The Financial Accounting Standards Board (FASB) issued a new lease accounting standard (ASC 842, Leases) on February 25, 2016, which provides new requirements of financial accounting and reporting for lessees and lessors. The objective of ASC 842 is “to establish the principles that lessees and lessors shall apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease.”

What’s Changed
The new standard introduces extensive changes to lease accounting and may cause implementation challenges to organizations during the adoption period:

- The most significant change will require lessees to account for both operating and finance leases on the balance sheet. This will result in increased transparency on the balance sheet, now recognizing both the right of use asset and the obligation to make lease payments.
- Increased levels of disclosures will require organizations to identify the nature of leasing transactions, the lease’s rights and obligations, assumptions and estimates used by management, and a summary of maturities. This will help investors and financial users better understand the amount and any uncertainty of cash flows arising from leases.
- The definitions and guiding principles in the new lease are closely aligned to the principles used in the new revenue recognition standard.
- Other notable changes include an exception for short-term leases, elimination of leveraged leases, new criteria for reporting sale leaseback transactions, and re-assessment of lease liability and lease payments.

Key Questions to Ask
In light of these changes, management should start asking these questions to prepare for this transition:

- What types of leases does your organization have?
- How complete and accurate is your organization’s leasing data?
- Is your leasing data secure? Is it stored in spreadsheets? In one system or many? Who is responsible for keeping leasing data up-to-date?
- Who owns leasing within the business? Accounting? Treasury? Procurement? IT? Is there a shared services group that owns all aspects of leasing? If not, should there be?
- Does your organization understand the new accounting guidance and expanded disclosures under the new standard and the necessary modification to underlying systems and processes?
- Are the leasing obligations disclosed in your annual reports today really accurate? Have they been poorly tracked and under (or over) stated?
- Is your CFO prepared to explain the organization’s leasing programs to investors?
- Does the organization have good processes in place to evaluate when to lease versus when to buy?
- Is the organization seeking out the most competitive financing terms as they would for any other purchase or debt transaction?
How Internal Audit Can Help

With adoption for calendar year-end companies in 2019, there are less than three years to think through the potential impact of the new standard, particularly in light of the requirement to retroactively apply the standard to previously issued financial statements. Companies should start working toward adopting the new accounting standard as soon as possible. The internal audit function of the organization can assist by:

- Educating key stakeholders on key changes of the new standard
- Performing a risk assessment to assess information needs, identify potential gaps, and understand impact
- Modeling the impact on financial statements and covenants
- Evaluating process optimization opportunities and system requirement needs
- Recommending and implementing tools, processes, and technologies based on client requirements, market landscape, and industry practices
- Providing support to effectively manage the inventory, impact and gap analysis, abstraction/collection, and conversion of lease data for FASB compliance
- Testing the completeness and accuracy of lease data
- Assisting with the development and training on new accounting policies and operating procedures for ongoing sustainability and administration
- Supporting the redesign of an effective internal control framework capable of addressing the changes from the new accounting standard

Companies must apply the requirements as of the beginning of the earliest comparative period presented. Therefore, working toward adopting the new accounting standard is imperative. Stay tuned for CohnReznick's next article on the key steps organizations should consider as part of a pre-implementation review program.

Organizational Impact

Aside from the significant impacts of market capitalization and credit ratings, the new standard imposes significant transition challenges and risks, requiring organizations to respond to expected changes in infrastructure, policies and procedures, and systems and data. Companies need to respond by assessing the impact and implementing the necessary effective response strategies, including investing in people and technology and building new processes and controls:

- Establish requirements to identify a lease
- Develop procedures to modify and re-assess leases
- Align with new revenue recognition standard
- Refine tax accounting and reporting procedures
- Determine relevant cash flows when establishing a right to use asset
- Review terms of existing financial obligations to determine if there are any "new debt" considerations
- Develop right of use asset impairment requirements and testing
- Enhance disclosure requirements (nature of transactions, rights and obligations, assumptions and estimates, maturities)
- Understand multi GAP/IFRS reporting requirements for multi-national organizations
- Leasing versus buying decision making
- Property and procurement policies and objectives
- Vendor selection, negotiation, and contract management
- Lease termination, execution, and maintenance
- Centralization and decentralization of leasing processes
- Managing the lease portfolio
- Evaluate the completeness, accuracy, and ongoing maintenance of the lease inventory
- Consider the different types of leases and how all information will be stored under the new standard
- Determine the audit trail for the leasing decisions and interpretations
- Understand reporting requirements and test if system can handle new standard requirements

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CohnReznick’s Governance, Risk, and Compliance (GRC) Practice provides boards of directors and senior management of public, private, and not-for-profit organizations with the experience, objectivity, and resources they need to meet their governance, risk, and compliance responsibilities—and to leverage the insight these activities generate to improve operations, enhance value, and ultimately help realize the organization’s missions.

Contact

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