

FASB FLASH REPORT

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FASB Issues Clarifications to Leases Standard

The FASB issued ASU 2018-10¹ which affects narrow aspects of the guidance in ASU 2016-02, *Leases (Topic 842)*. The amendments included in this ASU clarify the intended application of certain aspects of the new leases guidance and correct cross-reference inconsistencies. The new ASU is available [here](#), and has effective dates and transition provisions that align with an entity's adoption of ASU 2016-02, except for entities that early adopted Topic 842, for which the amendments in this ASU are effective upon issuance.

BACKGROUND

In February 2016, the FASB issued ASU 2016-02 to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing transactions. ASU 2018-10 includes sixteen narrow amendments to the leases standard resulting from implementation activities such as discussions between the FASB and stakeholders, technical inquiries, and routine Codification feedback.

¹ Codification Improvements to Topic 842, Leases

MAIN PROVISIONS

The amendments in ASU 2018-10 are similar in nature to those in the FASB's ongoing project to make improvements to clarify the Codification or correct unintended application of the guidance. However, the FASB decided to issue a separate ASU for improvements related to the new leases guidance to increase stakeholders' awareness and expedite the improvements.

Key Amendments

- **Rate Implicit in the Lease** – An amendment was made to the Master Glossary term 'Rate Implicit in the Lease' to clarify that the rate implicit in the lease cannot be less than zero. In other words, if the implicit rate is determined to be less than zero when applying the Master Glossary definition, a rate of zero should be used.


BDO Observation:

Some stakeholders questioned whether a negative rate implicit in the lease could be used for sales-type leases with significant variable payments in lieu of recognizing a loss at the commencement date of the lease (a Day-1 loss). The Board however clarified that a Day-1 loss is the intended outcome.


This is consistent with the decisions the Board previously made about the treatment of variable lease payments under Topic 842, other than those based on an index or a rate (i.e., the decision not to require entities to estimate future variable lease payments as that would be too costly and complex based on stakeholder feedback during the leases project).

The following summarizes the determination of the rate implicit in the lease under the ASU:

Scenario 1

 Rate implicit in the lease is positive. Calculate using Master Glossary definition.

Scenario 2

 Rate implicit in the lease would be negative. Use 0% as the rate implicit in the lease.

(FV) Fair value of underlying asset minus related investment tax credit retained/expected to be realized by the lessor

(IDC) Any deferred initial direct costs of the lessor

(LPs) Lease payments

(RV) The amount that a lessor expects to derive from the underlying asset following the end of the lease term

- **Impairment of Net Investment in the Lease** – The amendments in the ASU clarify the application of the impairment guidance for lessors when determining the loss allowance of a net investment in a lease, including the cash flows to consider in that assessment.

BDO Observation:

Some stakeholders had questioned whether the impairment guidance, prior to the amendments in this ASU, would have resulted in an accelerated and improperly measured loss allowance on a net investment in a lease because the cash flows associated with the unguaranteed residual asset appeared to be excluded from the assessment. The Board therefore decided to make amendments to the impairment guidance to clarify the cash flows to consider, and those include the cash flows associated with the unguaranteed residual asset. This is consistent with the inputs a lessor uses for the initial accounting of the net investment in a lease (which includes the expected value that the lessor expects to derive from the underlying asset following the end of the lease term).

- **Certain Transition Adjustments** – Amendments were made to both the lessee and the lessor transition guidance to clarify whether to recognize certain transition adjustments to earnings rather than through equity when an entity applies Topic 842 retrospectively to each prior reporting period and the entity does not elect the package of practical expedients in paragraph 842-10-65-1(f).²

² An entity may elect the following practical expedients, which must be elected as a package: 1. An entity need not reassess whether any expired or existing contracts are or contain leases; 2. An entity need not reassess the lease classification for any expired or existing leases; 3. An entity need not reassess initial direct costs for any existing leases.

- **Transition Guidance for Amounts Previously Recognized in Business Combinations** – The amendments clarify when transition paragraph 842-10-65-1(h)(3), which relates to assets or liabilities recognized for favorable or unfavorable terms of an operating lease acquired as part of a business combination, applies for lessors. Specifically, the transition paragraph applies when an entity does not elect the package of practical expedients and, for a lessor, an operating lease acquired as part of a business combination is classified as a sales-type lease or direct financing lease under Topic 842.

BDO Observation:

The amendments to the transition guidance bring important clarifications about whether certain transition adjustments should be recorded in earnings rather than through equity when an entity applies Topic 842 retrospectively to each prior reporting period and the entity does not elect the package of practical expedients. The amendments to the transition guidance focus primarily on unamortized initial direct costs that no longer meet the definition of initial direct costs under Topic 842 and on transition adjustments for situations in which the classification of a lease changes. Prior to those amendments, the transition provisions required such adjustments to be recorded through equity only.

The transition amendments in this ASU are further amended by ASU 2018-11 *Leases (Topic 842): Targeted Improvements*.³ Specifically, ASU 2018-11 provides entities with an additional (and optional) transition method to adopt the new leases guidance. This transition method allows entities to initially apply the new leases guidance by recognizing a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption, rather than at the beginning of the earliest period presented. An entity that adopts Topic 842 using the new transition method described in ASU 2018-11 will not be affected by the amendments made in ASU 2018-10 since the transition adjustments will be recorded in equity.

Other Codification Improvements Made

Topic within ASC 842	Description
Transition Guidance for Leases Previously Classified as Capital Leases under Topic 840 and Classified as Finance Leases Under Topic 842	An amendment was made to correct a reference in the subsequent measurement guidance before the effective date when an entity applies Topic 842 retrospectively to each prior reporting period (i.e., the existing transition method prior to ASU 2018-11).
Transition Guidance for Modifications to Leases Previously Classified as Direct Financing or Sales-Type Leases under Topic 840 and Classified as Direct Financing or Sales-Type Leases under Topic 842	An amendment was made to correct an inconsistency noted in the transition guidance for lease modifications. The amended guidance in paragraph 842-10-65-1(x)(4) now refers to how the lease is classified before a modification to be consistent with the guidance in paragraphs 842-10-25-16 through 25-17.
Transition Guidance for Sale and Leaseback Transactions	Amendments were made to clarify that the transition guidance on sale and leaseback transactions applies to all sale and leaseback transactions that occur before Topic 842's effective date and also to correct some referencing issues.
Lessor Reassessment of Lease Term and Purchase Option	The amendment clarifies that the exercise by a lessee of an option to extend or terminate the lease or to purchase the underlying asset should not be accounted for as a lease modification when the exercise of the option by the lessee is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date of the lease (or at the most recent effective date of a modification not accounted for as a separate contract).

³ Further information can be found in FASB Flash Report 2018-08 (insert link)

Topic within ASC 842	Description
Unguaranteed Residual Asset	The words "substantially all" were added to paragraph 842-30-35-4 to clarify the guidance on the sale of the lease receivable. Specifically, the amendment clarifies that a lessor should stop accreting the unguaranteed residual asset to its estimated value over the remaining lease term if the lessor sells substantially all of the lease receivable associated with a direct financing lease or a sales-type lease, which is consistent with current guidance under Topic 840.
Effect of Initial Direct Costs on Rate Implicit in the Lease	The ordering of content in the illustration on Lessor Accounting – Direct Financing Lease (Case C of Example 1 in paragraphs 842-30-55-31 through 55-39) was amended to more closely align that illustration with the guidance in paragraph 842-10-25-4.
Lessee Reassessment of Lease Classification	The amendments clarify how a lessee should reassess lease classification when there is a change in the lease term or the assessment of a purchase option. Such reassessment should be based on the facts and circumstances as of the date the reassessment is required (i.e., based on the fair value and remaining economic life of the underlying asset at the reassessment date). This is consistent with how an entity (lessee or lessor) should reassess lease classification for a lease modification that is not accounted for as a separate contract.

Topic within ASC 842	Description
Variable Lease Payments That Depend on an Index or a Rate	Amendments were made to clarify that a change in a reference index or a rate upon which some or all of the variable lease payments are based does not constitute the resolution of a contingency requiring remeasurement of the lease payments. Rather, variable lease payments based on an index or a rate are remeasured only when the lease payments are remeasured for another reason.
Lease Term and Purchase Option	The amendment corrects an inconsistency in the implementation guidance about how to consider lessor-only termination options in relation to the noncancelable period of the lease.
Failed Sale and Leaseback Transaction	An amendment was made to clarify that a seller-lessee in a failed sale and leaseback transaction should adjust the interest rate on the resulting financial liability as necessary to ensure that the interest on the liability does not exceed the total payments (rather than the principal payments) to avoid negative amortization of the financial liability.
Residual Value Guarantees	The cross-reference in paragraph 460-10-60-32 was corrected to refer to the appropriate guidance in paragraphs 842-40-55-20 through 55-21 about guarantees by a seller-lessee of the underlying asset's residual value in a sale and leaseback transaction.

Topic within ASC 842	Description
Investment Tax Credits	An inconsistency in terminology about the effect of investment tax credits on the fair value of the underlying asset between the definition of rate implicit in the lease and the lease classification guidance in paragraph 842-10-55-8 was corrected.

EFFECTIVE DATE AND TRANSITION

For entities that early adopted Topic 842, the amendments are effective upon issuance of the ASU, and the transition requirements are the same as those in Topic 842.

For entities that have not adopted Topic 842, the effective date and transition requirements are the same as the effective date and transition requirements in Topic 842.

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