
THE NEW LEASE ACCOUNTING STANDARD IS HERE, ARE YOU READY?

Contact:
Diana Cetares
Senior Manager
972-404-1010
dcetares@hmpc.com



Are you prepared to meet the new lease standard requirements? The new lease standard, Financial Accounting Standards Board (FASB) ASC 842, is effective for private companies with fiscal years beginning after December 15, 2021.

What is Lease Accounting (ASC 842)?

ASC 842, Leases, provides the financial accounting and reporting requirements for lessees and lessors. This standard establishes the right-of-use asset model, which shifts from the risk-and-reward approach to a control-based approach. Under the new standard, lessees will recognize an asset on the balance sheet, representing their right to use the leased asset over the lease term and recognizing a corresponding lease liability to make the lease payments. The lease liability is based on the present value of future lease payments using a discount rate to determine the present value based on the rate implicit in the lease, if readily determinable, or the lessee's incremental borrowing rate. As a result, a lessee's operating lease accounting model will change significantly. Additional complexity of the new standard requires the lease arrangements to be classified as either finance leases or operating leases.

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What changes can I expect?

Finance leases will separately recognize interest expenses on the liability and amortization expense on the right-of-use asset. The periodic expense at the beginning of the lease term will generally be greater than the corresponding cash payments but will decline over the lease term as the liability is reduced. Operating leases will recognize lease expense on a straight-line basis over the lease term as a single line item in operating expenses in the income statement.

For lessor accounting under ASC 842, a sale and related profit are recognized upon the commencement of the lease only when the arrangement transfers control of the underlying asset to the lessee. The changes in the new guidance are aligned with the new revenue recognition standard, ASC 606, as leasing is fundamentally a revenue-generating activity for lessors. ASC 842 also requires additional disclosures related to the lessor's exposure to asset risk and credit risk. Lessors will classify the lease as a sales-type lease, direct finance lease, or operating lease.

What challenges can I expect?

This standard represents a wholesale change to lease accounting; as a result, many entities will face significant implementation challenges such as:

- ❑ Not identifying embedded leases in arrangements
- ❑ The number of arrangements that were previously not identified as leases may now be identified as meeting the definition of a lease or embedded lease
- ❑ Existing systems and processes may need to be modified or enhanced in order to provide information necessary to address the new reporting and disclosure requirements
- ❑ Multiple departments across the organization will be affected by this standard, including information technology, tax, legal, treasury, and financial planning and analysis, among others
- ❑ Ongoing efforts might be more significant than the initial implementation effort

This standard includes extensive disclosures intended to enable users of financial statements to understand the amount, timing, and judgment related to a reporting entity's accounting for leases and the related cash flows. This standard requires disclosure of both qualitative and quantitative information about leases.

Why is Lease Accounting important?

ASC 842 establishes the principles that lessees and lessors should apply to report useful information to users of the financial statements about the amount, timing, and uncertainty of cash flows arising from a lease.

Who does Lease Accounting affect?

Lease accounting affects all entities that lease assets, including real estate, airplanes, and equipment. The standard excludes leases of intangible assets; leases to explore for or use nonregenerative resources; and leases of biological assets, inventory, and assets under construction.

How we can help.

HM&M can help you take steps to implement the new lease accounting standard. We can help assess the accounting and financial reporting impact and walk you through the software selection and standard implementation.

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Dallas | Fort Worth | Southlake
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