

# ASC 842 Guide for auditors



# Say “so long” to SALY

Sadly, SALY is suspended this year. ASC 842 is in effect, and auditing leases will never be the same. That is, until all clients adopt new accounting policies for all their leases. Who knows how long that will take?

## Don't panic

This guide explains the details of lease accounting as it applies to auditors.

The unfortunate truth is that many audit clients will need a lot of help becoming audit-ready.

This presents you, the auditor, with an opportunity. Encouraging the decisions in this guide at adoption will help you:

- Perform a rigorous audit with high customer satisfaction
- Simplify audit procedures and manage audit scope
- Increase audit efficiency and scalability
- Simplify future audits
- Build a more valuable auditor-client relationship
- Ensure effective, ongoing accounting policies

**About us:** Netgain has already helped hundreds of companies transition with our flagship product, NetLease. Now, we've brought together our CPAs and former auditors to produce this guide. We offer a cloud-based solution built for auditors that simplifies the transition for clients and creates a consistent audit workflow: NetLease for Auditors.



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# **Transition guidance Day one**

# Day one

## Audit procedures

The transition (Day One) accounting is crucial to the audit because the decisions made here will affect leases for their duration. Your clients will need to navigate a matrix of decisions to determine how to perform the initial accounting under the new standard.



**Risk point:** Transition decisions and their proper application are a high-risk area of the audit.

In the following sections, we'll explain the options clients have and how they will affect your audit.



**Perspective:** Auditors will inevitably need to help clients transition to 842. Use this opportunity to simplify the audit and build a lasting relationship with your client.

### Day-one audit considerations:



#### Practical expedients

- Entity policies elected
- Transition reliefs elected
- Transition method elected



#### Transition areas

- New GL accounts
- Transition journal entries
- Disclosure reporting

# Practical expedients

## Entity policy elections

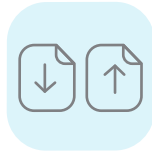
Guide audit clients through the practical expedients available. These policy decisions will greatly influence the level of effort required to comply with the new standard:

### Recommendation:



#### **Inclusion/exclusion of short-term or low-value leases**

Clients should elect to exclude these leases from their 842 portfolios. This will reduce balance-sheet impact and ongoing lease maintenance.



#### **Separating lease from non-lease components**

Clients should elect to separate these, when possible, to avoid unnecessary balance-sheet impact.



#### **Discount rate used**

Most clients will not have the data or sophistication to properly calculate a rate other than the risk-free rate available to private clients only.



#### **Portfolio approach**

Allows clients to simplify their ongoing accounting but will still require a discerning eye from the auditors. Clients rarely have a lease population that is homogenous enough to analyze as a portfolio.



**Perspective:** When possible, direct clients to take the path of least resistance based on their accounting expertise, data quality and resource availability.

| ENTITY ELECTIONS                                      | SUMMARY  | APPLICATION                          | GUIDANCE          | WHAT WE'VE SEEN   |
|---|--|--------------------------------------|-------------------|---|
| <b>Short-term or low value leases</b>                 | As an accounting policy, a lessee may elect not to apply the recognition requirements to short-term leases. Instead, a lessee may recognize the lease payment in profit or loss on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred. | Elected by class of underlying asset | ASC 842-20-25-2   | <p><b>Typically elected:</b> Reduces the level of effort of implementation and ongoing accounting.</p> <p><b>Low-value threshold:</b> No prescribed threshold from FASB (IFRS threshold \$5,000). Many companies use their fixed-asset capitalization limit for leases as well.</p> |
| <b>Not separating lease from non-lease components</b> | A lessee may choose not to separate non-lease components from lease components and, instead, to account for each separate lease component and the non-lease components associated with that lease component as a single lease component.   | Elected by class of underlying asset | ASC 842-10-15-37  | <p><b>Typically elected:</b> Particularly if non-lease components are predictable; high level of effort required during the analysis including determining the stand-alone selling prices of the non-lease components.</p>  |
| <b>Discount rate</b>                                  | A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease instead of its incremental borrowing rate, determined using a period comparable with that of the lease term, as an accounting policy election made by class of underlying asset.                                     | Elected by class of underlying asset | ASC 842-20-30-3   | <p>The vast majority of privately held companies are electing to use the risk-free rate despite the balance-sheet gross-up effects.</p> <p>For further analysis, see <b>Interest Rates</b> section of the guide.</p>  |
| <b>Portfolio approach</b>                             | A lessee may account for its leases at a portfolio level provided that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio.   | Elected at portfolio level           | ASU 2016-02 BC120 | <p><b>Not typically elected:</b> In theory, this approach is possible, but clients rarely have a portfolio of leases with characteristics similar enough to be accounted for at a portfolio level.</p>  |

# Transition reliefs

The transition reliefs a client uses also change the scope of the audit and subsequent audit procedures.

## Uncommon:

Use of hindsight: If a client elects to use hindsight when determining lease classifications, they will be allowed to analyze the actual outcomes of lease terms and provisions and adjust comparative periods accordingly.

- This expedient is considered only when a client has elected to restate comparative financial statement periods, which is exceedingly rare.
- This policy must be elected for all leases active during the respective period.



**Risk point:** If hindsight is elected, the audit team will need to test the lease-portfolio activity to verify lease renewals, terminations, asset impairments, etc.





# Transition reliefs

## Common:

Package of practical expedients: A client electing this package of expedients will greatly reduce the level of audit procedures required around the implementation. Essentially, this package eliminates the need for clients to reassess any previously made accounting decisions around portions of their lease-accounting portfolio.

- Whether a contract is or contains a lease: clients do not need to reevaluate their lease portfolio at transition. Contracts that have been deemed leases will continue to be recorded as leases, and contracts that were not deemed to contain a lease do not need to be reassessed.
- Lease classification: clients do not need to reperform any classification tests for their lease portfolio at transition. Any leases commencing after the transition date will need to be properly compared to the guidance-classification criteria.
- Initial direct costs: clients do not need to reassess costs of a lease that were included as initial direct costs for leases at transition. Under ASC 840, direct costs can include internal costs and external costs such as legal fees. Under ASC 842, initial direct costs are defined as incremental costs of a lease that were incurred solely because of the lease agreement. Therefore, certain incremental costs previously capitalized under ASC 840 will be expensed under ASC 842.



**Perspective:** Only under unique circumstances would a client benefit from not electing the package of practical expedients.

| TRANSITION RELIEFS  | SUMMARY   | APPLICATION   | GUIDANCE               | WHAT WE'VE SEEN  |
|---|---|---|------------------------|--|
| <p><b>Use of hindsight</b></p>  | <p>As an accounting policy, a lessee may elect not to apply the recognition requirements to short-term leases. Instead, a lessee may recognize the lease payment in profit or loss on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred.</p>   | <p>May be elected separately or in conjunction with the practical expedient package</p> | <p>ASC 842-10-65-1</p> | <p><b>Typically not elected.</b> High effort and cost for little benefit.</p>          |
| <p><b>Package of practical expedients:</b></p> <ul style="list-style-type: none"> <li>• <b>whether a contract is or contains a lease</b></li> <li>• <b>lease classification</b></li> <li>• <b>initial direct costs</b></li> </ul> | <p>An entity may elect the following practical expedients, which must be elected as a package and applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor), when applying the pending content that links to this paragraph to leases that commenced before the effective date:</p> <ul style="list-style-type: none"> <li>• An entity need not reassess whether any expired or existing contracts are or contain leases.</li> <li>• An entity need not reassess the lease classification for any expired or existing leases (that is, all existing leases that were classified as operating leases in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as finance leases).</li> <li>• An entity need not reassess initial direct costs for any existing leases.</li> </ul> | <p>Must be elected as a package</p>   | <p>ASC 842-10-65</p>   | <p><b>Typically elected.</b> Greatly improves implementation efficiency and costs.</p> |

# Transition methods

ASC 842 requires clients to transition using the modified retrospective method.

1

## Effective method:

Apply the new standard from the transition date forward. Comparative periods in the financial statements are still presented under ASC 840.

- This method is used by the majority of companies. See ***Choosing a transition method*** blog post for more details.

**Clients can choose one of these two options at the date of transition:**


2

## Comparative method:

Apply the new standard for all comparative periods presented in the financial statements. This means that clients will have to retroactively account under ASC 842 rules, with the option to obtain some relief using hindsight.

- ***Not recommended.***

or



**Ongoing  
guidance**  
**Day two**

# Day two

## Audit procedures

With ASC 842, the ongoing (Day Two) accounting has great significance to the auditor. It has become a material portion of the audit.

How a client performs lease accounting going forward impacts this audit and all audits for the rest of the leases' duration. Clients will need help choosing Day Two methods.



**Perspective:** Don't waste time trying to understand and test client spreadsheets.

**Use NetLease for Auditors.**

The table below describes common areas of audit risk and how to address them with substantive procedures.



**Risk point:** Excel sheets lend themselves to formulaic errors as well as misapplication of guidance.



| ENTITY ELECTIONS                         | RISK ADDRESSED  | SUMMARY   | EXAMPLE PROCEDURES   | NETLEASE REPORT   |
|--|---|---|--|---|
| <b>Lease Calculations</b>                | Initial balances (ROU Asset and Lease Liability) are not properly calculated and recorded.    | <ul style="list-style-type: none"> <li>• Accuracy</li> <li>• Completeness</li> <li>• Existence</li> </ul> | Compare asset and liability balances calculated by NetLease to balances booked by client.  | <ul style="list-style-type: none"> <li>• Journal Entry Report: Lease Activity</li> <li>• Lease Balance Roll Forward Report</li> </ul> |
| <b>Lease Calculations</b>                | Lease expense is not properly recorded.   | <ul style="list-style-type: none"> <li>• Accuracy</li> <li>• Completeness</li> </ul>                      | Compare lease expense journal entries generated by NetLease to client provided lease expense journal entries.  | <ul style="list-style-type: none"> <li>• Journal Entry Report: Lease Activity</li> </ul>  |
| <b>Lease Calculations</b>                | ROU asset amortization is not properly recorded.  | <ul style="list-style-type: none"> <li>• Accuracy</li> <li>• Completeness</li> </ul>                      | Compare ROU amortization journal entries generated by NetLease to client provided ROU amortization journal entries.  | <ul style="list-style-type: none"> <li>• Journal Entry Report: Lease Activity</li> </ul>  |
| <b>Embedded Leases</b>                   | Embedded leases are not identified and recorded by client.                                    | <ul style="list-style-type: none"> <li>• Completeness</li> </ul>  | N/A  | N/A   |
| <b>Lease Classification</b>              | Leases are not properly classified as operating or financing.                                 | <ul style="list-style-type: none"> <li>• Accuracy</li> </ul>  | Enter applicable lease information into Classification tab in NetLease to obtain a system generated lease classification to compare to client provided classification. | N/A   |
| <b>Quantitative Footnote Disclosures</b> | Lease assets/ liabilities presented by client are not accurate and complete.                  | <ul style="list-style-type: none"> <li>• Accuracy</li> <li>• Completeness</li> </ul>                      | Compare NetLease generated disclosure reporting package to client provided footnote disclosures.   | <ul style="list-style-type: none"> <li>• Supplemental Balance Sheet Information</li> </ul>  |
| <b>Quantitative Footnote Disclosures</b> | Lease expense presented by client is not accurate and complete.                               | <ul style="list-style-type: none"> <li>• Accuracy</li> <li>• Completeness</li> </ul>                      | Compare NetLease generated disclosure reporting package to client provided footnote disclosures.   | <ul style="list-style-type: none"> <li>• Components of Lease Costs and Impairments</li> </ul>   |
| <b>Quantitative Footnote Disclosures</b> | The cash-flow information presented by the client is not accurate and complete.               | <ul style="list-style-type: none"> <li>• Accuracy</li> <li>• Completeness</li> </ul>                      | Compare NetLease generated disclosure reporting package to client provided footnote disclosures.   | <ul style="list-style-type: none"> <li>• Supplemental Cash Flow Information</li> </ul>  |
| <b>Quantitative Footnote Disclosures</b> | Future lease liabilities presented by the client are not accurate and complete.               | <ul style="list-style-type: none"> <li>• Accuracy</li> <li>• Completeness</li> </ul>                      | Compare NetLease generated disclosure reporting package to client provided footnote disclosures.   | <ul style="list-style-type: none"> <li>• Undiscounted Lease Maturity Waterfall</li> </ul>   |
| <b>Quantitative Footnote Disclosures</b> | Weighted average remaining lease term and borrowing rate are not properly recorded by client. | <ul style="list-style-type: none"> <li>• Accuracy</li> <li>• Completeness</li> </ul>                      | Compare NetLease generated disclosure reporting package to client provided footnote disclosures.   | <ul style="list-style-type: none"> <li>• Weighted Average Term</li> <li>• Weighted Average Rate</li> </ul>                            |

# Embedded leases



## What is an embedded lease?

Not all contracts that meet the accounting definition of a lease are obvious. Sometimes, a contract may need to be recorded as a lease even if it is not labeled "lease." A contract meets the definition of a lease if it "conveys the right to control the use of a specified asset."

### For example

Acme Co. may have entered a contract with Standard Co. to host its data on a dedicated server. If embedded within the agreement is the right for Acme Co. to direct the use of that specific server, the agreement could meet the definition of a lease and need to be recorded as a lease

Companies looking to be compliant with ASC 842 must review contracts and investigate whether those contracts contain embedded leases. These can be difficult to identify, so many companies have elected to engage consulting firms to assist in this process.

## Identifying your client's embedded leases

Embedded leases can be tough to find. They can be a real lease in a stack of contracts, to coin a phrase. These are the best practices for finding them:



Meet with the operational teams across the organization. Interview them to determine if their contract structures could potentially contain embedded leases.



Obtain and analyze a full listing of expense-account activity during a specified time period. Search for consistent outgoing transactions to a single vendor and analyze the nature of the expense.



Ask legal to help. The legal department can help in reviewing contracts and identifying potential embedded leases.



## Embedded lease examples

Here are some real-world examples of leases that fit the definition: conveys the right to control the use of a specified asset.



A company requires one truck dedicated to making deliveries only for that company.



A customer requires a dedicated production line from a manufacturer to produce a run of products.

### ***Is Software as a Service (SaaS) considered an embedded lease?***

Thankfully, no. The right to use intangible assets is outside of the scope of ASC 842.

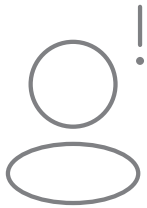
For intangible assets, look to the ASC 350 for proper accounting standards.

The background features several overlapping, semi-transparent shapes in light blue and teal. A large, light blue rounded rectangle is positioned at the top left. A teal circle is on the left side. Another teal circle is at the bottom right. A large, light blue rounded shape is at the bottom center. The text is centered in the upper half of the page.

# **Additional guidance**

# Auditing in Excel vs. NetLease for Auditors

We do not recommend auditing in Excel because of the extra risk it invites.



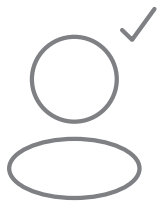
## Risks

- **Not scalable**
  - Need to create a custom lease schedule for any special conditions of the lease
- **No audit trail or visibility into activity and changes**
  - Excel version control does not provide full details
- **Difficulty organizing all documents required**
  - No central document repository
- **Difficulty auditing individual journal entries**
  - No control or automation around journal entries
- **Difficulty reporting**
  - No automation for reporting
- **Complexity of auditing lease modifications**
  - No automation around modifications or early terminations
- **High risk of errors and miscalculations**
  - Lack of automation invites human error

## Benefits of NetLease for Auditors

NetLease for Auditors creates a stable workflow for any number of leases at a fixed cost. Simply enter the lease-contract details and get complete amortization schedules and journal entries based on ASC 842, IFRS 16 and GASB 87 guidelines.

NetLease for Auditors:



### Benefits

- Predictable pricing standardizes audit cost by allowing unlimited users, clients and leases
- Saves time by standardizing audit procedures with complete amortization schedules
- Simplifies disclosure audit by creating out-of-the-box reports for disclosures
- Makes classification and modifications easy
- Produces sensitivity analysis for identifying client errors



**Perspective:** All sizes of audit firms benefit from NetLease for Auditors. Virtually all leases, even complex leases with early terminations or modifications, can be tested for accuracy.

# Excel vs. NetLease

It is worth your time to warn audit clients that the traditional Excel approach won't work with the complex requirements of ASC 842. Any cost savings they achieve will be outweighed by the drawbacks. Convincing your clients to implement a software solution has downstream benefits for both your client and your audit staff.

## For auditors:



### Risks of clients using Excel

- Ongoing lease accounting in Excel is difficult to audit
- Need to reverse-engineer client spreadsheets and calculations
- Modifications, terminations and other lease activities are prone to error
- No journal-entry automation
- No reporting available



### Benefits of NetLease

- Saves time by standardizing procedures around lease accounting
- Provides system-generated amortization schedules that require the client to think through the complete list of inputs required for accurate accounting
- Provides system-generated journal entries, including modifications and terminations
- Provides complete disclosure reporting
- Creates a central repository for lease documents
- Simplifies audit procedures
  - Incentivizes loyalty to the auditor because the next audit is simplified

# Excel vs. NetLease

## For audit clients:



### Risks of using Excel

- Complexity grows out of control if leases have any special conditions
- Difficult to perform at scale
  - Each lease needs its own accounting
- Prone to inaccuracy
  - Audit risk and ongoing accounting confusion
- Difficulty performing the three types of modifications and ROU impairments
- Time consuming



### Benefits of NetLease

- Improved accuracy and efficiency of lease accounting operations
  - Modifications
  - Terminations
  - Journal entries
  - Disclosure reports
- Saves time and resources with automation
- Simple reporting for better decision-making throughout the lease lifecycle
- Once they have been audited in NetLease for Auditors, leases do not need to be re-entered



**Perspective:** Both NetLease products are implemented and supported by CPAs and former auditors. Netgain brings four years of experience with software lease accounting. We show you how the calculations work so you can trust the system to eliminate accuracy risk.

[Set up a demo >](#)

