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Compilation Engagements
Implementation of the New Lease Standard

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In 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, *Leases*, codified in FASB *Accounting Standards Codification* (FASB ASC) 842, *Leases*. There are elements of the new standard that could impact almost all entities to some extent, although lessees will likely see the most significant changes. The standard is effective for nonpublic entities (as defined by the standard) for annual reporting periods beginning after December 15, 2021.

As a result of the new standard, practitioners will face significant challenges, not only in learning about and understanding the standard, but in performing effective compilation engagements. Advance consultation on the approach management may use, for the first year of implementation and beyond, to comply with the new standard is beneficial. These topical discussions between the practitioner and the client can be helpful in early identification of complex issues that could arise.

In this report, we address how the practitioner may comply with the requirements for a compilation engagement in the Statements on Standards for Accounting and Review Services (SSARSs), as they relate to the client's implementation of FASB ASC 842.

Practice Note*:* Before having conversations with clients about implementation of the new lease standard, practitioners need to make sure they have sufficient knowledge of the standard. See our previous reports for more information.

Preparing for Implementation

All entities that issue financial statements prepared in conformity with U.S. generally accepted accounting principles (U.S. GAAP) need to develop a plan for implementation of the lease standard. Lessees will need to recognize a right-of-use asset and a lease liability for virtually all their leases (other than leases for which the entity elects the short-term lease exemption). The liability will be equal to the present value of lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or financing. Operating leases will result in straight-line expense (similar to current operating leases) while financing leases with result in front-loaded expense pattern (similar to current capital leases). Classification will be based on criteria that are largely similar to those applied in current lease accounting, but without explicit bright lines.

CPEA Observation: Unlike the revenue recognition standard, which for the majority of entities resulted in additional disclosures and not a significant change in how revenue was recognized, the new lease standard will require balance sheet adjustment, in addition to significant additional disclosures. If they haven't already, clients need to start the implementation process as soon as possible due to the financial statement adjustments that will be required.

For a client to develop a plan for implementation, management will need to perform an assessment of existing leases and contracts to identify whether these arrangements qualify as a lease under the new standard. Under the new standard, the critical determination is whether a contract is or contains a lease because lessees are required to recognize lease assets and lease liabilities for all leases-finance and operating. This is the most significant change from legacy U.S GAAP (FASB ASC 840, *Leases*), which required capital leases to be recorded on the balance sheet and operating leases to be presented in disclosures only.

Once management has identified which contracts contain leases, they should compare those leases to the guidance in the new standard to determine the significant impacts and the related accounting. This assessment will vary by client based on the number and type of leases they have. In addition, they should review the transition and accounting policy options and make the appropriate elections based on their lease portfolio. The information obtained during this assessment will help management identify other impacts to the entity.

Part of a client's implementation of the new standard includes the recording of actual adjustments to financial statements to reflect the adoption as prescribed by the standard. All entities must use a modified retrospective transition method, with the only election being the date to which to apply the transition provisions. Entities have two choices: 1) the later of a) the beginning of the earliest comparative period presented in the financial statements and b) the commencement date of the lease (comparative method) or 2) the beginning of the period of adoption (effective date method). When initially issued, FASB ASC 842 did not include the effective date method. There are several key differences between the different transition provisions and further details can be found in our report **here.**

Assisting Your Client with Implementation

Over the years, many clients have looked to their accountants to directly assist them in understanding and complying with new accounting standards, such as the new lease standard. However, few previously issued accounting standards have had the significant balance sheet impact introduced by FASB ASC 842. The new lease standard is a fundamental change to how leases are recorded and results in significant balance sheet adjustments for almost all entities. Being mindful of the need to maintain independence (if required) when having conversations with clients regarding FASB ASC 842 may help avoid issues that could be troublesome for the practitioner and the client.

Practice Note: Independence is not required when performing a compilation in accordance with AR-C section 80, *Compilation Engagements.* However, the practitioner still must determine whether he or she is independent. If the practitioner is not independent, the compilation report must be modified to indicate the lack of independence.

The "Scope and Applicability of Nonattest Services" interpretation under the "Independence Rule" in the revised AICPA Code of Professional Conduct explicitly defines financial statement presentation, cash to accrual conversions, and performing reconciliations as nonattest services. These services are assessed alone and in combination with other services when assessing overall accountant independence. Provided management accepts responsibility and has the skills, knowledge, and experience to transition to and comply with the new standard, practitioners may be able to assist the client with the transition.

Practice Note: In the end, some clients may decide that using a special purpose framework to prepare the financial statements is a cost-effective alternative to adopting FASB ASC 842. The cash basis of accounting would focus on transactions and events that are derived from cash receipts and cash disbursements. The tax basis of accounting is based on the principles and rules for accounting for transactions under federal income tax laws and regulations. The AICPA's Financial Reporting Framework for Small and Medium-Sized Entities (FRF for SMEs) is based on the concepts of legacy U.S. GAAP and would require no change in accounting for leases and retains existing lease classifications (operating or capital). Ultimately, however, the use of a special purpose framework would depend on the users of the client's financial statements and whether those users would accept financial statements prepared using a framework other than U.S. GAAP. Keep in mind that financial statements prepared in accordance with a special purpose framework are required to provide informative disclosures similar to those required by U.S. GAAP.

What Level of Understanding Do You Need Regarding the Client's Leases?

According to AR-C 80, the practitioner should obtain an understanding of the applicable financial reporting framework and significant accounting policies used in the preparation of the financial statements. With regard to leases in financial statements prepared in accordance with U.S. GAAP, the practitioner's knowledge should include an understanding of FASB ASC 842 and how the client has implemented that guidance. Specifically, that may include knowledge about the following matters:

- The types and nature of the client's contracts and leases, including oral or implied contracts
- Whether the client has taken a comprehensive inventory of all existing leases and contracts and the processes used to take the inventory
- How the client identifies a lease under ASC 842 and how those leases are accounted for
- The transition method elected by the client and related transition adjustment
- Whether the client has adopted any of the available practical expedients
- The existence of any related party leases
- Prior accounting policies and practices related to leases including those related to disclosure of operating leases under FASB ASC 840
- Current process (if any) to apply FASB ASC 842 (remeasurements, modifications, new leases, terminated leases, etc.) after the transition adjustment (January 1, 2022 for most private companies)

Compilation Procedures

A compilation engagement is not an assurance engagement. In other words, the practitioner does obtain evidence in order to express an opinion or conclusion on the presentation of the financial statements or about their conformity to a particular financial reporting framework. Instead, the objective of a compilation engagement is to apply accounting and financial reporting expertise to assist management in the presentation of financial statements without undertaking to obtain or provide any assurance. Essentially, AR-C 80 requires that the practitioner read the financial statements in light of his or her understanding of the applicable financial reporting framework and the significant accounting policies adopted by management and consider whether such financial statements appear to be appropriate in form and free from obvious material misstatements.

Further, the practitioner is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the client. However, if the practitioner becomes aware that the records, documents, explanations, or other information, including significant judgments, provided by management are incomplete, inaccurate, or otherwise unsatisfactory, he or she should discuss this matter with management and request additional or corrected information.

CPEA Observation: Putting all of the above in plain-English—a compilation engagement requires an "intelligent read" of the financial statements and issuing a compilation report. The practitioner cannot ignore apparent accounting and disclosure deficiencies in the financial statements simply because the engagement "is only a compilation." While a compilation engagement does not require us to verify, corroborate, or review information supplied by the client, as CPAs, we do bring a certain level of knowledge to the table. If the financial statements are prepared using U.S. GAAP, we should have a requisite knowledge of U.S. GAAP and how that guidance would be applied to client financial statements. With the significance of FASB ASC 842 for most entities, it would be reasonable to expect that we would have a working knowledge of the lease guidance and client implications, especially to the balance sheet. Therefore, while we are not required to make inquiries or perform other procedures in a compilation engagement, we should be in a position, based on our knowledge of U.S. GAAP, generally, and FASB ASC 842, specifically, to be able to recognize when information supplied by the client appears to not conform to the new lease standard. If, on the basis of our knowledge of the client and its industry, the information does not conform to the new lease standard, we are required to determine the appropriate course of action. Also, depending upon the type of compilation engagement, it will be much more readily apparent as to whether the client has properly implemented FASB ASC 842. If the engagement is a compilation omitting substantially all disclosures, the financial statements that reflect the adoption of FASB ASC 842 could look very similar to financial statements prepared under FASB ASC 840 depending upon the presentation selected by the client, since the ROU assets and lease liabilities are not required to be separately identified on the face of the financial statements. If it is a compilation with disclosures, it will be much easier to determine whether the client has implemented the standard.

Question: If an accountant compiles financial statements with disclosures and operating leases are presented in disclosures only, what is the accountant's responsibility?

Answer: Since ASC 842 significantly changed the accounting and disclosure requirements for leases, it should be clear to the accountant whether the client has properly implemented ASC 842 based on the information provided to prepare the disclosures. If the information provided by the client is similar to the existing operating lease information disclosed under ASC 840, it would most likely indicate that the client did not properly implement ASC 842 and the accountant would have to take appropriate action, which is discussed in greater detail below.

Compilation Report Modifications

AR-C 80 does not require modification of the standard compilation report if the adoption of FASB ASC 842 is properly accounted for and disclosed in the financial statements. Nonetheless, practitioners may emphasize in a separate emphasis-of-matter paragraph that an accounting change has occurred. The following is an example of this optional paragraph:

> Emphasis-of-Matter
>
> As discussed in Note X to the financial statements, in 2022, the Company adopted FASB ASC 842, *Leases*.

The requirement in AR-C 80 differs from the guidance in AU-C 708, *Consistency of Financial Statements*, which indicates the auditor's report should include an emphasis-of-matter paragraph relating to the accounting change and instead leaves it up to the judgment of the practitioner. The professional responsibilities of a compilation engagement are different from those of an audit. However, if the accounting change is not properly disclosed or is not properly accounted for, the practitioner should modify the compilation report because of a departure from the applicable financial reporting framework.

In the course of performing the compilation, the practitioner may become aware that the client has not properly implemented FASB ASC 842. In that case, the following courses of action are possible if he or she believes that the lack of implementation results in material accounting and reporting deficiencies in the client's financial statements:

- Discuss with the client and advise that they should revise the financial statements by properly implementing FASB ASC 842 (AR-C 80.15)
- If the client does not revise the financial statements, decide whether a modification to the report would be adequate to indicate the deficiencies in the financial statements taken as a whole (AR-C 80.29)
- If modification of the report is not adequate to indicate the deficiencies in the financial statements as a whole, withdraw from the engagement (AR-C 80.32)

Practice Note: Failing to report a material departure from the applicable financial reporting framework is considered a significant deficiency for peer reviews performed under the AICPA Peer Review Program.

If the financial statements are not revised, the practitioner will need to consider whether modification of the standard report is adequate to disclose the departure. If the practitioner concludes that modification of the standard report is adequate, the departure should be described in a separate paragraph of the report under the heading "Known Departures From Accounting Principles Generally Accepted in the United States of America." The paragraph should include a description of the effects of the departure on the financial statements if such effects have been determined by the client or are known to the practitioner as the result of the compilation procedures. As noted above, if modification of the report is not adequate to indicate the deficiencies in the financial statements as a whole, the practitioner should withdraw from the engagement.

CPEA Observation: The practitioner is not required to determine the effects of a departure if management has not done so or if the effects are not known as a result of the compilation procedures. In such circumstances, the paragraph should indicate that such determination has not been made.

> Known Departure from Accounting Principles Generally Accepted in the United States of America
>
> As discussed in Note X to the financial statements, accounting principles generally accepted in the United States of America require the Company to record leases in accordance with requirements primarily codified in FASB Accounting Standards Codification section 842 which generally require that all leases are classified as either an operating or financing type lease and that a right of use asset and lease liability is recorded on the balance sheet. Management has not applied this principle of lease classification and, therefore, information about the nature, amount, timing, and uncertainty of leases, right-of-use assets and lease liabilities, and cash flows arising from leases may be misstated. The effects of this departure from accounting principles generally accepted in the United States of America on financial position, results of operations, and cash flows have not been determined.

Peer Review Impact

With the effective date for calendar year entities being financial statements for the year ending 12/31/2022, FASB ASC 842 implementation (or lack thereof) will significantly impact peer reviews beginning in 2023. As was seen with the implementation of FASB ASC 606, *Revenue from Contracts with Customers*, failing to implement FASB ASC 842 and/or failure to document the accountant's considerations related to FASB ASC 842 will result in a nonconforming engagement. Since FASB ASC 842 materially effects most entities, this could lead to multiple nonconforming engagements and quickly lead to a deficient peer review.

CPEA Observation: We recommend the practitioner include a memo to the file backed by an understanding of the entity and industry, which documents the practitioner's considerations as to the impact of FASB ASC 842 on the entity and whether it was properly implemented. Documentation of these considerations is key and could be the determining factor in deciding whether the engagement is nonconforming.

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