

Lease Accounting: Private Companies On the Clock After Delay

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In early 2020, the COVID-19 pandemic added another element of business disruption for organizations to manage while the effective dates to comply for FASB's new lease accounting standards were quickly approaching.

Following a pandemic-related delay, the new standard takes effect for entities within the "all other entities" category for fiscal years starting after Dec. 15, 2021, and for interim periods within fiscal years beginning after Dec. 15, 2022. The ramifications of the COVID-19 pandemic have affected organizations in ways we are yet to fully understand, and the impact on lease accounting processes continues to evolve in response to changes that have occurred in the business environment.

For public companies, FASB Accounting Standards Codification (ASC) Topic 842, *Leases*, took effect for fiscal years and interim periods within those fiscal years, beginning after Dec. 15, 2018. There is an exception for public not-for-profit entities, whose effective date is for fiscal years beginning after Dec. 15, 2019, including interim periods within those fiscal years.

Meanwhile, GASB delayed by one year the required implementation of GASB Statement No. 87, *Leases*, which is now applicable for fiscal years beginning after June 15, 2021.

PANDEMIC EFFECTS

COVID-19 arrived in early 2020 and spread rapidly and now has extended worldwide with the delta variant in 2021. By mid-March 2020, state and local governments began issuing restrictions shutting down many businesses other than health

care and providers of "essential services." Overall, business activity dropped significantly, resulting in one of the largest year-over-year GDP decreases ever recorded.

With the restrictions in place, many businesses essentially just shut down and were unable to pay the rent or their employees. Many landlords began offering rent deferrals and abatements whereby the lease remains in place but payment of rent for a certain period is deferred or reduced until an agreed-upon time when the business restrictions would be lifted. FASB's staff issued Q&A guidance last year that is intended to help with the accounting for such rent deferral arrangements and other pandemic-related lease concessions.

Many public companies that had previously implemented the new lease accounting standard took the opportunity to assess whether the potential ancillary benefits are being realized. These benefits often include digital migration of accounting records and processes and moving toward a paperless accounting environment, centralization of lease management activities, better administrative management over leasing activities including renewals/extensions and returns at lease expiration, and the opportunity to combine and negotiate larger transactions at more attractive pricing.

An area of continuing focus for public companies is to ensure that the lease accounting software solutions are fully integrated with their ERP accounting systems and with automated uploading of accounting entries. About half of Topic 842 adopter companies had not fully integrated their lease accounting processes with existing ERP systems earlier this year, according to a survey published by LeaseAccelerator and EY in March.

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IMPLEMENTATION LESSONS

As private and government organizations work toward adopting the applicable new lease accounting standard, there are some important implementation lessons learned from public companies, including:

- Implementation of the standard is more complicated than it first appears. Leases and lease contracts often are scattered in various locations across a company, and it can be an arduous task to locate all the leases for storage in a central repository. Extracting all the appropriate figures from lease contracts also can be challenging, especially when the contracts are not standardized. The implementation team will need to perform a completeness review to ensure all leases have been identified.
- Appropriate accounting policy decisions can be important in reducing complexity. For example, applying a portfolio approach to leases that are similar, particularly low-dollar, high-volume agreements, can result in considerable time savings. Practical expedients also exist that enable lessors in certain situations to not separate nonlease components from the associated lease component (lessees also have this option); permit an organization to apply the transition provisions of the new standard at its adoption date instead of the earlier comparative period presented in its financial statements; and permit lessors to account for and report sales taxes and certain lessor costs in a manner more closely aligned with FASB's new revenue recognition standard.
- Stakeholders outside the finance staff will be needed to provide supporting information because lease contracts are often held in various parts of the organization. Operations and legal staff in particular are key allies in this process.
- Finding all embedded leases can be an area for concern. For example, some service contracts include right-of-use provisions that may fit FASB's definition of a lease, and these will have to be accounted for under the board's lease accounting rules.
- Getting a complete set of documents for each lease can be a challenge. It's possible that all the information needed for accounting under the standard may not be in the lease agreement.
- Spreadsheets alone will not work for many companies. In these cases, a lease accounting software solution will be needed. Fortunately, many options are available following public companies' adoption of the standard, but it takes time to choose the right one and perform the installation.
- Determining the incremental borrowing rate can be more difficult than anticipated, as it often entails obtaining from financial institutions credit profile-specific indicative secured borrowing rate information across various maturity dates and assessing the appropriateness for lease accounting discount rate purposes.
- Continuing compliance after implementation is a challenge. Entitywide processes and controls need to be put into place so that new lease contracts that are signed by the company are added to the centralized lease repository. Staff also should be trained on how to recognize new embedded leases that may be hidden in other types of contracts.

In continuing to address lease accounting issues implementation for nonpublic entities, FASB recently proposed guidance that would permit the election to use the risk-free rate as the discount rate to be made by asset class, and if the risk-free rate is elected, the rate implicit in the lease would be permitted to be used instead if known. The proposed Accounting Standards Update is titled *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*. The board has collected comments on this proposal, and a final standard is expected after redeliberations.

Adopting the new standard can be a confusing and daunting task for many organizations, so preparing for this process takes time and often a considerable amount of effort.

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Sometimes there is no substitute for experience. In gathering the information, assessing the lease portfolio, making the accounting policy elections, and developing and executing the implementation plan, many organizations have retained the services of those who have done it before. The services can be in the form of a project leader, or they can be in the form of a coach or mentor. Organizations should assess whether it might be beneficial to obtain such services. In any event, the organization's auditor should be kept informed as to implementation plans and progress to better plan for the timing of the current-year lease accounting audit procedures.

While the response to the pandemic restrictions has resulted in significant changes in how business operations are now managed, some of those changes may permanently affect lease accounting. This includes what activities have been, and will continue to be, handled remotely and affect leased space requirements going forward.

With the lessons learned in response to the changed business environment, as nonpublic and governmental business organizations address lease accounting standard implementation, they will hopefully build on the lessons learned by others.

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