# Changes in Lease Accounting Are Just Around the Corner

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Are you ready for the new lease accounting standard – known as FASB Accounting Standards Codification (ASC) 842, Leases?

What is changing?

The new lease standard requires a lessee to **record all leases on the balance sheet**, unless the lease term is 12 months or less. This represents a significant change from historical lease accounting rules, which only required assets and liabilities to be recorded for capital leases, but not for operating leases. Overall, the new standard should not change a company's income statement or cash flow statement, but it may have material impacts to the balance sheet.

The intent of the new standard is to reduce the amount of off-balance sheet activity, providing financial statement users with greater transparency regarding the leasing activity and associated rights and obligations of lessees. Unintended consequences may include significantly impacting financial ratios and compliance with loan covenants.

When are the lease accounting changes effective?

The new standard will be effective for non-public business entities beginning with calendar year 2022. Many implementation lessons can be learned from public entities, as they implemented the leasing standard prior to private companies being required to implement the standard. To ease adoption, companies can elect a transition method whereby a cumulative-effect adjustment is recorded to opening retained earnings in the period of adoption, thus precluding restatement of prior periods.

Gathering the lease portfolio can be extremely difficult

Identification of a complete lease population is the first, and often most challenging, step in implementation, due to:

- Decentralization of agreements and data for leases historically classified as operating leases
- The requirement to search for embedded leases in service agreements and other contracts

An embedded lease could be present if a contract contains an explicitly or implicitly identified asset, and the company controls the use of this asset. For example, transportation and delivery service agreements could contain an embedded lease if a specific vehicle must be used to transport your company's inventory. Cloud computing service agreements could contain embedded leases if specific IT servers are dedicated to your company.

Additional implementation challenges

Other common issues include:

- ***Extent of effort required to adopt –*** Implementation frequently requires 6 – 12 months of cross-functional involvement, which can be a significant burden coming on the heels of the new revenue recognition standard.
- ***Developing an IT solution to manage compliance –*** Spreadsheet-based lease management tools often are no longer sufficient, given the increase in the volume of leases on the balance sheet and the complexity of measuring such assets and liabilities. Lease accounting software may be required to successfully manage all lease data.

Preparation for the new lease accounting standard should start now. Dean Dorton welcomes any questions about how the new standard will impact your business. Learn more about us, and our services at the link below:

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