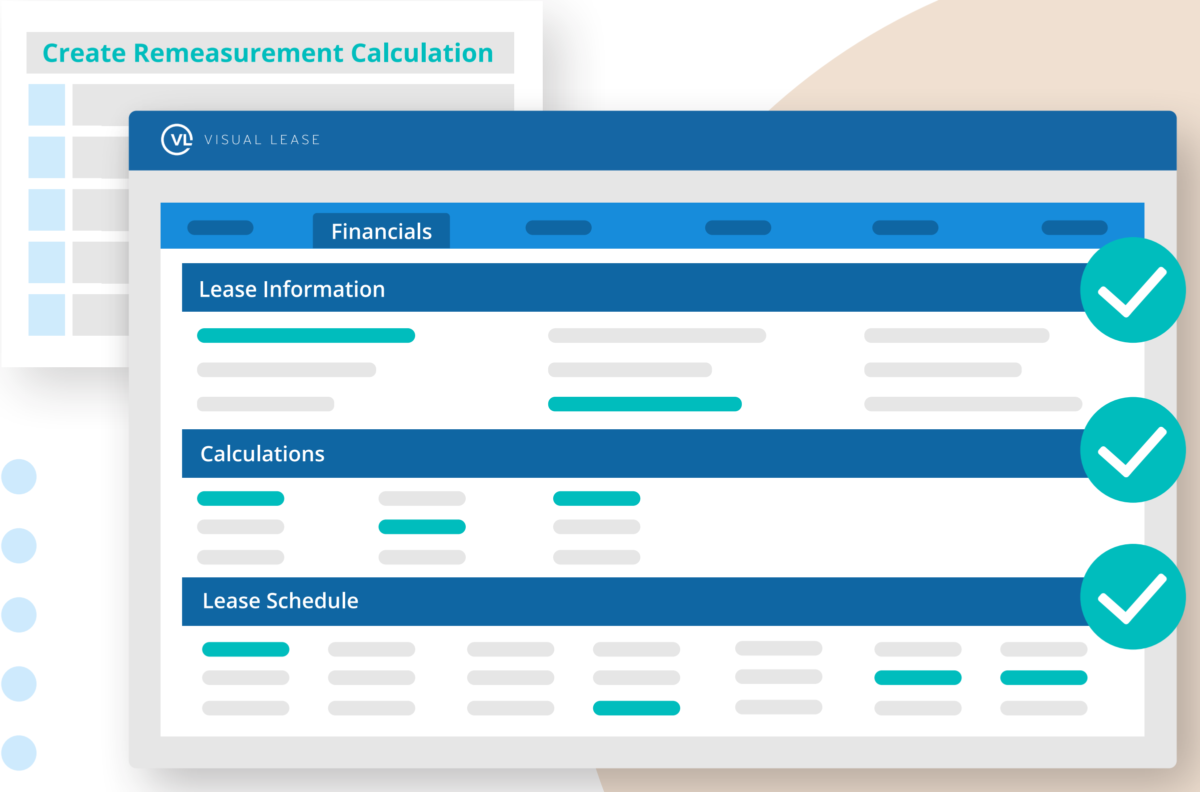
Now that the balance sheet is involved, any changes in lease agreements could result in both a change in the amount or nature of expenses as well as noticeable changes in the balance sheet.

If handled improperly, this can result in misrepresentation of the balance sheet.

There are specific rules regarding modifications, which include additions, terminations, extensions or other items that change the amount or timing of cash flows under the lease.

In some cases, the current lease is revised, while other circumstances require an entirely new lease to be established. The discount rate may also require an update.

Getting this accounting right is paramount to avoiding incorrectly remeasuring leases.



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How to address and mitigate risks associated with ASC 842

There are various ways to address risks associated with ASC 842. Primarily, the best methods are strong processes, internal controls over those processes and the use of lease accounting software.

In this section, we will discuss the intersection between process and internal controls with lease accounting software.

What do you need to consider in creating or tightening up accounting processes and internal controls?

Whether a company is newly implementing ASC 842 or already reporting under the new standard, identifying the key processes around lease accounting is important.

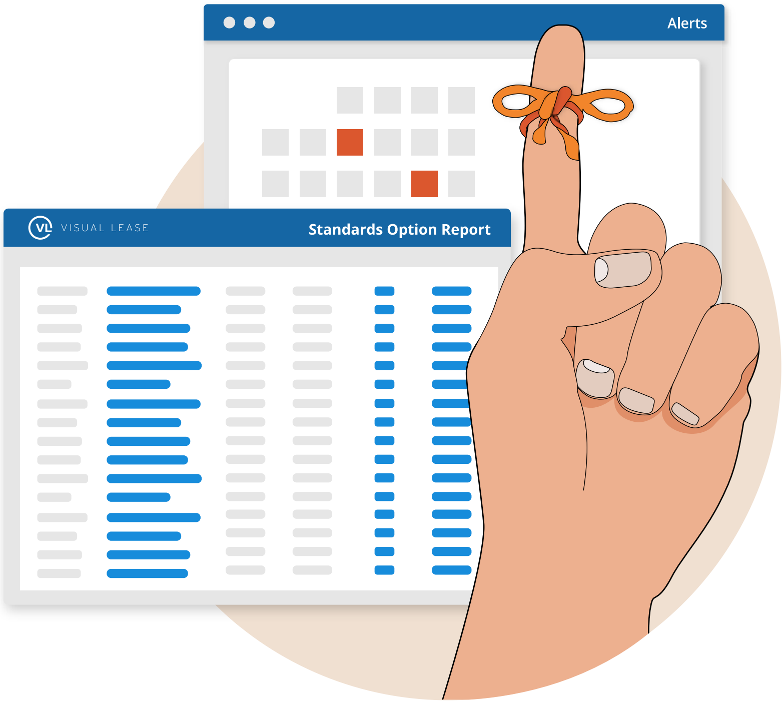
In the transition from ASC 840 to 842, controls must be in place to assure all leases have been identified, the initial recognition of lease assets and liabilities are accurate properly recorded and the adoption/implementation process has been fully documented.

Ensuring that transition controls are in place lessens the risk of using an incomplete lease population that misrepresents the initial balances.

Internal controls over the financial reporting processes need to reflect the new requirements of ASC 842.

Checklists used by management should ensure that all required disclosures are made and that calculations done specifically for the new standard are updated, reviewed and approved.

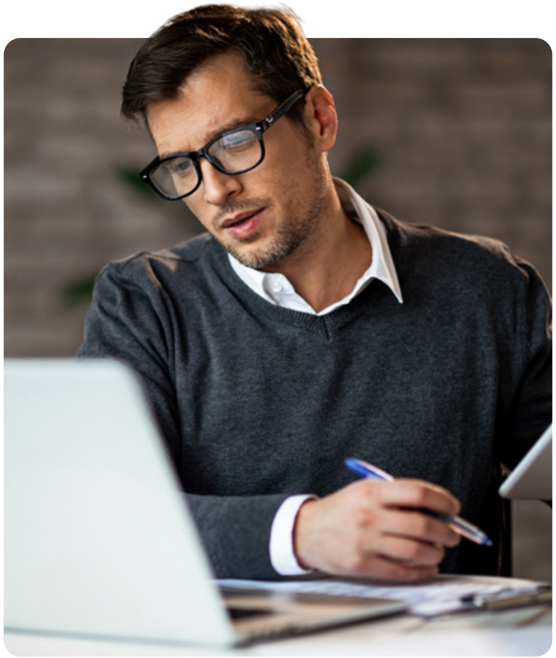
For instance, the new standard requires the disclosure of the weighted-average discount rate and remaining term for leases. This is a new requirement and should be part of an updated checklist so the calculation is updated.



Leasing activity is also dynamic. After implementation, controls over leasing activities should be established or updated to ensure that there is a proper process in place to manage ongoing lease activity such as:

- Review of each new arrangement to determine whether it is or contains a lease;
- A standard template/process for the classification test to determine the operating or finance lease designation, which should include evidence of review by management as well as guidance regarding where key inputs into the test should be obtained;
- Review and approval of all new leases, with a documented policy for determining lease terms under each;
- Review of any adjustments to be made to opening lease balances, such as initial direct costs, prepaid rent or lease incentives;
- Review and approval for all changes to leases, including documentation of the assumptions for the treatment of modifications;
- Centralization and regular review and approval of discount rates and foreign exchange rates used in the calculation of lease assets and liabilities.

Underlying all of this is that any system used in the lease reporting and disclosure process should be subjected to all the IT general controls that a company's financial reporting system is subjected to already.



Documenting the adoption and implementation of ASC 842 and establishing an accounting policy for the lease standard are key to setting the groundwork for accurate lease reporting.

While most companies may be equipped to do the work above in-house, engaging a third-party professional services firm experienced in implementation of the lease standard should be considered to assist with the documentation.

Firms that have experience implementing the new lease standard are knowledgeable in best practices that have been audit-tested at public and private companies. Bringing subject matter experts into the discussion also adds an additional layer of control, as third parties have an objective view of each company's adoption processes.

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Why is lease accounting software so critical?

Selecting a lease accounting solution is one of the key decisions a company will make while implementing ASC 842. Businesses can select between lease accounting software or an offline spreadsheet.

Spreadsheets offer a cheaper alternative – one that most in finance and accounting are used to employing on a regular basis.

But there are significant risks and inefficiencies in using a spreadsheet rather than lease accounting software.

While getting to Day 1 may be accomplished, the manual work required is incredibly time-consuming and error-prone.

Day 2 brings an additional layer of complexity not recommended for spreadsheets – such as lease management, complex calculations and reporting requirements.

Post-adoption, companies are required to consolidate lease reporting, especially if there are several decentralized segments, generate journal entries and provide the level of reporting and disclosure needed for financial statements.

Further, if a company operates in multiple countries, the impact of foreign currency translation comes into play. Leases that are denominated in a currency other than the local currency of the lessee are subject to specific rules, for example.

Managing the foreign currency in a spreadsheet requires a significant amount of manual adjustment. The assets recorded for foreign leases are measured initially and at each reporting period at the historical exchange rate for the two currencies. In addition, the lease liability is adjusted at each reporting period to reflect the current exchange rate, yielding foreign exchange gains or losses.

Employing lease accounting software reduces the time and effort required to handle different currencies and lease complexities.

Lease accounting software lessens the risks associated with ASC 842. Among the benefits:

- **Centralized lease data** – Pulling together all lease data pays off with information available at the touch of a button, including software serving as a document repository, lessening the risk of incomplete lease reporting
- **Automated calculations** necessary to measure and remeasure lease assets and liabilities are done within the software, eliminating the risk of a miscalculation or keying error in a spreadsheet
- **Make smarter business decisions** – With all lease data centrally contained in the software, management can use this for forecasting and providing an overall view of leasing activity within the company
- The software will **provide the required disclosures** under the new standard, eliminating additional time spent manually preparing the disclosures and lessening the risk that items are improperly calculated or excluded from the disclosure
- **Reconciliation** can be performed using the software as all journal entries and account balances may be generated by the software, allowing reviewers and approvers to compare the data to the information in a company's general ledger
- Parameters can be established within the software so there are **internal controls over leasing** desired by the company; for example, individuals cannot both enter and approve new or remeasured leases and leases can be assigned so that only individuals responsible for them can access and edit them
- Internal control reviews are performed by independent auditors over most lease accounting software, providing the company and its other stakeholders with assurance that the **information generated by the software is accurate** in the form of internal control reports

Conclusion

Failing to mitigate the risks of ASC 842 can result in serious consequences. It can potentially harm a company (or its management) and lead to increased costs from audits or litigation.

Focusing on the internal controls around lease accounting and using lease accounting software can lower those risks significantly.

Lease accounting software, like Visual Lease, not only supports ASC 842 compliance, but it can also help companies make better, strategic business decisions.

The consolidation of lease data and the ability to report on and forecast using that data provides management with indispensable information to help better run the business.

To see how you can ensure ongoing compliance and maintain accurate lease data with Visual Lease, visit **www.visuallease.com**

About Visual Lease

Visual Lease is the #1 lease optimization software for managing, analyzing, streamlining and reporting on lease portfolios. Developed by industry-leading lease professionals and CPAs, it combines GAAP, IFRS and GASB-compliant lease accounting controls with easy, flexible and automated lease management processes. More than 1000 of the world's largest publicly traded and privately-owned corporations rely on Visual Lease to control their lease portfolios, integrate with their existing business systems and maintain regulatory compliance. Committed to ongoing innovation and unparalleled customer service, Visual Lease helps organizations transform their lease compliance requirements into financial opportunities.