

Financial Accounting Standards Board (FASB) New Standard Related to Leases, ASC 842

After many years of deliberations and delays, the FASB's new standard related to leases, ASC 842, is ready for adoption.

Effective Date

For private companies, the standard is effective for fiscal years beginning after December 15, 2021. For a calendar year-end company, this means the standard would be adopted on January 1, 2022. We plan to work with our clients over the summer and fall months to prepare them for adoption by December 31, 2021.

Summary of Changes

The most significant change for lease accounting under ASC 842 (the "new guidance") is that Operating leases will now require an asset and liability to be recorded on the balance sheet. The income statement impact of leases is expected to remain very similar under the new guidance vs. the old guidance.

Capital Leases

- ✓ Under the old guidance, if a lease met one of four criteria, it was classified as a Capital lease. The obligations under the lease were recorded as a liability and the assets being leased were recorded as assets. The lease liability was amortized using the effective interest method and the company recorded depreciation and interest expense related to the lease. Certain disclosures were required.
- ✓ Under the new guidance, the lease classification criteria have not changed significantly. If a lease meets one of five criteria, it is now classified as a "Finance" lease. A lease liability will be recorded and a "right of use" asset will be recorded. The company will recognize depreciation and interest expense related to Finance leases. There are expanded disclosure requirements.

Operating Leases

- ✓ Leases that did not meet one of the criteria to be classified as a Capital lease under the old guidance were classified as Operating leases. The expense related to these leases was recognized on a straight-line basis over the term of the lease. No obligations under the lease or rights to use the asset were recorded on the balance sheet. The terms of these leases were disclosed in the footnotes.

- ✓ Leases that do not meet one of the criteria to be classified as Finance leases under the new guidance will still be called Operating leases. The obligations under the lease and the right to use the asset under the lease will be recorded on the balance sheet as a right of use asset and lease liability. Lease expense is recognized on a straight-line basis over the lease term. There are expanded disclosure requirements.

In the year of adoption, companies should expect to spend a significant amount of time and effort using the detailed terms and options of each lease to calculate the right of use asset and lease liability. Vrakas has a software solution available to clients to assist with these calculations and lease classifications, if they chose to use it. We will be following up with clients as applicable to discuss adoption of this standard and the software solution.

Below is a high-level comparison of the old guidance vs new guidance:

	ASC 840 (Old Guidance)	ASC 842 (New Guidance)	Expected Impact of change
Accounting for Capital / Finance Leases	<ul style="list-style-type: none"> ✓ Record liability and asset ✓ Book depreciation and interest expense ✓ Disclosures 	<ul style="list-style-type: none"> ✓ Record liability and right of use asset ** ✓ Book depreciation and interest expense ✓ Expanded disclosures 	Minimal
Accounting for Operating Leases	<ul style="list-style-type: none"> ✓ Do not record an asset or liability ✓ Book lease expense on a straight-line basis over the lease term ✓ Disclosures 	<ul style="list-style-type: none"> ✓ Record liability and right of use asset ** ✓ Book lease expense on a straight-line basis over the lease term ✓ Expanded disclosures 	Gross up of balance sheet

*** exemption allowed for "short-term" leases, resulting in off-balance sheet accounting. A "short-term" lease is defined as a "lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise." Lessees need to consider the definition of "commencement date" and "lease term" before automatically applying this exemption. There are still presentation and disclosure requirements for these leases.*



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Notes

1. ASC 842-10-55-12 states "Leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases on the basis of the legally enforceable terms and conditions of the lease...the classification and accounting for the leases should be the same as for leases between unrelated parties."
2. Finance leases under the new guidance will be similar to Capital leases under the old guidance, where expenses are higher in the early years of the lease due to using the effective interest method.
3. Operating leases will have straight-line expense over the lease term. Similar to the deferred rent concept under the old guidance, this straight-line amount may not tie to lease payments due to step-rents, other costs, etc.