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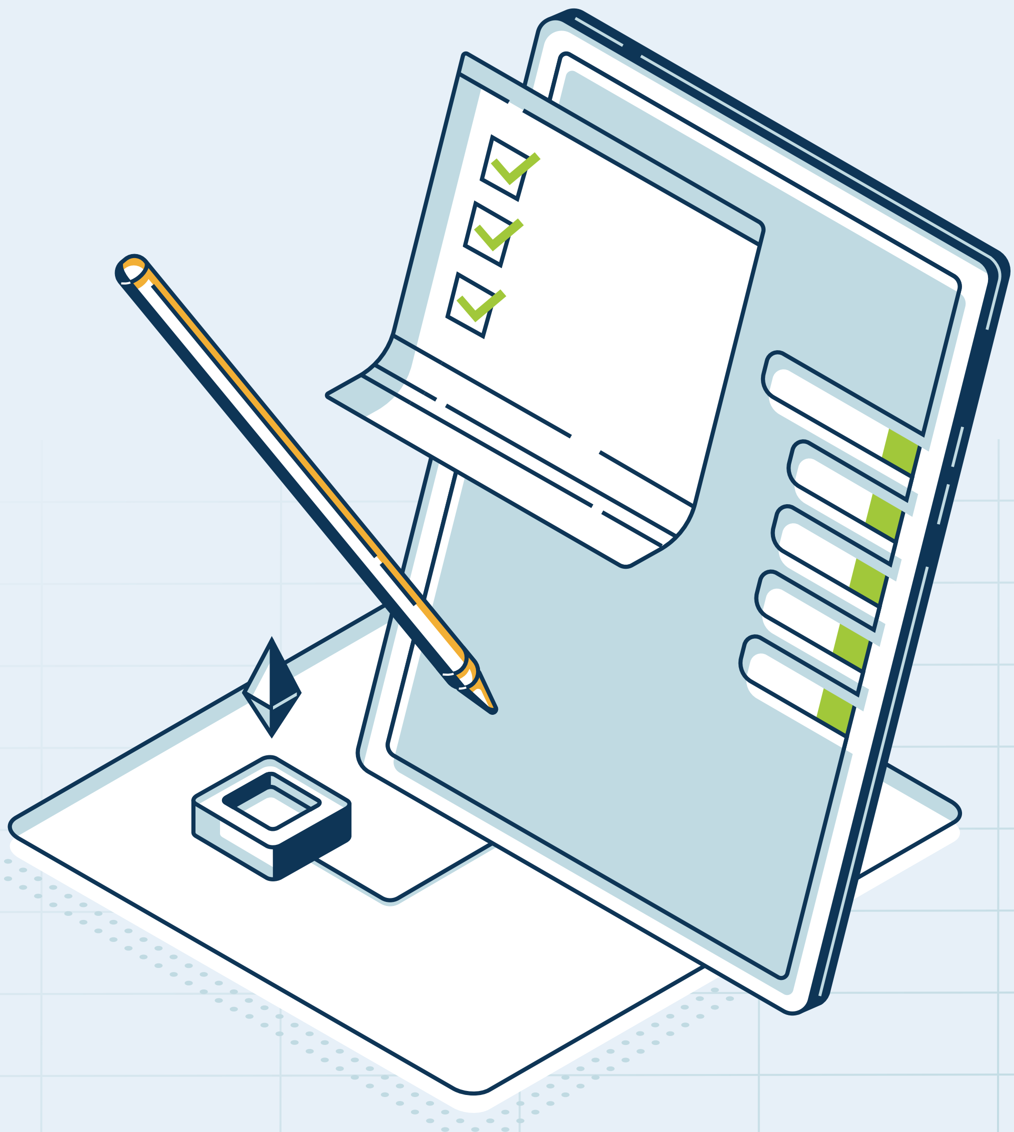
ASC 842 and IFRS 16 Audit Guide and Workbook



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Introduction

Welcome to the ASC 842 and IFRS 16 Audit Guide & Workbook!

This resource is designed to help you prepare for your upcoming audit and ensure a smooth and efficient process. By following the steps and interactive exercises in this workbook, you'll be well-equipped to handle auditor questions, address potential roadblocks, and proactively prepare key information.

6 Steps to a More Efficient Audit

1. Think like an auditor
2. Ensure completeness of your lease inventory
3. Identify which policies you use
4. Document your internal controls
5. Notify people in other departments ahead of time that you may be requesting information
6. Evaluate and prepare your systems

Whether you're facing a routine audit or switching auditors, follow along for a breakdown of each step, and you'll not only feel more prepared but also discover ways to make your overall audit process more efficient.

STEP 1

Think Like an Auditor

To effectively prepare for an audit, it's important to understand the auditor's perspective and anticipate their needs. By proactively addressing potential questions and concerns, you can ensure a smoother and more efficient audit process.

Auditor Perspective

1. Put yourself in the auditors' shoes. What are their primary objectives when auditing for lease accounting?
2. What questions might they ask and what information might they need to see?
3. How can you proactively address potential roadblocks or concerns before your audit begins?

Key Considerations

- **Complete and organized records:** Ensure your lease documentation is readily available and well-organized.
- **Clear explanations:** Be prepared to explain your lease accounting policies and judgments clearly and concisely.
- **Software access:** If you're using lease accounting software, grant auditors access to the system to streamline their review process.

The Auditor's Process

To effectively prepare for your audit, it's essential to understand the typical steps auditors take when evaluating your lease accounting. This will help you anticipate their needs and proactively address potential questions or concerns.

1. **Check for completeness.** Auditors will request any leases that have been added since your last audit. They'll be looking at or doing periodic testing on those, in addition to any amendments executed on older leases.

2. **Examine all your accounts,** particularly rent expense, short- and long-term lease liability, and right-of-use assets, and ensure 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.

   The extent of your lease testing — whether it's the entire population or a sample — depends on the number of leases you have and your auditors' sampling method.

3. **Review your policies.** ASC 842 and IFRS 16 required you to make judgment calls around such topics as materiality thresholds and the definition of "reasonably certain" for your organization. Review these policies ensuring they are still reflective of your current assumptions and business practices. If changes are required, your auditors will need to review these policies. Ideally, you've been communicating with them throughout the year, notifying them of each policy change as you implement it.

> **Note:** In the event you haven't been notifying your auditors along the way, we recommend you provide them with your updated policies prior to the audit.

The Auditor’s Process

Reflection

How confident are you in your ability to address the auditor’s questions and provide the necessary documentation for each step of the audit process?

What steps can you take to improve your preparedness in any of these areas?

Quick Reference Checklist

- [ ] Gather and organize all lease documentation.
- [ ] Prepare clear explanations of lease accounting policies and judgments.
- [ ] Grant auditors access to your lease accounting software (if applicable).
- [ ] Review and update lease accounting policies.
- [ ] Communicate policy changes to auditors throughout the year.
- [ ] Anticipate auditor questions and prepare comprehensive answers.
- [ ] Ensure all lease data and calculations are accurate and readily available.

STEP 2

Ensure Completeness of Your Lease Inventory

One of the auditor's primary focuses will be checking for completeness — ensuring that you have properly disclosed all your lease obligations. This means having a reliable process for identifying and capturing new leases as they occur.

Lease Inventory Checklist

- [ ] **Review your current lease identification policy.**
  - Does it clearly define what constitutes a lease?
  - Does it outline how new leases are identified and recorded?

  Action Item: If you don't have a policy, create one! If you do, review and update it as needed.

- [ ] **Identify a point person responsible for managing the lease inventory.**
  - Who in your organization has the best overview of lease-related activities?

  Action Item: Assign this responsibility clearly to ensure accountability.

- [ ] **Brainstorm which departments might have information about leases.**
  - This could include departments like procurement, IT, real estate, facilities, or legal.

  Action Item: List the departments in your organization that might handle leases.

- [ ] **For each department, identify a point person to contact regarding lease information.**

  Action Item: Add the contact person's name and contact information next to each department.

STEP 2

Ensure Completeness of Your Lease Inventory

Lease Inventory Checklist

- [ ] **Develop a process for gathering lease information from these departments.**
  - This could involve regular meetings, email updates, or access to a shared database.

  Action Item: Create a standardized template or form for departments to submit lease information.

- [ ] **Compile a list of all your company's locations, both owned and leased.**

  Action Item: Create a separate list of locations, including addresses and contact information.

- [ ] **Compare the lease information gathered from departments with your lease accounting software.**
  - Are there any discrepancies or missing leases?

  Action Item: Investigate any discrepancies and update your lease accounting software accordingly.

Reflection

- How confident are you in the completeness of your current lease inventory?
- What challenges do you anticipate in gathering lease information from different departments?
- How can you improve your lease identification and tracking process to ensure completeness in the future?

STEP 3

Identify Which Policies You Use

The shift to principles-based accounting under ASC 842 and IFRS 16 required significant judgment calls. Before your audit, revisit those decisions and ensure they still align with your current business practices. Document any changes and proactively communicate them to both your internal team and your auditors. We recommend regularly reviewing and updating these documents, keeping your auditors aware of any changes as they happen to foster transparency and ensure a smoother audit process.

Materiality

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 still exempt from being presented on your balance sheet. Companies reporting under US GAAP do not have such an exemption, but many chose to create their own policy for small-ticket items based on materiality provisions allowed. This approach is similar to a company developing a fixed asset capitalization policy.

Action Item: Document your materiality policy and any changes made since your last audit.

Discount Rates

Like everything else, discount rates should be reviewed periodically to ensure they are still applicable to your business and reflective of your economic position. Events such as mergers, acquisitions, or a change in credit rating among other factors can affect discount rates. Each time your discount rates are revisited, document the logic behind your decision to update them or keep them the same, and be prepared to explain it to your auditors.

Action Item: Review and update your discount rate documentation, including the rationale for any changes made.

STEP 3

Identify Which Policies You Use

Communication with Auditors

- How will you communicate any policy changes to your auditors?
- ***Best Practice:*** Proactively communicate policy changes to your auditors throughout the year, rather than waiting for the audit to begin. This fosters transparency and helps avoid potential issues during the audit.

Reflection

- How confident are you that your lease accounting policies are up-to-date and well-documented?
- What steps can you take to improve your policy documentation and communication with auditors?

Quick Reference Checklist

- [ ] **Materiality**
    - Document your materiality policy.
    - Detail any changes made since your last audit.
- [ ] **Discount Rates**
    - Review and update discount rate documentation.
    - Include the rationale for any changes made.
- [ ] **Communication with Auditors**
    - Establish a process for communicating policy changes to auditors.
    - ***Best Practice:*** Communicate changes proactively throughout the year.

STEP 4

Document Your Internal Controls

Strong internal controls are essential for accurate and reliable lease accounting. Your auditors will want to see documentation that demonstrates how you manage and protect your lease data.

Internal Controls Assessment

- Who is responsible for managing your lease data?
- How are you tracking changes to leases?
- What are your protocols for segregation of duties?
- Do you have a physical or electronic audit trail that can be reviewed?

Relying on Excel for lease accounting can make it tough to meet these criteria. You'll need to create and maintain your own system for tracking changes, and depend on consistent adherence from everyone involved. Should you or your auditors encounter an error in your data, be prepared for a potentially complex and time-consuming investigation.

Software and Internal Controls: A Closer Look

Does your lease accounting software support the following features?

- [ ] **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 original journal entries posted, identify the adjusting entries, and post the differences in a subsequent period.

STEP 4

Document Your Internal Controls

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.

Quick Reference Checklist

- [ ] **Internal Controls Assessment**
  - Document who is responsible for managing lease data.
  - Detail how lease changes are tracked (e.g., approvals, audit trails).
  - Outline protocols for segregation of duties.
  - Confirm the existence of a physical or electronic audit trail.

- [ ] **Software and Internal Controls**
  - **If using lease accounting software, ensure it supports:**
    - [ ] Role-based access controls.
    - [ ] Lease history documentation (who, when, what, and who approved).
    - [ ] Data entry validation (review and approval by a different user).
    - [ ] Locking journal entries to prevent changes after closing.
  - **If using Excel:**
    - [ ] Create and maintain a system for tracking changes.
    - [ ] Ensure consistent adherence to internal controls.

- [ ] **SOC Reports**
  - Obtain an up-to-date System and Organization Controls (SOC) report from your software vendor.

STEP 5

Notify Other Departments That You May Be Requesting Information

You might have already established an interdepartmental working group during your initial transition to the updated lease accounting standards. If not, now is an opportune time to do so. This team will be crucial for your ongoing lease accounting success, particularly as you prepare for your audit.

Check the boxes below to outline who should be included on your interdepartmental team:

- [ ] **Procurement/Legal:** They handle the negotiation and execution of lease agreements.
- [ ] **IT:** They manage technology systems that might store lease data
- [ ] **Real Estate/Facilities:** They oversee the physical spaces your company leases.
- [ ] **Supply Chain:** They may be involved in leasing equipment or other assets.
- [ ] **Any other departments with significant leasing activity:** This could include departments like marketing, sales, or operations, depending on your company's structure.

STEP 6

Evaluate and Prepare Your System(s)

Make sure your software is helping you, not hindering you, when it comes to lease accounting compliance. You put a ton of effort into getting your financials right. Your software should make that easier, not harder!

- **Accuracy is Key:** Your system needs to produce accurate calculations and reports.
- **Efficiency Boost:** The right software can automate tasks and save you time.
- **Audit Confidence:** Auditors will want to check how your system calculates lease accounting data. A reliable system makes this process smoother.

"Audits are a common part of our process activities. System report printouts make it much easier to show the auditors how the numbers were derived. The auditors love the automated system support as there is less room for human error. LeaseQuery checks the box as far as compliance goes."

LACEY GELSINGER, ESCO TECHNOLOGIES

System Functionality Checklist

- [ ] **Lease Data Centralization:** Can your system store all your lease information in one place and provide easy access to key data points?
- [ ] **Automated Calculations:** Can your system automatically calculate lease liabilities, right-of-use assets, and handle complex lease scenarios?
- [ ] **Reporting Capabilities:** Can your system generate the reports you need for compliance and allow for easy customization?
- [ ] **Integration with Other Systems:** Does your lease accounting software integrate with your other financial systems (e.g., general ledger, accounts payable)?
- [ ] **Audit Trail:** Does your system track changes made to lease data, showing who made the changes and when?

How to Avoid Common Audit Mistakes

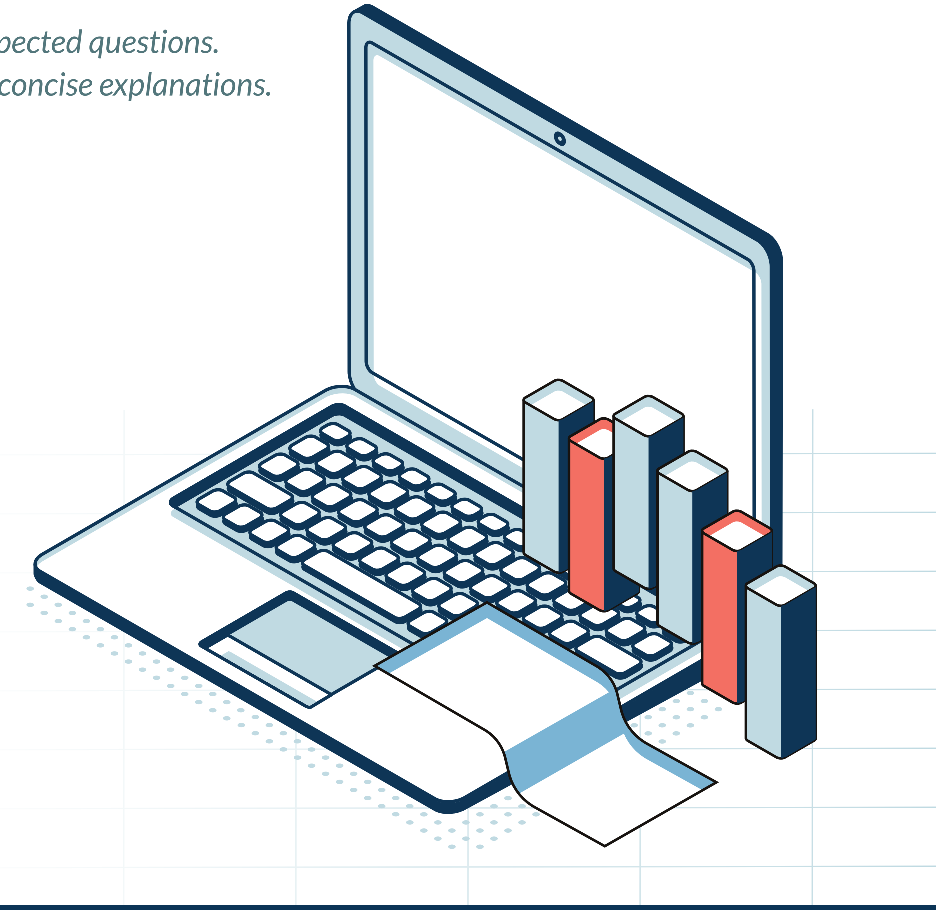
Start talking to your auditors before your audit.

The more your auditors know upfront, the smoother your audit will go. By proactively discussing your lease accounting judgments and interpretations, you'll gain valuable insights and avoid surprises during the audit.

Be prepared to explain your judgment calls.

Make sure you understand the "why" behind every lease accounting decision you've made. Well-organized documentation will help you clearly explain your judgments to the auditors, minimizing questions and confusion.

Remember: *Auditors may ask unexpected questions. Be ready to respond with clear and concise explanations.*



Audit Efficiency Tips

Plan for Success

A well-defined plan is crucial for a smooth and efficient audit

Communicate Effectively

Maintain strong relationships with departments that handle leases to ensure a complete lease inventory. Simplify processes and communicate regularly.

Utilize Efficient Tools

If you have ten or more leases, invest in lease accounting software with these key features:

- **Auditor Access:** Grant auditors direct access to your software.
- **Custom Reporting:** Enable auditors to create their own reports.
- **Excel Export:** Allow data export to Excel for audit purposes.
- **Easy Document Retrieval:** Store and access lease documents effortlessly.

Conclusion

Every accountant wants their company's audit to go well. By following the steps laid out in this guide and maintaining open communication with your auditors, you can ensure your audit process will be as efficient and pain-free as possible.

Remember, preparation and a proactive mindset are vital for a successful audit. By thinking like an auditor, ensuring completeness, documenting your policies and controls, maintaining communication with other departments, and utilizing efficient systems you can approach your audit with confidence, knowing that you have taken the necessary steps to be prepared.

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About FinQuery

FinQuery empowers 36,000+ professionals to make smarter spending decisions across their leases and vendor contracts. Our award-winning AI-driven software minimizes risk, boosts efficiency and cuts costs.

Explore FinQuery's platform, which includes solutions for contract management, prepaid and accrual accounting, and lease accounting ensuring compliance with ASC 842, IFRS 16, GASB 87 and GASB 96.

Learn more at FinQuery.com