



# ASC 842 AND IFRS 16: PREPARING FOR YOUR FIRST AUDIT

7 Steps to a Pain-Free Audit



# Introduction

Now that most of your leases are disclosed on your balance sheet, expect your first audit to be intense. What can you do to make the process go as smoothly as possible? How can you prevent headaches and roadblocks?

What does your PBC (prepared by client) list look like? What kinds of questions will your auditors ask? What are the questions you need to be prepared to answer?

This guide will walk you through each step you need to take to ensure a pain-free process. When you're done, you should be able to work much more seamlessly with your auditors. You may even find new efficiencies that can improve your overall audit process.

Think Like an Auditor	<b>3</b>
Ensure Completeness of Your Lease Inventory	<b>5</b>
Identify Which Policies You Will Use	<b>6</b>
Document Your Internal Controls	<b>8</b>
Notify Other Departments	<b>9</b>
Evaluate and Prepare Your System(s)	<b>11</b>
Do a Test Run	<b>12</b>
How to Avoid Common Mistakes	<b>13</b>
Efficiency Tips	<b>13</b>



## Step 1: Think Like an Auditor

When you're on the "client side," as auditors call it, you may view the audit process as a necessary, but unpleasant ritual. And sometimes, those feelings can be projected on the team of auditors.

Beginning with a sense of frustration can lead to complications down the line. Put yourself in your auditors' shoes. What would make their processes go more smoothly? Which issues do they want to avoid?

### The More Your Auditors Know Up Front, The Better

You'll find that you and your auditors want similar things. Just as it can be frustrating for you to respond to requests for missing information or clarification on your data, they find it frustrating to have to request and wait for that information.

Prevent these mutual headaches by taking the following steps:

- Ensure your records are complete from the start.
- Be comfortable explaining your judgement calls.
- Provide your auditors with access to your software, if you're using one.

**ASC 842 AND IFRS 16:**

**PREPARING FOR YOUR FIRST AUDIT**





## The Auditor's Process

The next step to thinking like an auditor is understanding their process. Here are the steps your auditors will take to evaluate your leases:

- 1 Request any leases that have been added since your last audit. They'll be looking for any leases you added in the last year, in addition to any amendments that have been added to older leases.
- 2 Examine all of your accounts, particularly rent expense, and ensure that your calculations are correct. For most companies, rent expense is the primary account relevant to leases. Your auditors may recreate and recalculate your amortization schedules and compare them to yours to verify accuracy.

Whether they test your entire lease population or just a portion of it is based on your lease volume and the sampling methodology used by the auditors. If you have a large number of leases, they will take a sample of those for testing.

- 3 Review your policies. ASC 842 and IFRS 16 require you to make judgement calls such as materiality thresholds, practical expedients (more on that later), etc. Your auditors will review these policies. Ideally, you've been communicating with them as you go, notifying them of each policy as you implement it.

In the event you haven't been notifying them along the way, we recommend that you provide them with your policies at the beginning of the audit.



## Step 2: Ensure Completeness of Your Lease Inventory

Your auditors will be checking for completeness – whether you have properly disclosed all of your lease obligations. In our Transition Guide, we outline the steps you need to take to ensure your lease inventory, and the data you collect, is complete.

### Let's recap those steps here:

1. Create a policy.
2. Identify a point person to head the transition.
3. Identify the potential departments in your company that would have or know about any leases or any leased assets.
4. Choose a point person in each department to work on the transition project.
5. Get a listing of all leased assets.
6. Identify all your locations, including owned properties. Choose a point person to head the transition at that location.
7. Send out a template for the point person from each location to complete.
8. Gather details of the 5-year lease commitments disclosed in your notes to the financial statements from the financial reporting department.
9. Get the details of your company's deferred rent (straight-line) schedule for each asset.
10. Get the details of rent expense for the most recently completed year-end audit.
11. The transition point person should reconcile the data gathered in Steps 5-7 to eliminate duplicates.
12. Review the information obtained in Steps 8-9 and compare to the listing from Step 11.
13. Calculate straight-line rent expense (using the possession date, end date and payment information).

Have you missed any of the steps outlined here? Now's the time to go back and complete them.

## Your Completeness Checklist:

- A complete inventory of your leases, and any amendments made to original contracts
- Amortization schedules for each lease
- A list of the policies you plan to use, which we'll walk you through in the next section



**ASC 842 AND IFRS 16:**

**PREPARING FOR YOUR FIRST AUDIT**



## Step 3: Identify Which Policies You Will Use

With all of your lease documents pulled together, the next thing you need to do is develop and document your policies. As you know, ASC 842 and IFRS 16 represent a shift from rules-based accounting to principles-based accounting.

You've had to make a lot of judgement calls based on your interpretation of the Boards' guidance. Take credit for your conclusions and document them to make it easy to communicate your policies internally and to your auditors.

Determine these policies up front, apply them consistently, and tell your auditors before it's time for them to review your financials.



### Tip

Click below to read more on how to determine your policies.

- [Discount and Borrowing Rates under IFRS 16 and ASC 842 Explained](#)
- [In Plain English: ASC 842 and IFRS 16 Practical Expedients](#)

### Materiality

Do you have a materiality threshold for which leases you're reporting? If you report under IFRS, any leases with assets that have a fair value of less than \$5,000 – alone or in the aggregate – are exempt from being presented on your balance sheet.

Companies reporting under GAAP do not have such an exemption, but you can create your own policy for small-ticket items based on materiality provisions allowed. This approach is similar to a company developing a fixed asset capitalization policy. This is another topic we discuss in depth in our Transition Guide.

### Discount Rates

Determining which discount rate you will use is one of the most complex aspects of the new standards. Once you have determined the discount rate that you plan to use, document the logic behind your decision, and be prepared to explain it to your auditors.

[Read our blog on discount rates here.](#)

### Practical Expedients

Electing practical expedients seems like a simple decision because each of the expedients can save you time and energy. But, it's important to closely examine each expedient and determine whether you will apply



it, and how. Some can be elected by class of asset, so you need to be clear if you're electing a practical expedient for some asset classes but not others.

[Read our blog on practical expedients here.](#)

## Current vs. New Policies

Another thing you need to do is to compare your policies under the old standards to your new policies under the new standards and make sure your system can reconcile them.

### Here's an example:

Let's say you have a lease in which ownership of the asset transfers to you once the lease is complete or there's a bargain purchase option. That lease meets the criteria of a capital/finance lease, so you account for it similarly to how you would if it were an owned asset.

There are multiple ways to depreciate this asset. Some companies use the double declining method or some method other than straight-line to depreciate their owned assets. Under the new standards, the required method is the straight-line method unless you can prove that another method is appropriate.

Therefore, when you transition finance leases from the old standards to the new ones, you could potentially have a change in your accounting policy. In the scenario above, the calculation of depreciation expense would change, based on the change from the double declining method to the straight-line method.

If that's the case, your software needs to be able to adapt based on the policy change. This is the kind of nuance that you need to be aware of as you review your policies and system standards.







## Step 4: Document Your Internal Controls

Internal controls are critical for all companies, but publicly held corporations are under more scrutiny. Section 404 of the Sarbanes-Oxley (SOX) Act requires that managers of these companies assess their internal controls, and that their auditors report on that assessment.

**Your auditors will be looking for the following documentation of your internal controls:**

- Who is responsible for managing your lease data
- How you are tracking changes to leases
- Your protocols for segregation of duties
- Whether you have a physical trail that can be reviewed

### Software and Internal Controls: A Closer Look

Your internal controls must be supported by the lease accounting tool(s) you use. These software features will ensure that your controls are up to par:



**Role-Based Access:** Restrict who can make changes to leases to prevent errors from being introduced into the system.



**Lease History Documentation:** The system should show who changed each lease, when the change was made, what was changed, and who approved it.



**Data Entry Validation:** All leases entered and all changes made to each lease must be reviewed and approved by a user other than the one responsible for making the entry/change.



**Locking Journal Entries:** If a transaction is made in the field after the books have been closed, your software should freeze the journal entries that were posted, identify the adjusting entries, and post the differences in a subsequent period.



Companies that use Excel for lease accounting may find it difficult to meet these criteria. You will need to develop your own system to track changes and rely on everyone involved to honor that system at all times.

Should you or your auditors encounter an error in your data, you should be prepared for a potentially cumbersome investigation process.



## SOC Reports

Ask potential vendors whether they have an up-to-date System and Organization Controls (SOC) report. SOC reports are written by third-party CPAs that have tested a vendor's software to verify that it performs as intended.

In short, a SOC report demonstrates that the policies and procedures surrounding the software are functioning properly. Any lease accounting software vendor worth your time should have one.

### Step 5: Notify People in Other Departments Ahead of Time that You May Be Requesting Information

If you follow our Transition Guide, you should have built an interdepartmental team with representatives from procurement, IT, real estate/facilities, supply chain, and other departments with heavy leasing obligations.

That team will continue to be integral after your transition is complete, especially as you gather the documents you need for your audit.

**ASC 842 AND IFRS 16:**

**PREPARING FOR YOUR FIRST AUDIT**



## Train Colleagues So They Can Identify Leases

You alone won't be able to review every single contract your company signs. Instead, it makes more sense to help your colleagues in other departments identify which contracts contain leases.

## Develop Your Document Requisitions Process

How will you gather the documents you need from other departments? Develop a process to ensure that you have a methodical way to compile the documents you need. Consider using some of these processes to streamline your efforts:

- Create a dedicated email address for lease document submissions.
- Develop a naming convention for files so they're easy to identify.
- Store all files in one searchable database so you and your auditors can easily retrieve them.

## Make Sure You Look at All Contracts

With embedded leases going on the balance sheet, there's no shortcut to ensuring that you've captured them all. You need to review all of your contracts. This is why training colleagues on how to identify leases is so important.

Click Below to Read More About Identifying Embedded Leases

**HOW TO FIND AND ADDRESS EMBEDDED LEASES**

**ASC 842 AND IFRS 16:**

**PREPARING FOR YOUR FIRST AUDIT**





## Step 6: Evaluate and Prepare Your System(s)

System functionality and integrations are a key piece of the compliance puzzle. You do a lot of hard work to prepare your financials. It's important that your software simplifies your work, instead of making it more complicated.

### Your General Ledger

#### New Lease Accounts

Do you need to create new accounts within your GL system? This is important because some of the required accounts have different foreign currency implications. Some of the new accounts a company may add are:

- ROU asset
- Short-term operating lease liability
- Long term operating lease liability

#### Foreign Currency Considerations

Let's take a closer look at the first account, for example: The ROU asset is deemed a non-monetary asset while the lease liabilities are deemed monetary liabilities. The implications for global companies are significant because the non-monetary assets have a re-measurement effect.

**ASC 842 AND IFRS 16:**

**PREPARING FOR YOUR FIRST AUDIT**



The ROU is remeasured (from local to functional) at historical rates while the monetary liability is remeasured at current rates. Your GL system needs to be able to account for this scenario appropriately.

### Other Considerations

If your leases contain nuances like percentage rent or if you operate using 13-period calendars, your software should be able to accommodate them.

### Give Your Auditors Access to Your Software

We highly recommend that you provide your auditors with a login to your software system so they can access data without having to request it. Taking this step will save time and reduce frustration for everyone.

If you use Excel, you will need to set aside time to train your auditors on the way your spreadsheets have been set up and calculated. They deal with several clients, all of whom use Excel in different ways. This will add time to your auditing process, so be prepared for that.

## Step 7: Do a Test Run of Required Audit Reports and Disclosures to Perform Your Own Internal Audit

Practice makes perfect. Identify any flaws in your processes or systems by doing a practice close.

Make sure you're able to produce the required journal entries and disclosures prior to year-end. Also check that you have complete and accurate amortization schedules.

Doing a test run will enable you to fix any errors or fill gaps where you may have missing information. Once your test run is complete, and you've remedied any issues that it brought to light, you're ready for your audit.





## How to Avoid Common Mistakes

As you walk through the steps in this guide, there are some steps you can take to avoid common pitfalls.

Start talking to your auditors before your audit. The fewer surprises your auditors encounter, the fewer questions they'll have for you. You'll have better peace of mind knowing that they've given their blessing on your judgement calls and interpretation of the standards.

Verify that your accounting is accurate under ASC 840 and IAS 17. Even if you elect the practical expedients that allow you to not reassess your leases or embedded leases, those expedients assume that your lease inventory is already complete and that your leases are already properly classified.

Verifying that your accounting is correct under the old rules will enable you to catch errors that may have been missed due to employee turnover, misinterpretation of the rules, etc. It doesn't matter what was done in the past. Cover your bases so you understand your books today, inside and out.

Be prepared to explain your judgement calls. We've noted this before, but we want to stress how important it is to feel comfortable understanding each judgement call that you make. If you have taken the time to document these positions, it can streamline the process and minimize confusion. You can't predict which issues your auditors will have questions about. They don't want to catch you off guard, but their inquiries might seem to come from left field. Be ready to respond.

## Efficiency Tips

Make your plan and stick to it. There's an old saying that goes, "Failing to plan is planning to fail." An orderly, deliberate process will lead to a straightforward, cost-efficient audit with no surprises.

Open lines of communication with departments that lease assets. You need strong interdepartmental relationships to ensure that your lease inventory is complete. Simplify your processes as much as possible for your colleagues in other departments. Identify the best channels of communication to touch base consistently. The benefits of streamlining collaboration with them will be well worth the effort.

Use tools that make you more efficient. If you have ten leases or more, you should invest in lease accounting software. However, not all software is created equally. There are key features you should look for to ensure that you choose a software that actually saves you time.



- Can your auditors access it? As we noted in Step 1 and Step 6, giving your auditors a login to your software of choice saves an immense amount of time. Instead of having to ask you for information, they can access it themselves. Choose a software with an easy-to-use interface so they can feel comfortable navigating it with minimal training from you.
- Does it have custom reporting features? Again, this will help your auditors tremendously. They can create their own reports, such as leases added in the last 12 months, to make it easier on themselves and you.
- Can it export to Excel? While we don't advise that you use Excel for lease accounting, it does have its place in the auditing process. Make sure that you can export data to Excel; your auditors will need those files for their workbooks.
- Does it make it easy to find lease agreements and amendments? Maintaining lease documents, whether they are hard copy documents or stored on a server, requires organization and storage space. Digging through files takes up a lot of time, and that can cause your costs to spiral. The right lease accounting solution should eliminate the need for paperwork and make finding lease documents easy for you and your auditors.

## LEASEQUERY MAKES YOUR POST-TRANSITION AUDIT PAINLESS

### Schedule a consultation and demo to see:

- A comparison of financial statements under ASC 840/IAS 17 vs. ASC 842/IFRS 16
- Complete disclosures required by regulators and auditors
- Built-in controls for data accuracy
- How to enter a lease in minutes, including all pertinent details
- How the system distinguishes between capital/finance and operating leases
- Customizable and standardized reports
- How to transition journal entries from ASC 840/IAS 17 to ASC 842/IFRS 16



### Schedule a Consultation and Demo

LeaseQuery.com | 1-800-880-7270