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Understanding ASC 842 leases: A guide for dairy producers

This new standard introduces significant changes to the way leases are recognized and measured, impacting financial statements and disclosure requirements.

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As a dairy producer, navigating the complexities of financial reporting can be a daunting task. One area that requires special attention is the accounting for leases, particularly with the implementation of the Accounting Standards Codification 842 (ASC 842). ASC 842 became effective for non-public entities with the annual financial statements due for the period ending Dec. 31, 2022. In this article, I will analyze ASC 842 and provide a comprehensive guide to help you understand and comply with these regulations.

Overview of ASC 842

ASC 842, which was issued by the Financial Accounting Standards Board (FASB), replaces the previous lease accounting standard, ASC 840. Its primary objective is to improve transparency and comparability in financial reporting by requiring lessees to recognize lease assets and liabilities on their balance sheets. Under the new standard, leases are classified as either finance leases or operating leases.

Identifying a lease

The determination of whether a financial arrangement is defined as a lease is made at the inception of the contract. ASC 842 states that a contract is (or contains) a lease if it conveys the right to control the use of the asset for a long period of time in exchange for consideration. “Control” is further defined as having both the right to obtain substantially all of the economic benefits from use of the asset and the right to direct the use of the asset. Typically, a finance lease will contain a purchase option at the expiration of the lease. Under an operating lease, the ownership of the asset is not expected to be transferred from lessor to lessee at any time.

Recognition and measurement of leases

Under ASC 842, both finance leases and operating leases are recorded on the balance sheet as right-of-use (ROU) assets and liabilities. Under a finance lease, which transfers substantially all of the risks and rewards of ownership to the lessee, the ROU asset will represent the remaining useful life of the asset and the lease liability will represent the payments still due on the contract. Operating leases, on the other hand, only require the recognition of an ROU asset and a lease liability for the remaining contract terms, and these amounts usually mirror each other.

The ROU asset is initially measured at the present value of lease payments, adjusted for any lease incentives or initial direct costs. The lease liability is measured in the same manner. Subsequent measurement of the lease liability involves interest expense recognition and amortization of the ROU asset over the lease term.

Practical implications for dairy producers

The implementation of ASC 842 leases has several practical implications for dairy producers. Firstly, the recognition of lease assets and liabilities on the balance sheet could impact key financial ratios, such as debt-to-equity ratios and return on assets. Lenders and investors may interpret these changes differently, so it is important to communicate and explain the impact of the new standard to stakeholders.

Secondly, dairy producers will need to establish robust systems and processes to identify and account for leases accurately. Lease agreements, including both written and verbal contracts, must be thoroughly evaluated to determine if they meet the criteria for lease classification. This also includes service contracts and equipment leases that may have embedded leases within them. It is essential to maintain detailed records of lease terms, payments and other relevant information to support the financial statement disclosures.

ASC 842 was amended in March 2023 to address the common issue with leasing arrangements between related parties. This update is effective for all entities with a fiscal/calendar year beginning after Dec. 15, 2023, but early adoption is permitted. As many dairy producers own and operate their dairy and dairy land in separate entities, it is important to recognize that even if a written lease agreement is not in place, the transaction may still be subject to ASC 842. The standard requires that entities determine whether a related party arrangement between entities under common control is defined as a lease. Common control refers to a condition where two or more parties, either through ownership, management, contract or otherwise, are under the control of one group or person. This is typical in family groups. If the arrangement is determined to be a lease, it must be classified and accounted for on the same basis as an arrangement with an unrelated party. Furthermore, if there are no written terms in regard to the transaction, then the practical expedients cannot be utilized and the entity must evaluate the enforceable terms and conditions.

The updated guidance also specifies how leasehold improvements should be treated for leases between entities under common control. Leasehold improvements made by the lessee in a common control arrangement must amortize the cost over the useful life of the improvements. If the lessor obtains the right to control those improvements, the amortization period may not exceed the amortization period of the common control group. Additionally, when the lessee no longer controls the underlying asset, those costs must be transferred to the lessor through an adjustment to equity.

Enhanced disclosures and footnote requirements

ASC 842 also introduces enhanced disclosures and footnote requirements. These disclosures provide users of financial statements with additional information about a company's leasing activities. Dairy producers must disclose qualitative and quantitative information, such as lease terms, cash flows and significant judgments used in applying the standard. The objective is to provide stakeholders with a clearer understanding of the company's lease obligations and commitments.

Implementation challenges and considerations

Implementing ASC 842 leases may present certain challenges for dairy producers. The most significant challenge lies in identifying and evaluating all lease arrangements, including embedded leases within service contracts or equipment leases. Lease terms, such as renewal and termination options, must be carefully considered to ensure accurate measurement and classification.

Additionally, the adoption of new accounting software or system upgrades may be required to effectively track and account for leases under the new standard. Collaboration between accounting and operational teams is crucial to ensure all leases are captured, and the necessary data is available for accurate financial reporting.

ASC 842 has brought significant changes to lease accounting, requiring dairy producers to recognize lease assets and liabilities on their balance sheets. Compliance with the new standard requires a thorough understanding of lease classification, recognition, measurement and enhanced disclosure requirements. By taking the time to grasp the intricacies of ASC 842 and implementing appropriate systems and processes, dairy producers can navigate the complexities of lease accounting and ensure compliance with the regulations while providing stakeholders with transparent financial information.

Remember, seeking guidance from accounting professionals with expertise in lease accounting can be invaluable in achieving a smooth transition and maintaining accurate lease records.