JANUARY 2019
www.bdo.com

A NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

BDO KNOWS: FASB

FOR A SMOOTHER LANDING INTO THE NEW LEASES STANDARD

In February 2016, the Financial Accounting Standards Board ("FASB" or "the Board") issued its highly-anticipated leasing standard in Accounting Standards Update (ASU) 2016-02[1] ("ASC 842" or "the new standard") for both lessees and lessors. Under its core principle, a lessee recognizes right-of-use (ROU) assets and related lease liabilities on the balance sheet for most leases. The pattern of expense recognition in the income statement depends on a lease's classification. Lessor accounting remains largely consistent with previous U.S. GAAP but has been updated for consistency with the new lessee accounting model and with the new revenue standard, ASU 2014-09.[2]

The new standard is available here. For additional information and insights on the new standard, refer to our publication "BDO Knows: FASB—Topic 842, Leases", which is available here. See also our publication "Definition of a Lease: What's In and What's Out of ASC 842" which illustrates the definition of a lease through examples, which is available here.

The new standard is effective for public business entities and certain other entities for fiscal years beginning after December 15, 2018 (therefore January 1, 2019 for calendar year-end companies), and for interim periods within those fiscal years. For all other entities, the new standard is effective for fiscal years beginning after December 15, 2019, and interim periods beginning the following year. Early adoption is permitted for all entities.

1 Leases (Topic 842)

2 Revenue from Contracts with Customers (Topic 606)

Read more ▶

CONTENTS

The new standard provides for two transition methods – the modified retrospective approach and the new transition alternative. These methods are discussed throughout this publication. Regardless of the transition method elected, the new standard initially applies to all existing leases (like a full retrospective approach, but with modifications affecting when or how to recognize those existing leases). Generally, one key objective the FASB had in mind when developing the transition provisions was to allow entities to "run-off" the accounting for their existing leases, with the exception for lessees to recognize their existing operating leases on the balance sheet.

At first, transition to the new standard may seem relatively straight-forward. However, applying the transition requirements can be complex with important nuances that should be considered. After issuing ASU 2016-02, the FASB also issued several additional ASUs that affect certain aspects of transition. Both the FASB and SEC staffs have also on a number of occasions provided interpretive views about specific aspects of the new standard. Accordingly, having a clear understanding of the transition provisions as amended, and as interpreted, will be key to successfully adopting the new standard.

This publication summarizes the transition requirements of the new standard. It includes insights into certain aspects of the transition requirements and practical examples to assist entities in implementation.

TRANSITION METHODS

Modified Retrospective

The new standard initially included a single transition method which we will refer to as the modified retrospective approach. Under that transition method, an entity applies ASC 842 retrospectively to each prior reporting period, subject to specific practical expedients and transition requirements. Therefore, an entity that is a lessee must recognize operating leases on balance sheet at the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease (this later of two dates is the date of initial application under this transition method). The recognition requirement applies to all existing operating leases, including leases that expired before the adoption date. An entity (lessee or lessor) must also provide the new and enhanced disclosures in all periods presented, including the prior periods. The effect of adopting the new standard is recognized as a cumulative effect adjustment to retained earnings at the beginning of the earliest period presented.

New Transition Alternative

In July 2018, the FASB issued ASU 2018-11[3], which provides entities with an additional (and optional) transition method with which to adopt the new standard (we will refer to it as the new transition alternative). Under the new transition alternative, an entity initially applies the new standard to all leases existing at the adoption date (the date of initial application under this transition method) and recognizes a cumulative effect adjustment to the opening balance of retained earnings at that date. This means that the comparative periods presented in the financial statements remain under the legacy leases guidance (ASC 840). If an entity elects this new transition alternative, it is required to provide the ASC 840 disclosures for all prior periods presented that remain under the legacy leases guidance. The FASB provided this additional transition method to reduce costs and complexity for preparers in implementing the new standard.

3 Leases (Topic 842) – Targeted Improvements

Read more ▶

A CLOSER LOOK - WHAT'S DIFFERENT BETWEEN THE TWO TRANSITION METHODS

To illustrate the main differences between the two transition methods, assume a calendar year-end public business entity that adopts the new standard on January 1, 2019 and that presents three years of income statements (current period and two comparative periods). In that situation, the beginning of the earliest period presented for that entity is January 1, 2017, and its adoption date is January 1, 2019.

For that entity, the main differences between the two transition methods are summarized in the following table.

	Modified Retrospective Approach	New Transition Alternative
Date of Initial Application	The later of January 1, 2017 and lease commencement date. For example, for a lease that commenced before January 1, 2017, the date of initial application is January 1, 2017. For a lease that commenced after January 1, 2017, the date of initial application is its lease commencement date.	January 1, 2019 for all existing leases.
Recognition	Recognize on balance sheet all existing leases at the date of initial application (see line above). Adjust the income statement for prior periods as necessary (e.g., write off costs incurred after January 1, 2017 that no longer meet the definition of initial direct costs, if applicable – see the package of practical expedients discussion).	Recognize on balance sheet all existing leases at January 1, 2019. Adjust retained earnings at January 1, 2019 for any effects of adoption.
Discount Rate for Operating Leases	Determined at the date of initial application (i.e., see first line above).	Determined at January 1, 2019.
Operating Leases Denominated in a Foreign Currency	Apply ASC 830 for leases denominated in a foreign currency. This means that foreign currency exchange rates should be tracked, and transaction gains and losses recognized, during the comparative periods for those operating leases now recognized on balance sheet.	Comparative periods are not affected since they remain under ASC 840 (i.e., operating leases are not recognized on balance sheet). Starting on January 1, 2019 (when all existing operating leases are recognized on balance sheet), apply ASC 830.
Disclosures[4]	Provide all ASC 842 disclosures for the current and all comparative periods.	Provide ASC 842 disclosures for the current period only. Provide ASC 840 disclosures for the comparative periods.

4 Article 10 of Regulation S-X requires SEC registrants to provide all of the annual disclosures in the quarterly filings in the year of adoption for new accounting pronouncements.

Read more

A CLOSER LOOK - WHAT STAYS THE SAME BETWEEN THE TWO TRANSITION METHODS

As illustrated in the table above, the new transition alternative generally changes when an entity initially applies the new standard (e.g., when an entity initially recognizes operating leases on balance sheet). It does not change how an entity initially applies the new standard. For example, the guidance about how an entity initially measures existing operating leases is the same regardless of whether the modified transition approach or the new transition alternative is elected.

BDO Observation: Given the significant cost relief provided by the new transition alternative, we expect many entities will adopt the new standard using that transition method rather than the modified retrospective approach.

Example 1: Transition Approach and Date of Initial Application:
Susie's Stitch-n-Sew (Susie's) entered into a five-year noncancelable arrangement on 1/1/2018 with a mall operator that meets the definition of a lease under ASC 840. Assume 1/1/2018 is both the inception date and commencement date of the lease. On 1/1/2019, Susie's adopts the new standard. Susie's initial application of the new standard depends on the transition method it elects.

Susie's adopts the new standard using the modified retrospective approach	Susie's adopts the new standard using the new transition alternative
Susie's recognizes the above lease (along with any other existing leases) at the date of initial application which, under this transition method, is the later of 1/1/2017 (if Susie's presented three periods of income statement) and the lease commencement date. For the above lease it is 1/1/2018, the commencement date. Susie's should also provide the ASC 842 disclosures for all periods presented, including the comparative periods.	Susie's recognizes the above lease (along with any other existing leases) on balance sheet on 1/1/2019, which is Susie's date of initial application under the new transition alternative. The prior period balance sheet (i.e., 12/31/2018) remains under ASC 840 which means Susie's balance sheet at 12/31/2018 does not include the above lease. However, Susie's is required to provide the ASC 840 disclosures for all prior periods still under ASC 840, including the 2018 balance sheet, and therefore includes among the other ASC 840 disclosures the future lease payments still to be made as of 12/31/2018. Users may compare both balance sheets through constructive capitalization of the 2018 balance sheet using the footnote disclosure on future lease payments remaining at 12/31/2018. Susie's should also provide the ASC 842 disclosures for the period of adoption (i.e., 2019).

Read more

TRANSITION PRACTICAL EXPEDIENTS

The new standard includes several transition practical expedients that the FASB provided to reduce an entity's cost of adopting the new standard. Four of those practical expedients were included in the original standard (ASU 2016-02). They include a package of three practical expedients and the practical expedient to use hindsight. Another practical expedient was added subsequently to address specific concerns raised by certain stakeholders relating to diversity in practice that exists under current U.S. GAAP in the accounting for land easements and the costs associated with implementing the new standard to those arrangements.

Package of Practical Expedients

The new standard provides the following three practical expedients that must be applied as a package:

PACKAGE:

1. Not reassessing whether expired or existing contracts are or contain leases

2. Not reassessing lease classification for expired or existing leases

3. Not reassessing initial direct costs for existing leases.

If an entity elects to apply these practical expedients, they must be applied to all leases, regardless of whether the entity is a lessee or a lessor in the arrangement.

> BDO Observation: Considering the significant benefits associated with the package of practical expedients, we expect that most entities will elect it. Nonetheless, there are important considerations which we will discuss separately for each practical expedient included in this package.

Practical Expedient 1 – Not Reassessing Expired or Existing Contracts

The scope of the new standard is generally consistent with prior guidance and limits the application of the standard to leases of property, plant or equipment. The glossary defines a lease as "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration".

To conclude that a contract is or contains a lease under ASC 842, there must be an identified asset and the contract must grant to the customer throughout the period of use both (a) the right to obtain substantially all of the economic benefits from the asset's use (the economic criterion), and (b) the right to direct the use of the identified asset (the power criterion).

Identified Asset + Economic Criterion + Power Criterion = Lease

See our publication "[Definition of a Lease: What's In and What's Out of ASC 842]" for additional information, insights, and practical examples about determining whether a contract is or contains a lease.

If an entity elects the package of practical expedients, it will not reevaluate its existing contracts under the new guidance. The entity can simply carryforward its previous conclusions reached under ASC 840 when adopting ASC 842. For example, if an entity evaluated a contract under ASC 840 and correctly determined that the contract contained a lease, the entity can carry forward that conclusion when applying the transition requirements of the new guidance.

> BDO Observation: The FASB provided this practical expedient as it concluded that the costs of applying the new definition of a lease to all existing contracts generally would exceed the related benefits (the Board expected that most leases under ASC 840 would be leases under ASC 842).
>
> However, electing the package of practical expedients does not grandfather errors. For example, if the entity did not previously evaluate a contract under ASC 840 and that contract would meet the definition of a lease, or if it evaluated a contract but reached an erroneous accounting conclusion, those errors would not be grandfathered by the election of the package of practical expedients. In those situations, if the entity still plans on electing the package of practical expedients, it must evaluate those contracts under ASC 840 (i.e., not under ASC 842) to be able to benefit from the package of practical expedients.

Read more ▶

Practical Expedient 2 – Not Reassessing Lease Classification

Under ASC 842, a lease is classified as a finance lease by a lessee and a sales-type lease by a lessor if any one of the following five criteria is met:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life of the underlying asset.[5]
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

When none of the above criteria are met, a lessee classifies the lease as an operating lease. For lessors in that situation, there are two additional criteria to consider before concluding on whether the lease is an operating lease or a direct-financing lease. See our publication "**BDO Knows: FASB—Topic 842, Leases**" for additional information, insights, and practical examples.

If an entity elects the package of practical expedients, it will not reassess classification of its expired or existing leases under the new guidance. The entity can simply carry forward its previous conclusions reached under ASC 840 when adopting ASC 842. For example, if an entity determined that a lease was classified as an operating lease under ASC 840, the entity can carry forward that classification when applying the transition requirements of the new guidance.

If the entity does not elect the package of practical expedients, it must reassess lease classification under ASC 842 at the later of the commencement date of the lease or the most recent lease modification under ASC 840 that required the entity to reassess lease classification. If the classification changes, there are specific transition recognition and measurement requirements that generally result in the entity revaluing the lease.

BDO Observation: The FASB provided this practical expedient as it concluded that the costs of applying the new lease classification tests to all existing leases generally would exceed the related benefits (for example, the Board expected that most operating leases under ASC 840 would also be classified as operating leases under ASC 842). However, there are situations in which lease classification could change between ASC 840 and ASC 842, and entities impacted may want to consider the information ultimately provided to their users in determining whether to elect the package of practical expedients or not.

Practical Expedient 3 – Not Reassessing Initial Direct Costs

Under ASC 842, initial direct costs are defined as the incremental costs that would not have been incurred if the lease had not been obtained. This means that commissions and payments made to an existing tenant to incentivize that tenant to terminate its lease generally meet the new definition of initial direct costs. But other costs, such as costs to negotiate or arrange the lease that would have been incurred regardless of whether the lease was obtained are not initial direct costs. Examples of such costs include fixed employee salaries, general overheads, costs incurred by the lessor to solicit potential lessees through advertising, and other costs related to activities that occur before a lease is obtained (such as costs to negotiate the lease, obtain legal or tax advice, or evaluate a potential lessee's financial condition). This is because the potential lessee could have walked away at the last minute and these costs would still be due to attorneys, employees, etc. See our publication "**BDO Knows: FASB—Topic 842, Leases**" for additional information, insights, and practical examples.

If an entity elects the package of practical expedients, it will not reassess capitalized initial direct costs of existing leases under the new guidance just described. The entity can simply include existing unamortized initial direct costs under ASC 840 in the initial measurement of the lease. For example, assume an entity (a lessee) deferred initial direct costs related to an operating lease under ASC 840, and the unamortized balance of such initial direct costs is $5,000 at the date of initial application. If the entity elects the package of practical expedients, it would include that $5,000 balance to the initial measurement of the ROU asset for that operating lease.

5 This criterion is not applicable if the lease commences at or near the end of the asset's economic life.

Read more ▶

If an entity does not elect the package of practical expedients, it should assess all existing capitalized initial direct costs and write off those that do not meet the definition of initial direct costs under ASC 842. Whether those costs are written off to retained earnings or earnings depends on the transition method elected and, for the modified retrospective transition, the date those costs were incurred, as illustrated in Example 2 .

BDO Observation: The definition of initial direct costs under ASC 842 is substantially narrower than the definition under ASC 840 and aligns with the definition of incremental costs to obtain a contract in ASC 340-40. This may represent a significant change for certain entities, for example, those with active leasing programs that currently capitalize external legal and other consulting fees, internal legal fees and costs associated with an internal leasing department. Under the new standard, those costs will generally be expensed as incurred.

An entity expecting to be significantly impacted by this change in definition of initial direct costs should consider the aggregate effect of electing the package of practical expedients before reaching a decision. For example, if an entity capitalized a significant amount of initial direct costs under ASC 840 for existing leases and expects to capitalize a significantly lower amount for new leases, expenses on the income statement for the periods under ASC 842 will reflect both (a) amounts of lease origination costs for new leases incurred during the period that do not meet the definition of initial direct costs under ASC 842, and (b) amortization of initial direct costs previously capitalized under ASC 840.

However, not electing the package of practical expedients means the entity will not be able to benefit from the other two expedients included in the package (not reassessing whether a contract is a lease, and not reassessing lease classification). While the outcome of these two reassessments may be expected to be substantially the same as under ASC 840, the time and effort to perform and document the reassessment may be significant. Accordingly, an entity should consider its specific facts and circumstances in determining whether to elect the package of practical expedients or not (e.g., usefulness of information in the financial statements, time needed to reassess existing contracts, etc.).

Example 2: Transition Approach and Package of Practical Expedients

In Example 1, we introduced Susie's lease of retail space commencing on 1/1/2018 for a five-year noncancelable period. Also assume that there are three five-year renewal options and the following additional details about Susie's lease.

- Payment terms. Rent payments started on 1/1/2018 and are $50,000 per month plus one percent of sales during the initial five-year term. Base rent increases by 10% in each five-year renewal period.

- Leasehold improvements. Susie's incurred costs to construct leasehold improvements to customize the space to its brand requirements with an estimated useful life of eight years. The unamortized leasehold improvements balance at the end of the initial lease term are significant to Susie's.

- Initial direct costs. Susie's incurred initial direct costs of $22,000, which includes $15,000 of legal fees for the review and negotiations of the lease, and a $7,000 broker commission.

Accounting under ASC 840

Susie's concluded that the contract was a lease under ASC 840. Susie's also determined that the lease term was ten years under ASC 840 (the initial five-year term plus one five-year renewal period). This is because the unamortized leasehold improvements at the end of the initial lease term were significant to Susie's. Therefore, Susie's concluded it was reasonably assured to exercise the first renewal option. Susie's also determined that the lease was an operating lease.

Because the lease is an operating lease, Susie's did not recognize this lease on balance sheet under ASC 840. In its financial statements for the year ended 12/31/2018, Susie's provided all required ASC 840 disclosures, including the future lease payments to be made at the balance sheet date. This disclosure included the future lease payments of $5,700,000 for the above lease (four remaining years at $50,000 per month plus five years at $55,000 per month). Susie's also disclosed its contingent rent paid and the terms of the lease. There were no modifications to the lease agreement.

Read more ▶

Example 2 (continued):
Adoption of ASC 842
On 1/1/2019, Susie's adopts the new standard. Susie's initial application of the new standard depends on which transition method it elects and whether it elects the package of practical expedients or not.

Susie's adopts the new standard using the new transition alternative	
Susie's recognizes the above lease on 1/1/2019, as illustrated in Example 1.	
And elects the package of practical expedients (which it must do for all its leases)	And does not elect the package of practical expedients
Accordingly, Susie's does not reassess:	Accordingly, Susie's reassesses:
Whether this contract is a lease (i.e., it is a lease for purposes of adopting ASC 842),	Whether this contract is a lease. In this case, Susie's concludes the contract is also a lease under ASC 842,
Lease classification (i.e., it is an operating lease for purposes of adopting ASC 842),	Lease classification. In this case, Susie's determines the lease is also classified as an operating lease at 1/1/2018 under ASC 842,
Initial direct costs capitalized (i.e., the $22,000 would continue to be capitalized). Therefore, the amount of unamortized initial direct costs of $19,800 at 12/31/2018 ($22,000 initial direct costs less one year of amortization) is included in the initial measurement of the ROU asset on 1/1/2019.	Initial direct costs capitalized. In this case, Susie's determines that a portion of initial direct costs (the $15,000 legal fees) capitalized under ASC 840 does not meet the definition of initial direct costs under ASC 842. Therefore, the unamortized portion of these initial direct costs ($13,500 at 12/31/2018) must be written off as an adjustment to retained earnings on 1/1/2019. The unamortized portion of other costs that meet the definition of initial direct costs under ASC 842 (the $6,300 unamortized commission) is added to the initial measurement of the ROU asset on 1/1/2019.

Read more

Example 2 (continued):

Susie's adopts the new standard using the modified retrospective approach	
Susie's recognizes the above lease on 1/1/2018, as illustrated in Example 1.	
And elects the package of practical expedients (which it must do for all its leases)	And does not elect the package of practical expedients
Accordingly, Susie's does not reassess:	Accordingly, Susie's reassesses:
Whether this contract is a lease (i.e., it is a lease for purposes of adopting ASC 842),	Whether this contract is a lease. In this case, Susie's concludes the contract is also a lease under ASC 842,
Lease classification (i.e., it is an operating lease for purposes of adopting ASC 842),	Lease classification. In this case, Susie's determines the lease is also classified as an operating lease at 1/1/2018 under ASC 842,
Initial direct costs capitalized (i.e., the $22,000 would continue to be capitalized). Therefore, the entire amount of initial direct costs of $22,000 is included in the initial measurement of the ROU asset on 1/1/2018.	Initial direct costs capitalized. In this case, Susie's determines that a portion of initial direct costs (the $15,000 legal fees) capitalized under ASC 840 do not meet the definition of initial direct costs under ASC 842. Therefore, the $15,000 must be written off as an expense (rather than through retained earnings) when incurred because those costs were incurred during a period for which an income statement is presented. The remaining costs that meet the definition of initial direct costs under ASC 842 (the $7,000 commission) is added to the initial measurement of the ROU asset on 1/1/2018.

Hindsight Practical Expedient

An entity may use hindsight in determining the lease term, in assessing purchase options, and in assessing impairment of ROU assets. This expedient must be elected at the entity level and may be elected separately or in conjunction with either or both the package of practical expedients and the land easements practical expedient. The hindsight practical expedient applies to all leases (e.g., an entity cannot choose to apply it only to leases under which it is a lessor and not to leases under which it is a lessee).

If an entity elects the hindsight practical expedient, the entity must perform the reassessment of lease term and purchase options at the adoption date (e.g., January 1, 2019 for a calendar year-end public business entity) irrespective of the transition method elected, and considering all economic factors relevant to that assessment, including those that are contract-based, asset-based, market-based and entity-based consistent with ASC 842-10-55-26. An entity cannot simply look at renewals or purchase options it knows have been or will be exercised.

BDO Observation: Electing the hindsight practical expedient may be time consuming depending on the volume of leases that an entity has. In addition, the assessment must be performed at the date of adoption (e.g., January 1, 2019 for calendar year-end public business entities). It cannot be performed at an earlier date without adjusting the evaluation for significant changes in economic factors between the date of evaluation and date of adoption. Considering the level of work generally needed for this practical expedient, many entities plan not to elect it.

Example 3 – Hindsight Practical Expedient

Assume that in Example 2 Susie's elects the hindsight practical expedient. Irrespective of the transition method Susie's elects and whether Susie's elects the package of practical expedients, Susie's should reassess the lease term and purchase options for all its existing leases, including its retail lease, as of 1/1/2019 (the date at which it adopts the new standard). In performing that assessment, Susie's should consider all economic factors relevant to that assessment at 1/1/2019 as described in ASC 842-10-55-26 to determine whether it is reasonably certain to exercise its renewal and purchase options.

Land Easements Practical Expedient

Land easements (also commonly referred to as rights of way) represent the right to use, access, or cross another entity's land for a specified purpose. Easements are used in a variety of industries, but are especially common in the energy, utilities, transportation and telecom industries. For example, an electric utility will typically obtain a series of contiguous easements so that it can construct and maintain its electric transmission system on land owned by third parties. A land easement may be perpetual or term based, may provide for exclusive or nonexclusive use of the land, and may be prepaid or paid over a defined term.

Diversity in practice currently exists in the accounting for land easements with entities applying either ASC 350, ASC 360, or ASC 840. For example,

- Some entities account for their land easements as intangible assets based on the guidance in Example 10 of ASC 350-30, Intangibles—Goodwill and Other—General Intangibles Other than Goodwill which refers to land easements in that example as intangible assets,
- Some entities apply ASC 360 and consider the prepaid land easement as a cost to bring property, plant or equipment (for example, a pipeline) to the condition and location necessary for its intended use,
- Some entities apply ASC 840 (for example, a cell tower company entering into a land easement for the right to erect a communication tower).

Because of that diversity, in January 2018 the FASB issued ASU 2018-01[6], which is intended to reduce the cost and complexity associated with assessing all existing and expired land easements when adopting ASC 842. ASU 2018-01 allows entities that previously did not account for their land easements as leases under ASC 840 to elect a transition practical expedient to not assess those land easements under ASC 842 when adopting the new standard. Instead entities electing this practical expedient will continue to account for those land easements under other Topics unless the land easement is modified on or after ASC 842's adoption date. Once an entity adopts ASC 842, it must apply the new leases guidance prospectively to all new and modified land easements to determine whether they meet the definition of a lease under ASC 842. An entity that currently accounts for land easements as leases under ASC 840 cannot elect this practical expedient.

6 Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842

An entity must elect this expedient at the entity level, and it may be elected separately or in conjunction with either or both the package of practical expedients and the hindsight practical expedient.

A CLOSER LOOK – DIVERSITY IN ACCOUNTING WHEN A LAND EASEMENT IS NOT A LEASE UNDER ASC 842

When an entity evaluates a land easement under ASC 842 and determines it is not a lease, the issuance of ASU 2018-01 does not address the diversity in accounting observed outside of the leases guidance. For example, as previously discussed some entities have applied ASC 350 while others have applied ASC 360. The FASB noted in paragraph BC11 of ASU 2018-01 that it did not intend to address diversity in the guidance applied when a land easement does not meet the definition of a lease. For example, consider an entity that accounts for its land easements as intangible assets before adoption of the new standard based on the guidance in Example 10 of ASC 350-30. If that entity enters into a land easement after adoption of the new standard and determines that it does not meet the definition of a lease, the entity can continue its practice of accounting for the land easement as an intangible asset. In other words, while there is diversity in guidance applied when an easement is not a lease, the FASB intentionally did not address that diversity.

BDO Observation: The FASB provided this practical expedient for cost-benefit reasons. Specifically, through outreach with stakeholders in industries most involved with land easements, the FASB learned that many land easements are perpetual (and therefore would not meet the definition of a lease because they are not "for a period of time"). In addition, many land easements are prepaid and therefore already recognized on the balance sheet, with no liability to recognize upon adoption of ASC 842. The Board therefore did not want entities to incur significant time and effort (considering the volume of land easements and age of those easements) to evaluate them under the new standard, especially considering that adoption of the new standard was generally not expected to have a material impact for these existing land easements.

While diversity in practice in accounting for land easements exists prior to ASC 842, it generally would be inappropriate for an entity to change its accounting policy prior to adoption of ASC 842 from accounting for those as leases under ASC 840 to accounting for those under ASC 350 or ASC 360.

TRANSITION – LESSEES

We previously explained when entities should recognize leases on balance sheet. The date at which a lease is recognized on balance sheet is the date of initial application, which depends on the transition method selected. We will now explore how the entity should measure those leases on balance sheet. The measurement generally depends on whether lease classification changes between ASC 840 and ASC 842. If an entity elects the package of practical expedients, the entity applies the guidance for leases that do not change lease classification. If an entity does not elect the package of practical expedients, the entity must first reassess lease classification under ASC 842 before determining which transition guidance to apply.

Measurement of Existing Operating Leases Under ASCs 840 And 842

The measurement of the lease at the date of initial application is summarized as follows:

LL

A lessee initially measures the lease liability (LL) for a lease classified as operating lease under ASC 840 and 842 at the present value of:

- The remaining minimum rental payments as determined under ASC 840, and
- Any amounts probable of being owed under a residual value guarantee.

This present value calculation is performed using the discount rate for the lease determined at the date of initial application.

ROU

The ROU asset is initially measured using the initial measurement of the lease liability, adjusted for the following:

- Any prepaid or accrued rent payments,
- Any unamortized lease incentives or tenant improvement allowances,
- Any unamortized initial direct costs, and
- The carrying amount of any liability recognized in accordance with ASC 420 on exit or disposal cost obligations for the lease.

IDCs

Unless the entity elects the package of practical expedients, any unamortized initial direct costs (IDCs) that no longer meet the definition of initial direct costs under ASC 842 should be written off. Whether existing capitalized costs are written off to retained earnings or earnings depends on the transition method elected and, for the modified retrospective transition, the date those costs were incurred as illustrated in Example 2 .

After this initial recognition, the lessee subsequently recognizes a single lease cost generally on a straight-line basis. The lease liability is measured each period like the initial recognition just described. The difference between the single lease cost and the interest accretion of the lease liability is applied to the ROU asset to determine the amortization of the ROU asset. Said another way, other than the recognition of operating leases on balance sheet, the income statement profile will generally remain the same.

Read more ▶

However, there are exceptions to this subsequent measurement just described:

The initial measurement of the ROU asset includes an ASC 420 liability	In those situations, the transition guidance requires a lessee to account for the lease under the subsequent accounting guidance for impaired ROU assets. As a result, the lease will no longer receive straight-line treatment in the income statement. Instead, the entity will subsequently amortize the ROU asset on a straight-line basis consistent with finance leases and accrete interest on the lease liability. While the pattern of recognition in the income statement will no longer be straight line; the total cost is still presented as a single lease cost.
The ROU asset is impaired under ASC 360 on or after adoption date	Like ROU assets that initially include an ASC 420 liability, if the ROU asset is impaired under ASC 360, the lease will no longer receive straight-line treatment in the income statement post impairment date.
A modification to the contract is made on or after adoption date, and the modification does not result in a separate contract (see ASC 842-10-25-8)	In those situations, the lessee must follow the requirements of the new standard from the effective date of the modification. This means, for example, that the lessee no longer will be permitted to use minimum rental payments as applied in ASC 840; rather the lessee will use lease payments as defined in ASC 842.
The lessee is required to remeasure the lease liability in accordance with ASC 842-20-35-4 through 35-5	Same as for modifications not accounted for as separate contracts.

Read more ▶

Example 4 – Initial Measurement of Existing Operating Lease Under ASCs 840 and 842

We will continue Susie's lease of retail space in Example 2. Assume that Susie's adopts the new standard on 1/1/2019 using the new transition alternative and that it elects the package of practical expedients. Susie's date of initial application is 1/1/2019, which is the same as its adoption date. We will also assume that Susie's discount rate for the retail space lease is 6% at 1/1/2019.

Susie's lease details relevant to the initial recognition of this lease were as follows:

▶ Lease term. Ten years (five-year noncancelable period plus first five-year renewal period)

▶ Payment terms. Rent payments started on 1/1/2018 (i.e., payments are made at the beginning of the month) and were $50,000 per month plus one percent of sales during the initial five-year term. Payments were then $55,000 per month plus one percent of sales for the second five-year period. The rent payments based on percentage of sales are contingent rents under ASC 840 and therefore are not included in the initial measurement of the lease.

▶ Initial direct costs. Susie's incurred initial direct costs of $22,000, which includes $15,000 of legal fees for the review and negotiations of the lease, and $7,000 broker commission. The unamortized costs at 1/1/2019 are $19,800. Because Susie's elected the package of practical expedients, it will include the entire $19,800 as part of the initial measurement of the ROU asset.

Susie's initially measures the lease as follows:

LL

Measure the lease liability at the present value of the unpaid minimum rental payments at 1/1/2019, discounted at 6%. Note that one $50,000 payment is made on 1/1/2019 and therefore is not included in the initial measurement of the lease liability. Based on the present value calculation, Susie's determines the initial measurement of the lease liability is $4,340,078.

ROU

IDCs

Measure the ROU asset at the following:

Initial amount of the lease liability	$4,340,078
Less carrying amount of ASC 420 liability	N/A
Plus prepayments (payment on 1/1/2019)	50,000
Plus unamortized initial direct costs	19,800
Less unamortized lease incentives	N/A
Initial measurement of the ROU asset	**$4,409,878**

Note that there is no adjustment to retained earnings for this lease considering the initial measurement requirements and the fact that Susie's elected the package of practical expedients.

Read more ▶

A CLOSER LOOK - EXECUTORY COSTS FOR EXISTING OPERATING LEASES

An entity is required to use the minimum rental payments as determined under ASC 840 when initially measuring existing operating leases. Because ASC 840 is not clear on whether executory costs (i.e., taxes, insurance and maintenance) should be included as part of minimum rental payments, diversity in practice has developed under ASC 840. Therefore, questions arose on how to recognize existing operating leases in transition. The SEC staff addressed those questions at the **2017 AICPA Conference on Current SEC and PCAOB Developments** and, most recently, at the **2018 AICPA Conference on Current SEC and PCAOB Developments**:

> **Lessee transition – minimum rental payment composition policies**
> Andrew W. Pidgeon, Professional Accounting Fellow, Office of the Chief Accountant
> *The first consultation I am going to share builds upon a topic discussed last year at this conference by one of my colleagues related to lessee measurement of leases at transition to Topic 842.[2] Topic 842 requires lessees to measure leases at transition based on Topic 840[3] "remaining minimum rental payments."[4] My colleague noted that diversity in practice exists related to executory costs, and their inclusion in, or exclusion from, Topic 840 minimum rental payments. He further noted that the staff did not object to registrants consistently applying their historical accounting policy regarding the composition of minimum rental payments when concluding whether executory costs should be included in remaining minimum rental payments for purposes of establishing the lease liability in transition to Topic 842.*
>
> *Earlier this year, we received a consultation regarding a registrant's ability to change its policies related to the composition of minimum rental payments, including a change at transition to Topic 842. For example, to change from excluding executory costs from, to including executory costs in, minimum rental payments. We observed that Topic 250[5] permits a registrant to change from one generally accepted accounting principle to another generally accepted accounting principle when there are at least two generally accepted principles if the change is preferable.[6] In response to the consultation, we communicated that the staff did not object to a registrant's application of Topic 250 to change its policy relative to the composition of Topic 840 minimum rental payments, including a change at transition to Topic 842.[7]*
>
> *[2] Michael P. Berrigan, Professional Accounting Fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Remarks before the 2017 AICPA Conference on Current SEC and PCAOB Developments (December 4, 2017), at: https://www.sec.gov/news/speech/berrigan-aicpa-2017-conference-sec-pcaob-developments. [3] FASB ASC Topic No. 840, Leases ("Topic 840"). [4] ASC 842-10-65-1(l). [5] FASB ASC Topic No. 250, Accounting Changes and Error Corrections ("Topic 250"). [6] ASC 250-10-45-2(b). [7] Registrant requirements related to accounting policy changes are identified in Rule 10-01(b)(6) of Regulation S-X; see also, ASC 250-10-S99-4 and the related guidance in SAB Topic 6.G.2.b, Reporting Requirements for Accounting Changes*

Read more ▶

Example 5 – Inclusion or Exclusion of Executory Costs in Minimum Rental Payment
In Susie's lease of retail space in Example 2, assume that Susie's rent payments of $50,000 for the first five years and $55,000 for the following five years include payments for taxes, insurance and maintenance (i.e., executory costs) provided by the lessor.

Accounting Policy A: Inclusion of Executory Costs in Minimum Rental Payment
Susie's has historically included those executory costs as part of minimum rental payments when accounting for its leases and disclosing future minimum lease payments. Accordingly, when initially measuring this operating lease, Susie's should measure the lease liability at the present value of the future minimum rental payments of $50,000 and $55,000 that remain to be paid at the date of initial application. This calculation was illustrated in Example 4 .

Accounting Policy B: Exclusion of Executory Costs From Minimum Rental Payments
Susie's has historically excluded those executory costs from minimum rental payments when accounting for its leases and disclosing future minimum lease payments. Accordingly, when initially measuring this operating lease, Susie's should measure the lease liability at the present value of the future minimum rental payments that remain to be paid at the date of initial application, and those future payments would exclude the executory costs that Susie's has historically excluded from its minimum rental payments.

Changing from inclusion to exclusion and vice versa
If Susie's desires to change its approach for executory costs, including a change at transition to ASC 842, it should apply ASC 250 on accounting changes and determine that the change is preferable. If so, the change should be applied retroactively.

A CLOSER LOOK - PAYMENTS BASED ON AN INDEX OR A RATE FOR EXISTING OPERATING LEASES

Another question that arose on the application of minimum rental payments relates to those based on an index or a rate, and whether existing operating leases should be initially measured using the index or rate at inception or using the current value at the date of initial application. The SEC staff also addressed that question at the **2018 AICPA Conference on Current SEC and PCAOB Developments**.

> **Lessee transition – minimum rental payment measurement policies**
> Andrew W. Pidgeon, Professional Accounting Fellow, Office of the Chief Accountant
> *More recently, we received another consultation regarding minimum rental payments and lessee transition to Topic 842. That consultation, submitted by a group of registrants, related to the measurement of minimum rental payments that are based on an index or a rate ("indexed payments"). Specifically, the inquiry related to whether at transition to Topic 842 leases with indexed payments should be measured based on the index or rate value from lease inception, or the then current index or rate value.*
>
> *Topic 840 requires lessees to disclose "future minimum rental payments."[8] We understand that in order to meet that disclosure requirement, some lessees disclose future minimum rental payments related to indexed payments based on the index or rate value at lease inception, and other lessees disclose those payments based on the current rate or index value. Similar to the consultation shared during last year's conference regarding the composition of minimum rental payments, we observed that Topic 840 does not provide specific guidance with regard to the measurement of future minimum rental payments for disclosure of indexed payments. Therefore, the staff did not object to a registrant consistently applying their Topic 840 accounting policy regarding the measurement of future minimum rental payments for disclosure when concluding whether remaining minimum rental payments should be calculated based on the lease inception or current index or rate values for purposes of measuring leases at transition to Topic 842.*
>
> *Additionally, the consultation discussed a registrant changing its policy relative to the measurement of future minimum rental payments for indexed payments, including at transition to Topic 842. Specifically, the consultation discussed a change from using lease inception index or rate values, to using current index or rate values to measure future minimum rental payments. The consultation*

Read more ▶

concluded that the change was a change in accounting policy subject to Topic 250. The staff did not object to that conclusion. The staff further communicated that when evaluating whether that policy change is preferable, it would be reasonable for a registrant to consider as part of its Topic 250 analysis, if the lease obligation that results from using current index or rate values represents a better measurement of the registrant's current lease obligations.

[8] ASC 840-20-50-2(a).

A CLOSER LOOK – DISCOUNT RATE USED TO INITIALLY MEASURE EXISTING OPERATING LEASES

The transition guidance in ASC 842 provides that existing operating leases should be initially measured using the discount rate for the lease at the date of initial application. The guidance however does not specify whether the discount rate should be determined based on (1) the remaining lease term (and remaining minimum rental payments) or (2) the total lease term (and total minimum rental payments). The SEC staff addressed that question at the 2017 AICPA Conference on Current SEC and PCAOB Developments.

Lease Transition — Incremental Borrowing Rate
Michael P. Berrigan, Professional Accounting Fellow, Office of the Chief Accountant
Another transition topic addressed by the staff relates to the incremental borrowing rate a lessee should apply when measuring the lease liability in transition. […] registrants observed that the transition guidance does not specify whether the discount rate selected should be based on the original lease term or the remaining lease term.[7]

Some registrants concluded that the lessee should select a discount rate based on the original lease term as they believe that rate better reflects the borrowing rate embedded within the contract when the lessee entered into the arrangement. Other registrants concluded the lessee should select a rate based on the remaining lease term as they believe the rate more accurately reflects the rate applicable to the remaining lease liability recognized in transition. The staff observed that the transition guidance does not specify the lease term that should be used to determine the discount rate and further observed that either rate used in transition may significantly differ from the rate that would have been determined at commencement of the lease (i.e. the original commencement date of the lease). The staff concluded that the selection of either of these rates, that is either the rate based on the original lease term or the remaining lease term, is reasonable and ultimately did not object to a registrant's consistent application of either approach to determine the lessee's lease liabilities in transition.

[7] To illustrate, assume an entity previously entered into a 20 year lease with total payments of $20 million and that the remaining lease term as of the earliest date presented in the financial statements upon adoption of ASC 842 is five years with remaining payments of $5 million. The question raised is whether it is appropriate for the entity to select the discount rate applicable as of the date of the first period presented in the financial statements based on an original lease term (for example, the rate applicable for a 20 year borrowing with payments of $20 million) or the remaining lease term (for example, the rate applicable for a five year borrowing with payments of $5 million).

Read more ▶

Example 6 – Determining the Discount Rate for Existing Operating Leases

In Example 4, Susie's adopted the new standard on 1/1/2019 and elected the new transition alternative. Its retail space lease commenced on 1/1/2018 and Susie's initially determined that the lease term under ASC 840 was ten years (and therefore nine years remain at 1/1/2019). Susie's total fixed lease payments under the lease were $6,300,000, and payments remaining at 12/31/2018 are $5,700,000 as disclosed in its footnotes.

In determining the discount rate for all of its existing operating leases, including the retail space lease just described, Susie's is permitted to use either of the following two approaches. The approach Susie's selects must be applied consistently to all of its existing operating leases when transitioning to the new standard, and Susie's should disclose which approach it applied.

Approach A: Use the Remaining Lease Term and Remaining Minimum Rental Payments

For its lease of retail space above, Susie's would determine the discount rate based on the following assumptions:

- A remaining lease term of nine years (ten-year lease term less one year elapsed at 1/1/2019),
- Remaining lease payments of $5,700,000 (four remaining years at $50,000 per month plus five years at $55,000 per month).

Approach B: Use the Total Lease Term and Total Minimum Rental Payments

For its lease of retail space above, Susie's would determine the discount rate based on the following assumptions:

- A total lease term of ten years,
- Total lease payments of $6,300,000 (five initial years at $50,000 per month plus five years at $55,000 per month).

A CLOSER LOOK – LESSEE PRACTICAL EXPEDIENT NOT TO SEPARATE DURING TRANSITION

The new standard includes a practical expedient for lessees not to separate the nonlease components of a contract (for example, maintenance or operation of the underlying asset) from the associated lease component. The practical expedient must be elected by asset class. While the transition guidance in the new standard specifically addresses certain practical expedients (for example, the short-term lease exemption and the lessor practical expedient not to separate the nonlease components from the associated lease component), it does not address the lessee practical expedient not to separate. However, even though it is not specifically addressed in the transition provisions, we believe an entity can elect, by asset class, the lessee practical expedient to not separate during transition. If elected in transition, the entity should also apply the lessee practical expedient to new leases within that asset class after adoption.

A CLOSER LOOK – REALLOCATION OF PRIOR IMPAIRMENT LOSSES

Prior to adopting the new standard, entities may have had impairments of asset groups. In that situation, the impairment loss was allocated to the recognized long-lived assets in the asset group. Because operating leases were not recognized on balance sheet before the new standard, an operating lease did not receive any allocation of the impairment loss at that time. Accordingly, some stakeholders questioned whether upon adoption of the new standard, entities would be required to reallocate prior impairment losses because of the new asset now recognized for an existing operating lease.

The FASB specifically addressed this question at a public Board meeting in November 2016 in which it clarified that it was not the intent of the new standard to require entities to reallocate prior impairment losses. ASC 360 applies to ROU assets starting at adoption. The FASB also observed that reallocating prior impairment losses would result in writing up some of the long-lived assets in the asset group, which is not permitted under U.S. GAAP.

Read more ▶

A CLOSER LOOK – EXCESS IMPAIRMENT LOSSES NOT RECOGNIZED

Prior to adopting the new standard, entities may have had impairments of asset groups that resulted in the complete write-off of the recognized long-lived assets in the asset group (or a write-off limited to the fair value of the individual long-lived assets), with remaining and "unused" impairment losses. Had an operating lease in the asset group been recognized on balance sheet at the time of the impairment, some or all the unused impairment losses may have been recognized. Accordingly, some stakeholders questioned whether on adoption of the new standard, an entity would be required or permitted to recognize some or all the prior unused impairment losses. We believe an entity may be able to reduce the ROU asset initially recognized for unused impairment losses with a corresponding adjustment to retained earnings (assuming the asset group continues to be impaired). If the entity elects the modified retrospective transition and the impairment occurred during the comparative periods the adjustment would be recognized in earnings in the relevant period.

Considering the discussion in "A Closer Look – Reallocation of Prior Impairment Losses ", we also believe it would be acceptable for an entity to recognize the impairment in earnings on adoption rather than revisiting prior impairments in order to determine whether unused impairment losses existed.

A CLOSER LOOK – SUBLEASE LIABILITIES EXISTING AT ADOPTION DATE

As previously discussed, ASC 842 provides explicit transition guidance for leases with existing ASC 420 liabilities. However, the new standard is silent about existing sublease liabilities recognized under ASC 840. Because of the lack of guidance, there may be more than one acceptable approach in transition depending on the facts and circumstances, such as netting the existing sublease liability against the ROU asset (similar to the treatment of ASC 420 liabilities in transition) or writing off the existing sublease liabilities through retained earnings as part of the cumulative effect adjustment at transition (and evaluating the ROU asset for potential impairment).

Measurement of Existing Capital Leases under ASC 840 That Are Finance Leases under ASC 842

The initial measurement at the date of initial application is summarized as follows:

LL

A lessee initially measures the lease liability for a lease classified as a capital lease under ASC 840 and as a finance lease under ASC 842 at the carrying amount of the capital lease obligation under ASC 840.

ROU

The ROU asset is initially measured at the carrying amount of the capital lease asset, plus any unamortized costs that meet the definition of initial direct costs under ASC 842, or for which the entity elects the package of practical expedients.

IDCs

Unless the entity elects the package of practical expedients, any unamortized initial direct costs that no longer meet the definition of initial direct costs under ASC 842 should be written off. Whether existing capitalized costs are written off to retained earnings or earnings depends on the transition method elected and, for the modified retrospective transition, the date those costs were incurred as illustrated in Example 2.

In short, other than the change in description of the asset to ROU asset and the obligation to a lease liability, the transition guidance for existing capital leases under ASC 840 that are classified as finance leases under ASC 842 results in the carryforward of the existing asset and liability under ASC 840.

After initial recognition, finance leases follow the general subsequent measurement guidance in ASC 840 before adoption date (if the entity elected the modified retrospective transition) and ASC 842 on and after adoption date (irrespective of the transition method elected). As an exception, when applying the subsequent measurement guidance in ASC 842 after adoption, a lessee does not remeasure the lease payments for amounts probable of being owed under residual value guarantees. This is because the capital lease obligation under ASC 840 already included the full amount of the residual value guarantee.

Read more ▶

Measurement for Leases That Change Classification

If an entity does not elect to apply the package of practical expedients during transition, then it must reassess lease classification under ASC 842, which may or may not result in changes:

- If lease classification does not change, the lessee applies the guidance described in the preceding two sections.
- If classification changes, a lessee should initially recognize those leases at the date of initial application as further described below.

However, we believe that changes in lease classification should be the exception rather than the norm for most entities considering the similarities in lease classification guidance between ASC 840 and ASC 842.

Leases classified as operating leases under ASC 840 and classified as finance leases under ASC 842

LL

The initial measurement of the lease liability in transition is the same as the initial measurement for existing operating leases for which classification does not change. That is, it is still the present value of remaining minimum rental payments as applied under ASC 840 and amounts probable of being owed under a residual value guarantee using a discount rate determined at the date of initial application.

ROU

The ROU asset is first calculated as the applicable proportion of the lease liability at the commencement date. The applicable proportion of the lease liability is the remaining lease term at the date of initial application relative to the total lease term. The amount calculated is then adjusted for any prepaid or accrued lease payments and any liability recognized in accordance with ASC 420.

IDCs

Because the entity did not elect the package of practical expedients, any unamortized initial direct costs that no longer meet the definition of initial direct costs under ASC 842 should be written off. Whether existing capitalized costs are written off to retained earnings or earnings depends on the transition method elected and, for the modified retrospective transition, the date those costs were incurred as illustrated in Example 2 .

Leases classified as capital leases under ASC 840 and classified as operating leases under ASC 842

LL

The initial measurement of the lease liability in transition is the present value of the remaining lease payments (i.e., as defined under ASC 842; not the minimum rental payments under ASC 840) using a discount rate determined at the date of initial application.

ROU

The ROU asset is initially measured using the initial measurement of the lease liability and is then adjusted for the following, as applicable, depending on the transition method elected:

- Any prepaid (accrued) lease payments,
- Any (unamortized) lease incentives,
- Any (unamortized) initial direct costs, and
- The difference between the carrying amount of the capital lease asset and the capital lease obligation which are derecognized at the date of initial application.

IDCs

Because the entity did not elect the package of practical expedients, any unamortized initial direct costs that no longer meet the definition of initial direct costs under ASC 842 should be written off. Whether existing capitalized costs are written off to retained earnings or earnings depends on the transition method elected and, for the modified retrospective transition, the date those costs were incurred as illustrated in Example 2 .

Following this initial recognition on the date of initial application, the lease will then be accounted for under ASC 842.

Read more ▶

TRANSITION - LESSORS

Measurement

Like lessees, the measurement of existing leases generally depends on whether lease classification changes between ASC 840 and ASC 842. If an entity elects the package of practical expedients, the entity applies the guidance for leases that do not change lease classification. If an entity does not elect the package of practical expedients, the entity must first reassess lease classification under ASC 842 before determining which transition guidance to apply.

The following tables summarize the transition provisions for each lease classification scenarios.

Existing lease is an operating lease under ASC 840 and ASC 842	▶ Continue to recognize at the date of initial application the underlying asset along with any related lease assets or liabilities. ▶ Account for previous securitized receivables as secured borrowings in accordance with other U.S. GAAP. ▶ If the entity does not elect the package of practical expedients, any unamortized initial direct costs that no longer meet the definition of initial direct costs under ASC 842 should be written off. Whether existing capitalized costs are written off to retained earnings or earnings depends on the transition method elected and, for the comparative transition method, the date those costs were incurred.
Existing lease is a sales-type lease or direct financing lease under ASC 840 and ASC 842	▶ Continue to recognize at the date of initial application the net investment in the lease. This includes any unamortized initial direct costs capitalized as part of the net investment in the lease under ASC 840, even if the entity did not elect the package of practical expedients. ▶ Follow the subsequent measurement guidance in ASC 840 before adoption date if the entity elected the modified retrospective transition. ▶ Regardless of the transition method elected, after adoption date follow the subsequent measurement guidance in ASC 842. ▶ There is specific guidance for modifications after adoption date when those modifications are not accounted for as a separate contract (ASC 842-10-65-1(x)(4)).

Read more ▶

Existing lease is an operating lease under ASC 840 and a sales-type lease or direct financing lease under ASC 842	The objective is to account for the lease, beginning on the date of initial application, as if it had always been accounted for as a sales-type lease or direct financing lease under ASC 842. Accordingly: ▶ Derecognize the underlying asset at the date of initial application, ▶ Recognize a net investment in the lease at the date of initial application as if the lease had been accounted for as a sales-type lease or direct financing lease under ASC 842 since lease commencement, ▶ Record any difference between the two entries above as an adjustment to equity or earnings depending on the transition method elected and other criteria (ASC 842-10-65-1(w)(3)). Then account for the lease under ASC 842.
Existing lease is a sales-type lease or direct financing lease under ASC 840 and an operating lease under ASC 842	The objective is to account for the lease, beginning on the date of initial application, as if it had always been accounted for as an operating lease under ASC 842. Accordingly: ▶ Recognize the underlying asset at the date of initial application at what the carrying amount would have been had the lease been classified as an operating lease under ASC 840, ▶ Derecognize the carrying amount of the net investment in the lease, ▶ Record any difference between the two entries above as an adjustment to equity or earnings depending on the transition method elected and other criteria (ASC 842-10-65-1(y)(3)). Then account for the lease under ASC 842 and the underlying asset under ASC 360.

Read more ▶

A CLOSER LOOK – PRACTICAL EXPEDIENT NOT TO SEPARATE FOR OPERATING LEASES

ASU 2018-11 provided lessors with a practical expedient that allows them, as a policy election by asset class, to combine nonlease components with lease components if specific eligibility criteria are met (i.e., the nonlease component(s) would be within the scope of ASC 606, the lease and nonlease components have the same timing and pattern of transfer, and the lease would be an operating lease if accounted for separately). When those eligibility criteria are met, accounting is then dictated by the predominant component(s) (that is, ASC 606 or ASC 842). Once the practical expedient is elected for an asset class, the lessor is required to apply it to all future lease contracts within that asset class that meet the conditions for combination. The lessor is also required to combine with the lease component all nonlease components that meet the conditions (i.e., it cannot combine nonlease component #1 with the lease component and account for nonlease component #2 separately when nonlease components #1 and #2 both meet the conditions for combination).

This lessor practical expedient must be elected at the adoption date and must be applied to all existing and new lease contracts. As a result, the election of the practical expedient may result in a change in presentation for some lessor entities. For example, lessor entities that previously presented tax, insurance and maintenance recoveries separately from rental income are no longer permitted to present those recoveries separately in the income statement if they elect the lessor practical expedient not to separate. Those lessor entities may disclose in the notes to the financial statements the amount of recoveries received during the period as long as those are not described as revenue.

A CLOSER LOOK – RECOGNITION AND PRESENTATION FOR LESSOR COSTS IN NET LEASES

A lessor may incur various costs in its role as a lessor or as owner of the underlying asset (lessor costs), such as property taxes and certain insurance costs. A requirement for the lessee to pay those costs, whether directly to a third party on behalf of the lessor or as a reimbursement to the lessor, does not transfer a good or service to the lessee other than the right to use the underlying asset. ASU 2016-02 required a lessor to report those amounts as revenue and expenses (that is, on a gross basis). Stakeholders raised concerns with this requirement, including challenges with estimating those costs when the lessee pays directly the amounts to third-parties, and limited benefits because the amounts in the income statement would net to zero.

In response to those concerns, the FASB issued ASU 2018-20[7] which made the following amendments.

Lessor costs are paid by the lessee directly to third-parties	Exclude from variable payments, and therefore from revenue. That is, there is nothing to report in the income statement.
Lessor costs are paid by the lessor and reimbursed by the lessee	Account for reimbursements as variable payments. That is, a lessor is required to present lessor costs on a gross basis in the income statement.

While the effective date and transition approach differs for entities that did not early adopt ASC 842 as compared to those that did, the new guidance nevertheless must be applied to all new and existing leases. Accordingly, the issuance of ASU 2018-20 may result in a change in presentation in the income statement for some lessor entities.

7 Leases (Topic 842) – Narrow-Scope Improvements for Lessors

OTHER TRANSITION REQUIREMENTS

In addition to the above transition provisions applicable to lessees and lessors, the new standard includes other transition provisions, including for leveraged leases, sale and leaseback transactions, existing build-to-suit lease arrangements and amounts previously recognized as part of business combinations.

Leverage Leases

Unlike the legacy leases guidance, a lessor can no longer classify a lease as a leveraged lease under the new standard. However, existing leveraged leases are grandfathered into the new standard and should continue to be accounted for by the lessor like in ASC 840 until they expire or are modified. If a leveraged lease is modified on or after the adoption date, it must be accounted for as a new lease as of the effective date of the modification in accordance with ASC 842.

Sale and Leaseback Transactions

Previous sale and leaseback transaction was accounted for as a failed sale and leaseback under ASC 840 and remains a failed sale at adoption date	Reassess whether a sale would have occurred under ASC 842 as follows: ▶ If the entity elected the modified retrospective transition: reassess at the beginning of the earliest period presented and subsequently. If any such reassessment results in sale accounting, account for the transaction on a modified retrospective basis from the date sale accounting is achieved. ▶ If the entity elected the new transition alternative: reassess at the beginning of the period of adoption. If that reassessment results in sale accounting, recognize the sale as an adjustment to equity at the beginning of the period of adoption and account for the leaseback under ASC 842.
Previous sale and leaseback transaction was accounted for as a sale and leaseback under ASC 840	▶ Do not reassess the transaction. That is, it remains a successful sale and leaseback transaction. ▶ Account for the leaseback under the transition requirements applicable to existing leases. ▶ Other adjustments must be made depending on the classification of the leaseback and the transition method elected, as further discussed below.

Read more ▶

A CLOSER LOOK – DEFERRED GAINS OR LOSSES ON EXISTING SALE AND LEASEBACK TRANSACTIONS

As previously discussed, a previous sale and leaseback transaction that was accounted for as a sale and leaseback under ASC 840 is not reassessed under ASC 842. However, there may have been deferred gains or losses recognized on those transactions. The transition provisions require that certain adjustments be made depending on the classification of the leaseback and the transition method elected.

Previous sale and capital leaseback	Continue to recognize the deferred gains or losses that exist at: ▶ If the entity elected the modified retrospective transition: the later of the beginning of the earliest period presented and the date of sale, ▶ If the entity elected the new transition alternative: the adoption date. Amortize the deferred gains or losses starting from the date determined above as follows: ▶ If the underlying asset is land only, straight-line over the remaining lease term, ▶ If the underlying asset is not land only and the leaseback is a finance lease, in proportion to the amortization of the ROU asset, ▶ If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the recognition of total lease cost in the income statement.
Previous sale and operating leaseback	▶ Write-off deferred gains or losses not resulting from off-market terms as an adjustment to retained earnings, unless the entity elects the modified retrospective transition and the date of sale is during the comparative periods presented (in which case the adjustment goes to earnings). ▶ Deferred gains or losses resulting from off-market terms should be recognized as a financial liability or adjustment to the ROU asset, respectively.

Read more ▶

Example 7 – Deferred Gain on Existing Sale and Leaseback Transaction

Susie's has a number of retail stores that it leases, like the one we illustrated earlier. Susie's has one such retail store that it leases as a result of a past sale and leaseback transaction in which Susie's sold the retail store it owned and then leased back for some period of time. The terms of the transaction were at market. The transaction was properly accounted for as a sale under ASC 840 (i.e. no failed sale) and the leaseback was determined to be an operating lease. Further, the profit on sale did not exceed the present value of the minimum lease payments under ASC 840. Therefore, the entire gain was deferred over the leaseback term.

In accordance with ASC 842, Susie's does not reassess whether the above sale and leaseback transaction would have qualified for sale accounting under the new standard. Because there were no off-market terms, Susie's will recognize the deferred gain balance on the sale-leaseback transaction as a cumulative-effect adjustment to retained earnings at the adoption date if it elects the new transition alternative. If Susie's elects the modified retrospective transition method, the adjustment would also go to retained earnings unless the date of sale is after the beginning of the earliest period presented in which case the adjustment would go to earnings in the relevant period.

Build-to-Suit Arrangements

An entity (as lessee) may be deemed the accounting owner of a construction project solely because of the transaction's build-to-suit designation under ASC 840. In that situation, the entity recognized an asset (for example, the construction costs the lessee or lessor incurred) and a corresponding liability. The transition provisions generally require the lessee to derecognize those assets and liabilities when transitioning to ASC 842 unless the construction is still in progress at the adoption date and the lessee is determined to be the accounting owner under ASC 842. See ASC 842-40-55-5 for determining whether the entity controls the asset under construction and therefore is deemed the accounting owner.

A CLOSER LOOK – WRITE OFF OF ASSETS AND LIABILITIES IN A BUILT-TO-SUIT ARRANGEMENT

The transition provisions of the new standard require the write-off of assets and liabilities recognized solely because of a transaction's build-to-suit designation under ASC 840. As such, an entity should carefully analyze the composition of those assets and liabilities in determining whether the full amount of the asset and liability should be written off. For example, the asset recognized may include lease prepayments (e.g., the lessee paid construction costs of the lessor) or leasehold improvements that the lessee paid for themselves, or the liability may include lessor lease incentives received related to leasehold improvements, items which are not solely related to the build-to-suit designation. In those situations, we believe those amounts retain their characteristics (e.g., as prepaid lease payments, leasehold improvement assets or lease incentives) and, accordingly, should not be written off but included in the initial measurement of the ROU asset or as leasehold improvements.

Read more ▶

Business Combinations

The transition provisions of ASC 842 require entities to derecognize assets or liabilities recognized under ASC 805 on business combinations related to favorable or unfavorable terms for acquired operating leases. The transition requirements depend on whether the entity is the lessee or the lessor, and for the lessor, whether lease classification changes from operating lease to sales-type or direct financing lease (that is, when the lessor does not elect the package of practical expedients).

Entity is a lessee	Derecognize that asset and liability with the corresponding adjustment to the carrying amount of the ROU asset.
Entity is a lessor and lease classification changes from operating to sales-type or direct-financing lease	Derecognize that asset and liability with the corresponding adjustment to retained earnings. Also follow the other transition requirements applicable to existing operating leases that are sales-type or direct-financing leases under ASC 842 (which require the lessor to account for the lease as if it had always been a sales-type or direct financing lease).
Entity is a lessor and the lease remains an operating lease	No adjustments needed. Continue to recognize and account for the favorable or unfavorable terms as the entity did before adopting ASC 842.

APPLICATION OF THE PORTFOLIO APPROACH IN TRANSITION

The new standard allows for a portfolio approach. Specifically, paragraph 120 in the Basis for Conclusions to ASU 2016-02 indicates that the standard permits both a lessee and a lessor to apply the leases guidance at a portfolio level for leases with similar characteristics as long as the use of the portfolio approach would not differ materially from the application of the new standard to the individual leases in the portfolio. ASC 842-20-55-18 through 55-20 provide an example in which the portfolio approach is utilized in determining the discount rate for the lease.

We believe the application of the portfolio approach will be particularly beneficial during transition for the recognition of existing operating leases on balance sheet. For example, an entity (lessee) may decide to group existing operating leases into portfolios of leases that have similar characteristics (e.g., in terms of lease payments, lease term, etc.) to determine the discount rate to initially measure those leases.

Read more ▶

CONTACTS:

THOMAS FAINETEAU
National Assurance Partner
214-243-2924 / tfaineteau@bdo.com

JIN KOO
National Assurance Partner
214-243-2941 / jkoo@bdo.com

ANGELA NEWELL
National Assurance Partner
214-689-5669 / ajnewell@bdo.com