Review Engagements
Implementation of the New Lease Standard

By: Andrew Merryman and Russ Madray

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 review 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 will address how the practitioner may comply with the requirements for a review 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 will 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 only 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 not 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, (which is required in a review engagement) when having conversations with clients regarding FASB ASC 842 may help avoid issues that could be troublesome for the practitioner and the client.

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.

However, it may be more practical for some clients to engage a third party (for example, a consultant or another CPA firm) to assist them in making the required calculations to apply the provisions of FASB ASC 842. Nevertheless, the engagement of third parties does not reduce management’s responsibility for the transition or the practitioner’s responsibility to obtain sufficient appropriate review evidence regarding the presented financial information and disclosures.

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?

The objective of a review engagement performed under AR-C 90, Review of Financial Statements, is to obtain limited assurance as a basis for reporting whether the practitioner is aware of any material modifications that should be made to the financial statements for them to be in conformity with the applicable financial reporting framework. A review engagement is an assurance engagement as well as an attest engagement in which the practitioner accumulates review evidence to obtain a limited level of assurance.

According to AR-C 90, to perform the review engagement, the practitioner should possess or obtain an understanding of the industry in which the client operates, including the accounting principles and practices generally used in the industry. Further, the practitioner is required to obtain knowledge about the client sufficient to identify areas in the financial statements where there is a greater likelihood that material misstatements may arise and to design procedures to address those areas. The knowledge should include an understanding of (a) the client’s business and (b) the accounting principles and practices used by the client.

With regard to leases, the practitioner’s knowledge may include 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 FASB 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)
Suggested Inquiries Related to Leases

Based on the practitioner’s understanding of the industry, knowledge of the client, and awareness of the risks that the review report may not be appropriately modified, the practitioner should design and perform analytical procedures and make inquiries and perform other procedures, as appropriate, to obtain limited assurance as a basis for reporting whether there are any material modifications that should be made to the financial statements for the statements to be in accordance with the applicable financial reporting framework.

**CPEA Observation:** In the first year of implementation, analytical procedures over leases will be more challenging, especially to determine whether the client has properly implemented FASB ASC 842. However, analytical procedures are required in the performance of a review engagement and would need to be performed with respect to other elements of the financial statements.

There are additional tests of details the accountant can perform to obtain limited assurance regarding FASB ASC 842 implementation, however this report is limited to a discussion of inquiry procedures.

**Practice Note:** Inquiry is a fundamental technique used in a review engagement to collect evidence relevant to the financial statements. Although the process of inquiry is simple, successful use of the technique depends on the individual who makes the inquiries. Specifically, the inquiry procedures are most effective when the practitioner considers what questions to ask and pursues a significant line of questioning with appropriate professional skepticism. The quality of the review engagement is reduced if the practitioner performs inquiry in a mechanical fashion and accepts responses from entity personnel without being appropriately skeptical. In a review engagement, the inquiry process is an ongoing activity, reflecting the practitioner’s inquisitive nature and professional judgment. Based on the aforementioned requirement for the accountant to, “obtain knowledge about the client sufficient to identify areas in the financial statements where there is a greater likelihood that material misstatements may arise and to design procedures to address those areas”, we feel that a simple inquiry such as “Did you adopt ASC 842” is likely insufficient.

The following illustrative inquiries are not intended to serve as a program or checklist to be utilized with regard to leases; rather, they address areas where inquiries might be made in a review engagement. In addition, the practitioner may feel that it is necessary to make several inquiries in an effort to answer questions related to the issues addressed in these illustrative inquiries. The specific inquiries to be made are ultimately determined by the practitioner’s professional judgment:
1) Has FASB ASC 842 been implemented and if so, has management quantified the potential impact to the financial statements?
2) How does the entity use property, plant, and equipment in the ordinary course of business and has management reviewed the related contracts for lease implications?
3) What accounting policy elections have been made with respect to leases?
4) What was the process used to review existing contracts for lease implications?
5) Have any practical expedients been elected?
6) Has management obtained all information necessary for the new required disclosures?
7) What tools are used to track and account for leases (excel, accounting software, etc.)?
8) Have related party leases been reviewed for applicability with FASB ASC 842?
9) Based on responses to the above inquiries, more detailed inquiries such as those detailed below may be appropriate:
   a. How was the lease term determined?
   b. What discount rates are used?
   c. What amounts are included in lease payments for the ROU asset and lease liability
   d. How are nonlease components treated?
   e. What process was used to determine the lease classification (operating or financing)?
10) Has the entity applied the transition provisions of FASB ASC 842 for the transition adjustment appropriately for existing leases?
11) How has the entity accounted for leases under FASB ASC 842 after the effective date including modifications, remeasurements, reassessments, and impairment?
12) What is the entity’s process for making the appropriate disclosures under FASB ASC 842, in particular those disclosures that are new (short term lease cost, variable lease cost, weighted-average discount rate and lease term, etc.)

Based on the responses to these inquiries, the accountant may need to perform additional follow up procedures, which may include the following:

- Obtain the entity’s inventory of leases. Reconcile to prior year lease disclosure and to listing of leases included in the entity’s transition adjustment.
- Select a sample of contracts not included in the lease inventory and review for potential lease implications under FASB ASC 842.
- Based on the inventory of leases, recalculate year-end balances in ROU lease assets and liabilities.

Suggested Management Representations Related to Leases

Written representations are necessary information that the practitioner requires in connection with a review of the client’s financial statements. Accordingly, similar to
responses to inquiries, written representations are review evidence. The specific written representations obtained will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. The following are examples of representations that are relevant to leases.

- Management has disclosed the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud (fraud includes intentional erroneous financial statements)
- Management has disclosed that it has performed a comprehensive inventory of its existing contracts for potential impacts of FASB ASC 842
- Management has provided all relevant information and access, as agreed upon in the terms of the review engagement
- Management believes (or does not believe) that significant assumptions used in making accounting estimates are reasonable

It is also important to tailor the representation letter to include additional appropriate representations from management relating to matters specific to the client’s business or industry. Accordingly, the practitioner may consider it useful to obtain written representations concerning specific lease issues, such as the terms and conditions of:

- Related party leases
- Existence of any sale/leaseback arrangements
- Short-term leases

Review Report Modifications

AR-C 90 does not require modification of the standard review report if the adoption of FASB ASC 842 is properly accounted for and disclosed in the financial statements. Nonetheless, the practitioner may emphasize in a separate emphasis-of-matter paragraph that an accounting change has occurred. When an emphasis-of-matter paragraph is included in the review report, the practitioner should:

- Include it immediately after the accountant’s conclusion paragraph
- Use the heading “Emphasis of a Matter” or other appropriate heading
- Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements
- Indicate that the accountant’s conclusion is not modified with respect to the matter emphasized

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*. Our conclusion is not modified with respect to this matter.

**CPEA Observation:** The requirement in AR-C 90 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. The professional responsibilities of a review 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 review report because of a departure from the applicable financial reporting framework.

In the course of performing the review, 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 the practitioner believes that the lack of implementation results in material accounting and reporting deficiencies in the client’s financial statements:

- Persuade the client to revise the financial statements by properly implementing FASB ASC 842
- Decide whether a modification to the report would be adequate to indicate the deficiencies in the financial statements taken as a whole
- If the practitioner determines the effects of the departure are material but not pervasive to the financial statements, a qualified conclusion should be issued
- If the practitioner determines the effects of the departure are material and pervasive to the financial statements, an adverse conclusion should be issued
- 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

**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.

**CPEA Observation:** Due to the significant impact of FASB ASC 842 to the balance sheet at many entities, not implementing FASB ASC 842 may result in a material misstatement to the financial statements and a qualified or adverse conclusion may be appropriate. The impact of U.S. GAAP departures related to the implementation of FASB ASC 842 may very well differ from the impact of U.S. GAAP departures related to the implementation of FASB ASC 606, *Revenue from Contracts with Customers*, because for many entities the adoption of FASB ASC 606 primarily resulted in new disclosures and had little effect on the recognition and measurement of revenue amounts in the financial statements.
Qualified Report

Based on the results of analytical procedures and inquiries, if the accountant concludes that the effects of the departure are material but not pervasive to the financial statements, a qualified conclusion should be issued. The following is an illustration of a sample qualified conclusion paragraph.

**Basis for Qualified Conclusion**

As disclosed in Note X to these financial statements, accounting principles generally accepted in the United States of America require that all leases are accounted for in accordance with FASB ASC 842, *Leases*. Management has informed us that the Company’s operating leases have been expensed with no resulting balance sheet impact, and that 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.

**Adverse Conclusion**

If the accountant concludes that the effects of the departure are material and pervasive to the financial statements, an adverse conclusion should be issued. The following is an illustration of a sample adverse conclusion paragraph.

**Basis for Adverse Conclusion**

As disclosed in Note X to these financial statements, the Company has not adopted FASB ASC 842, *Leases*. Existing operating leases were expensed as incurred with no resulting impact to the balance sheet. Under accounting principles generally accepted in the United States of America, operating leases should be recorded on the balance sheet with a right-of-use asset and lease liability. Had XYZ Company properly adopted FASB ASC 842, many elements in the accompanying financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to adopt FASB ASC 842 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, FABS ASC 842 implementation (or lack thereof) will significantly impact peer reviews beginning in 2023. As was seen with the implementation of FASB ASC 606, 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 affects most entities,
this could lead to multiple nonconforming engagements and quickly lead to a deficient peer review.

**CPEA Observation:** Unlike FASB ASC 606, adoption of FASB ASC 842 will often result in a material balance sheet impact. As discussed above, the practitioner must do more than just ask the client if they have implemented FASB ASC 842. Because this standard has a material impact to several financial statement areas for many entities, the practitioner will be performing more procedures during the first year of implementation than what is normally performed during a review engagement. 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, what procedures were performed, and a conclusion as to whether it was properly implemented. Documentation of these considerations is key and could be the determining factor in deciding whether the engagement is nonconforming.