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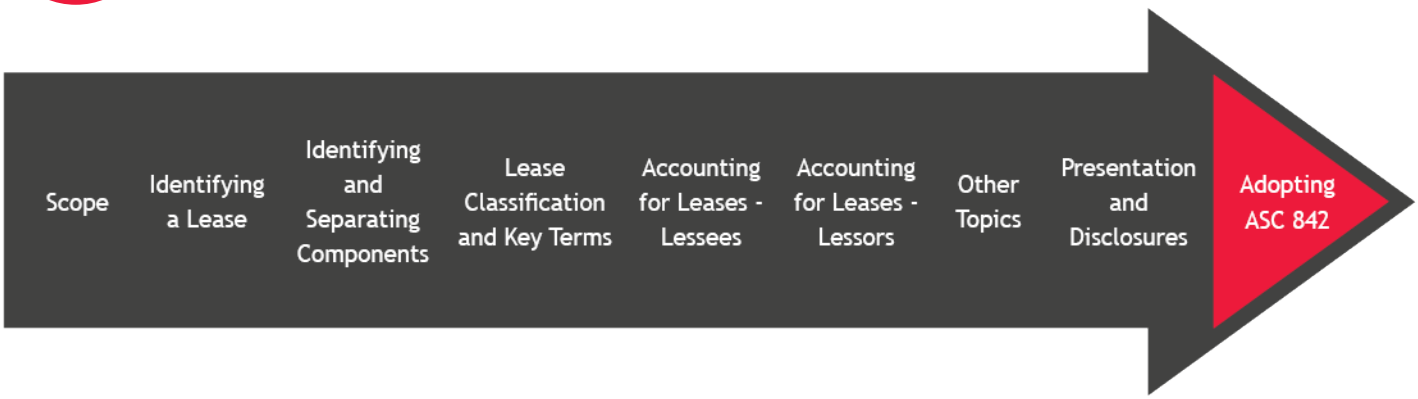
Accounting for Leases Under ASC 842

UPDATED SEPTEMBER 2021

BDO Knows Adopting ASC 842



OVERVIEW

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, to increase transparency and comparability among entities by requiring:

- Lessees to recognize leases on balance sheet, and
- Lessees and lessors to provide more information about their leasing arrangements so that users can better assess the amount, timing, and uncertainty of cash flows from leases.

Under its core principle, a lessee recognizes a right-of-use asset and a lease liability 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 was updated for consistency with the new lessee accounting model and with ASC 606 on revenue from contracts with customers.

ASC 842 was effective for public business entities and certain other entities for fiscal years beginning after December 15, 2018 (January 1, 2019 for calendar year-end public companies), and for interim periods within those fiscal years. For other entities, ASC 842 is now effective for fiscal years beginning after December 15, 2021 and interim periods beginning the following year considering deferrals in effective date the FASB provided to those entities. Early adoption is permitted for all entities.

ASC 842 provides for two transition methods, to which we refer in this article as the modified retrospective approach and the transition alternative. These methods are discussed in detail throughout this article. Regardless of the transition method elected, ASC 842 initially applies to *all* 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 balance sheet. The run-off approach means that, for example, the initial measurement of existing operating leases by lessees is based on the *minimum rental payments*, as the entity applied it under ASC 840, and for an existing capital lease that is classified as a finance lease under ASC 842, the initial amount reported under ASC 842 is the carrying amount of the capital lease asset and obligation under ASC 840. This also means that, when leases are initially reported using ASC 840 data (minimum rental payments) or carrying amounts, the entity will not reallocate the consideration in the contract if the contract includes nonlease elements (components). However, this run-off approach ceases, and the lease is accounted for under ASC 842, if the lease is modified on or after ASC 842's effective date and that modification is not accounted for as a separate contract and, for a lessee, if it is required to remeasure the lease payments and the lease liability.

At first, transition to the new leasing 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 adopt ASC 842.

This article 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 their implementation of ASC 842. As the icon at the beginning of this article suggests, implementing ASC 842 typically will require cross-functional teamwork.

As entities ready themselves to adopt ASC 842 and obtain an understanding of the transition requirements, they should consider the new processes (or updates to existing processes) and controls they need for a robust adoption, implementation, and ongoing application of the new standard. Entities should consider the following as they adopt ASC 842:

Determine System Needs

Many entities that adopted ASC 842 found that they needed to implement software solutions. Unless an entity has a very low number of leases, a software solution may result in a more efficient application of ASC 842 considering its requirements, from initial recognition through ongoing accounting and reporting, including remeasurement of leases on balance sheet for specific events, and the number of disclosures to provide.

Know the Lease Population

One of the key challenges in adopting the new standard is ensuring that the lease population is complete, including leases for which payments are fully variable and embedded leases. There are usual suspects, of course, like real estate lease contracts, which are relatively easy to identify and generally are already tracked. But an entity's contracts are not always labeled as "leases." Leases may be embedded in other contracts such as service contracts, IT contracts, and transportation contracts, to name just a few.

If a contract includes the right to use an asset (i.e., a lease), it should be tracked and accounted for as part of adopting ASC 842. This is true even if one elects the package of practical expedients, which includes the ability to not reassess existing contracts. Historically, entities may not have thoroughly assessed service contracts for the existence of embedded leases, given the similarities between operating lease accounting and service expense accounting. However, that assessment was technically required under ASC 840, and the package of practical expedients does not grandfather errors.

This completeness assessment will be a critical and potentially time-consuming step. This also typically won't be an accounting department exercise only — it may involve people from various departments across the entity, including procurement, treasury, IT, and legal, and potentially from foreign locations.

Assess Efforts Related to Lease Data Input

Another time-consuming step in the implementation process involves gathering the lease data so that lease assets and liabilities are accurately calculated and reported in the financial statements after adoption. As previously noted, many entities have found that they need a software solution in order to manage compliance with the new lease standard. Use of manual processes such as calculating right-of-use asset and lease liability values on Excel spreadsheets may be less efficient.

Regardless of the method chosen, an entity will need to plan for sufficient time to input the data into the relevant system or program for each lease so that each is accurately reported and disclosed.

EFFECTIVE DATES

For calendar-year public business entities (PBEs), certain not-for-profit organizations (NFPs) and certain employee benefit plans (EBPs), ASC 842 took effect in 2019 and interim periods within that year. For other calendar-year entities, ASC 842 was initially required to take effect in 2020, and interim periods in 2021. However, in November 2019, the FASB issued ASU 2019-10 which initially deferred the effective date of ASC 842 by one year. Also, because of the disruption caused by the Coronavirus Disease 2019 (COVID-19), including resource constraints, dislocation, and other priorities that entities faced with the COVID-19 pandemic, the FASB decided to further defer the effective date of ASC 842 by another year for private companies and certain NFPs.

The following table summarizes the final effective dates of ASC 842:

Effective Dates	
Public business entities, NFPs that have issued or are conduit bond obligors for securities traded, listed or quoted on an exchange or over-the-counter market, and EBPs that file or furnish financial statements with or to the U.S. Securities and Exchange Commission (SEC)	▶ Except for NFPs discussed below: Fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. ▶ NFPs that have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020: Fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. ▶ Early application is permitted.
All other entities	▶ Fiscal years beginning after December 15, 2021 and interim periods within fiscal years beginning after December 15, 2022. ▶ Early application is permitted.

At the December 2019 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff announced that it would not object to a public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC adopting ASC 842 for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Those dates were consistent with the effective dates for ASC 842 as amended in ASU 2019-10. Refer to paragraph 842-10-S65-1.

Also, the CAQ SEC Regulations Committee published its July 2020 highlights which noted "Given that the FASB has deferred the effective dates of certain accounting standards in light of COVID-19, the SEC staff will extend its prior relief related to the adoptions of ASC 842 and ASC 606 to entities that meet the definition of a PBE only because their financial statements or financial information is included in other entities' filings with the SEC to satisfy the requirements of Rules 3-05, 3-09 or 4-08(g) of Regulation S-X."

With the new effective dates, a calendar year-end private company is required to adopt ASC 842 on January 1, 2022 for its annual financial statements. While the 2022 annual financial statements may not be issued until sometime in 2023, that calendar-year-end private company is required to recognize its operating leases on the balance sheet on January 1, 2022 and from that date to apply ASC 842 and other GAAP requirements to its existing leases and new leases. Private companies should therefore consider those requirements in their implementation plan.

EFFECTIVE DATES OF ADDITIONAL ACCOUNTING STANDARDS UPDATES

As part of its monitoring of ASC 842 implementation by companies, the FASB made a number of amendments to ASC 842 to address stakeholder concerns. The following table summarizes those ASUs and their effective dates, as further amended by FASB's deferral of effective dates in ASU 2020-05. Note that early application generally is also permitted.

ASU	Key Amendments	Effective Dates for PBEs, Certain NFPs/EBPs	Effective Dates for All Other Entities
2018-01	▶ Land easement practical expedient for transition	▶ Fiscal years (FYs) and interim periods beginning after 12/15/2018. ▶ NFPs that have not yet issued financial statements or made financial statements available for issuance as of 6/3/2020: FYs and interim periods beginning after 12/15/2019.	▶ Fiscal years (FYs) beginning after 12/15/2021 and interim periods beginning after 12/15/2022.
2018-10	▶ Various codification improvements		
2018-11[1]	▶ Lessor practical expedient to not separate nonlease components in a lease contract ▶ Alternative transition method		
2018-20[2]	▶ Lessor accounting policy for sales taxes and other similar taxes ▶ Lessor costs paid by lessees directly to third parties ▶ Lessor recognition of variable payments in lease contracts with nonlease components		
2019-01	▶ Determining fair value of the underlying asset by lessors that are not manufacturers or dealers ▶ Presentation by lessor on statement of cash flows for certain leases	▶ FYs and interim periods beginning after 12/15/2019.	▶ FYs beginning after 12/15/2021 and interim periods after 12/15/2022.
2020-04	▶ Optional expedient for modifications of lease contracts that reference LIBOR	▶ Effective for all entities as of 3/12/2020 through 12/31/2022.	
2021-05[3]	▶ Accounting by lessors for certain leases with variable lease payments	▶ FYs and interim periods beginning after 12/15/2021. ▶ FYs beginning after 12/15/2021 and interim periods after 12/15/2022.	
2021-09[4]	▶ Discount rate for lessees that are not public business entities		

[1] Effective dates presented are for entities that did not adopt ASC 842 by the issuance date of ASU 2018-11. For entities that had adopted ASC 842, refer to paragraph 842-10-65-2 for additional effective date and transition guidance.

[2] Effective dates presented are for entities that did not adopt ASC 842 by the issuance date of ASU 2018-20. For entities that had adopted ASC 842, refer to paragraph 842-10-65-3 for additional effective date and transition guidance.

[3] For entities that had adopted ASC 842 by the issuance date of this ASU, refer to paragraph 842-10-65-5 for additional effective date and transition guidance.

[4] NFPs (including a conduit bond obligor) and EBPs are not *public business entities* (according to the definition in the Master Glossary) and, therefore, are permitted to make the risk-free rate election. Also, for entities that adopted ASC 842 before issuance date of this ASU, refer to paragraph 842-10-65-6 for additional effective date and transition guidance.

TRANSITION METHODS

MODIFIED RETROSPECTIVE APPROACH

ASU 2016-02 initially included a single transition method with which to adopt ASC 842, which we refer to in this article 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.

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.

The later of the two dates above represents the "application date" under this transition method; that is, the date at which the ASC 842 transition requirements are applied to the lease.

The recognition requirement applies to all existing operating leases, including leases that expired before the effective date (adoption date) but subsequent to the application date. However, if a lessee elects the accounting policy related to short-term leases for an asset class, the lessee does not apply the approach discussed in this article to those short-term leases. A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. See **Accounting for Leases - Lessees** for additional guidance on short-term leases. Note that under this transition a lessee should determine whether a lease qualifies as a short-term lease based on the lease term at lease commencement rather than based on the remaining term at the application date. Also, any lease that commences after ASC 842's effective date is accounted for under ASC 842.

The effect of adopting ASC 842, if any, is recognized as a cumulative effect adjustment to retained earnings at the beginning of the earliest comparative period presented.

An entity (lessee or lessor) must also provide the new and enhanced disclosures under ASC 842 in all periods presented, including the prior periods. See previous article, **Presentation and Disclosures**, for additional guidance.

TRANSITION ALTERNATIVE

In July 2018, the FASB issued ASU 2018-11, *Leases (Topic 842) – Targeted Improvements*, which provides entities with an additional (and optional) transition method with which to adopt ASC 842, which we refer to in this article as the transition alternative. Under this transition method, an entity initially applies ASC 842 to all leases existing at the effective date (adoption date) and recognizes a cumulative effect adjustment to the opening balance of retained earnings, if any, as of that date. The adoption date therefore represents the "application date" under this transition method.

As discussed above, if a lessee elects the accounting policy related to short-term leases for an asset class, the lessee does not apply the approach discussed in this article to those short-term leases. Note that under this transition alternative, a lessee should determine whether a lease qualifies as a short-term lease based on the lease term at lease commencement rather than based on the remaining term at the adoption date. Also, any lease that commences after ASC 842's effective date is accounted for under ASC 842.

The comparative periods presented in the financial statements remain under the legacy leases guidance (ASC 840). If an entity elects this transition alternative, it is required to provide the ASC 840 disclosures for all prior periods presented that remain under the legacy leases guidance. This transition requirement does not change the existing disclosure requirements in ASC 840 (for example, it does not create interim disclosure requirements that entities previously were not required to provide).

The FASB provided this additional transition method to reduce costs and complexity for preparers in implementing ASC 842. Given the significant cost relief provided by this transition alternative, we expect many entities will adopt ASC 842 using that transition method rather than the modified retrospective approach.

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 adopted ASC 842 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 comparative 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	Transition Alternative
Application Date	The later of (1) January 1, 2017 and (2) lease commencement date. For example: ▶ For a lease that commenced before January 1, 2017, the application date for that lease is January 1, 2017. Therefore, the entity applies the ASC 842 transition requirements to that lease on January 1, 2017. ▶ For a lease that commenced after January 1, 2017 such as June 15, 2017, the application date is its lease commencement date of June 15, 2017.	January 1, 2019 for all existing leases. Therefore, the entity applies the ASC 842 transition requirements to all of its existing leases on January 1, 2019.
Recognition	Recognize all existing leases at the application date (the "later of date" above). Record a cumulative effect adjustment to retained earnings, if any, as of January 1, 2017 and adjust the income statement for prior periods as necessary (e.g., write off costs incurred after January 1, 2017 that do not meet the definition of initial direct costs under ASC 842, if applicable – see package of practical expedients discussion below).	Recognize all existing leases as of January 1, 2019. Record a cumulative effect adjustment to retained earnings, if any, as of January 1, 2019 for any effects of adoption (e.g., write off of unamortized initial direct costs under ASC 840 that do not meet the definition of initial direct costs under ASC 842, if applicable – see package of practical expedients discussion below).
Discount Rate for Operating Leases (Lessees)	Determined at the application date (i.e., the "later of date" discussed above).	Determined as of January 1, 2019 for all existing operating leases.
Operating Leases Denominated in a Foreign Currency (Lessees)	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	Provide all ASC 842 disclosures for the current and all comparative periods.	Provide ASC 842 disclosures for the current period and provide ASC 840 disclosures for the comparative periods.

WHAT STAYS THE SAME BETWEEN THE TWO TRANSITION METHODS?

As illustrated in the table above, the transition alternative generally changes *when* an entity initially applies ASC 842 (e.g., when a lessee recognizes operating leases on balance sheet) but it does not change *how* an entity initially applies it. 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 transition alternative is elected.

Example 1 - Transition Approach and Application Date

FACTS

- 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.
- Susie's classified the lease as an operating lease.
- Assume 1/1/2018 is both the inception date and commencement date of the lease.
- On 1/1/2019, Susie's adopts ASC 842. Susie's initial application of ASC 842 depends on the transition method it elects.

SCENARIO 1: Susie's adopts ASC 842 using the transition alternative

- Susie's recognizes the above operating lease (along with any other existing operating leases) on balance sheet on 1/1/2019 (adoption date), which is Susie's application date under the transition alternative.
- The prior period balance sheet (i.e., for the year ended 12/31/2018) remains under ASC 840 which means it does not include recognition of an ROU asset or lease liability for the above lease.
- Susie's is required to provide the ASC 840 disclosures for all prior periods still under ASC 840, which includes the 2018 balance sheet. Therefore, Susie's provides all disclosures required under ASC 840, including the disclosure about future minimum rental payments required as of 12/31/2018 in accordance with paragraph 840-20-50-2. This information will enable users to compare both balance sheets, for example, through constructive capitalization of the 2018 balance sheet using the footnote disclosure of future minimum rental payments remaining at 12/31/2018.
- Susie's should also provide the ASC 842 disclosures for the period of adoption (i.e., for 2019).

SCENARIO 2: Susie's adopts ASC 842 using the modified retrospective approach

- Susie's recognizes the above operating lease (along with any other existing leases) at the application date, which for this operating lease is 1/1/2018 (i.e., the later of 1/1/2017 if Susie's presented three periods of income statement, and the lease commencement date of 1/1/2018).
- Susie's should provide the ASC 842 disclosures for all periods presented, including the comparative periods.

TRANSITION DISCLOSURES

An entity provides transition disclosures required by ASC 250 on accounting changes and error corrections, except for:

- The requirements in paragraph 250-10-50-1(b)(2) on the effect of the change on income from continuing operations, net income (or other appropriate captions), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted, and
- The requirements in paragraph 250-10-50-3 for the effects discussed above on financial information reported for interim periods.

An entity that elects the transition alternative should provide the transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the period of adoption rather than at the beginning of the earliest period presented.

Also, as discussed later in this article if an entity elects one or more practical expedients, it should disclose that fact.

PUBLIC COMPANY DISCLOSURE CONSIDERATIONS

SAB 74 DISCLOSURES. In periods prior to ASC 842's adoption, registrants are required to make disclosures under the SEC's Staff Accounting Bulletin No. 74 (codified in SAB Topic 11.M), *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period* ("SAB 74"). SAB 74 requires that when a recently issued accounting standard has not yet been adopted, a registrant disclose the potential effects of the future adoption in its interim and annual SEC filings. SAB 74 disclosures should be both qualitative and quantitative. According to Center for Audit Quality (CAQ) Alert 2017-03, ***SAB Topic 11.M – A Focus on Disclosures for New Accounting Standards***, the SEC staff expects that SAB 74 disclosures will become more robust and quantitative as the new accounting standard's effective date approaches. As such, the following types of SAB 74 disclosures are expected in a registrant's financial statements in the periods before new accounting standards are effective:

- *A comparison of accounting policies*. Registrants should compare their current accounting policies to the expected accounting policies under the new accounting standard(s).
- *Status of implementation*. The status of the process should be disclosed, including significant implementation matters not yet addressed or if the process is lagging.
- *Consideration of the effect of new footnote disclosure requirements in addition to the effect on the balance sheet and income statement*. A new accounting standard may not be expected to materially affect the primary financial statements; however, it may require new significant disclosures that require significant judgments.
- *Disclosure of the quantitative impact of the new accounting standard if it can be reasonably estimated, or disclosure that the expected financial statement impact of the new accounting standard cannot be reasonably estimated.*
- *Qualitative disclosures*. When the expected financial statement impact is not yet known by a registrant, a qualitative description of the effect of the new accounting standard on the registrant's accounting policies should be disclosed.

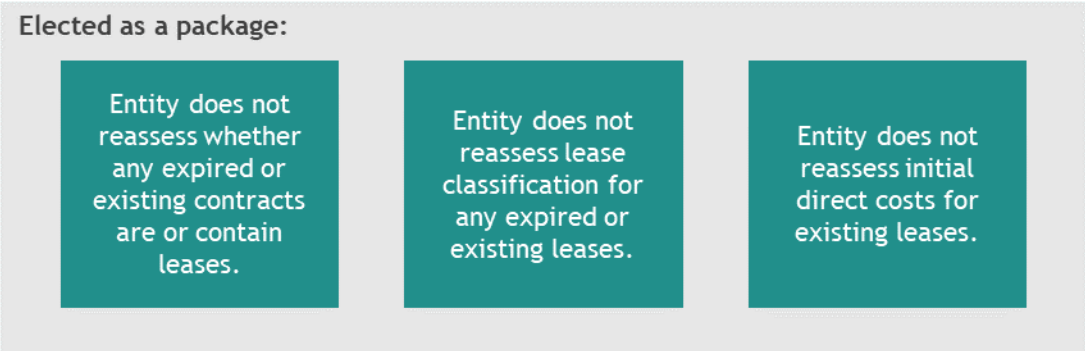
SELECTED FINANCIAL DATA – 5 YEAR TABLE. Some SEC registrants questioned whether they must recast all periods reflected in the 5-year "Summary of Selected Financial Data" to be in accordance with ASC 842. However, registrants are only required to adjust the periods in the financial data table that correspond to the periods adjusted in the registrant's financial statements. For example, for an entity that adopted ASC 842 as of the effective date (i.e., without restating prior comparative periods), the four prior years in the selected financial data table would not be adjusted. However, registrants are required to provide the disclosures required by Instruction 2 to S-K Item 301 regarding comparability of the data presented.

TRANSITION PRACTICAL EXPEDIENTS

The FASB provided several transition practical expedients to reduce an entity's cost of adopting ASC 842. The package of practical expedients and the practical expedient to use hindsight were provided in ASU 2016-02. Another practical expedient was added subsequently to address specific concerns raised by certain stakeholders relating to diversity in practice that existed in the accounting for land easements and the costs associated with implementing ASC 842 to those arrangements.

PACKAGE OF PRACTICAL EXPEDIENTS

ASC 842 provides three practical expedients that, if elected must be applied as a package consistently to all of an entity's leases (as a lessee and as a lessor) that commenced before the effective date.

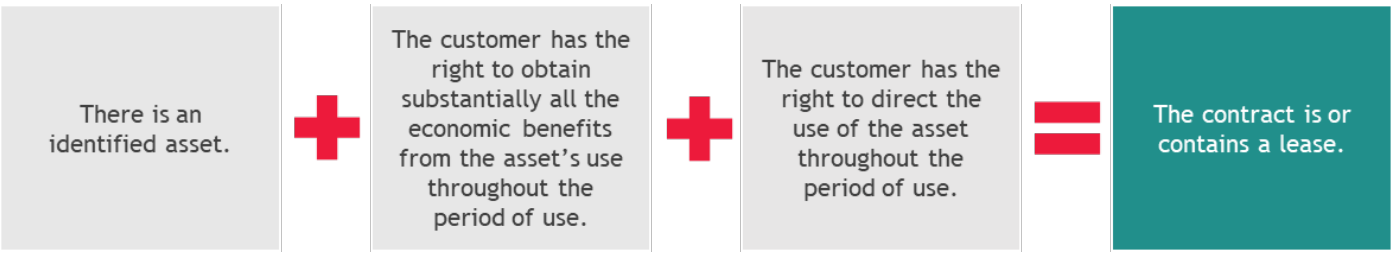


Considering the significant benefits associated with the package of practical expedients, we expect that most entities will elect it. Nonetheless, there are important considerations which we will discuss separately for each practical expedient included in this package.

NOT REASSESSING EXPIRED OR EXISTING CONTRACTS

ASC 842 is generally consistent with prior guidance and limits its application to leases of property, plant or equipment. A lease is defined 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."

A contract is or contains a lease under ASC 842 when:



While the definitions of a lease under ASC 840 and ASC 842 are similar, there are nuances that could result in a different conclusion. For example, under ASC 840 a customer could have the right to control the use of an asset solely based on obtaining substantially all the output from that asset, assuming the contract is priced in a certain way (e.g., some power purchase agreements). However, those same arrangements may not be leases under ASC 842 if the customer does not direct the use of the underlying asset (i.e., power criterion). See earlier article, Identifying a Lease, for additional guidance.

However, if an entity elects the package of practical expedients, it does not reevaluate its existing contracts under ASC 842. Instead, the entity carries forward 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 carries forward that conclusion when applying the transition requirements of ASC 842.

Errors and Omissions of Assessment under ASC 840 Not Grandfathered

The FASB provided this practical expedient because the Board expected that most leases under ASC 840 would be leases under ASC 842 and therefore the costs of applying the new definition of a lease to all existing contracts generally would exceed the related benefits. However, electing the package of practical expedients does not grandfather errors or omissions of assessment. For example, if the entity did not previously evaluate a contract under ASC 840 (e.g., a potential embedded lease in a service contract) and that contract would meet the definition of a lease, or if it evaluated a contract but reached an incorrect accounting conclusion, those errors are not 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.

NOT REASSESSING LEASE CLASSIFICATION

Based on the lease classification guidance in ASC 842 (as amended by ASU 2021-05):

If one or more of the following conditions are 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. (Exception exists for leases that commence at or near the end of the economic life of the underlying asset)
- The present value of the sum of lease payments and any residual value guaranteed by the lessee not reflected in lease payments equals or exceeds substantially all of the underlying asset's fair value.
- 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.

The lessee classifies the lease as a finance lease; and the lessor classifies the lease as a sales-type lease (unless there are variable lease payments not based on an index or a rate and that would result in the lessor recognizing a selling loss).

When none of the above criteria are met, a lessee classifies the lease as an operating lease, and a lessor classifies the lease as either an operating lease or a direct financing lease based on additional requirements. See earlier article, Lease Classification and Key Terms, for additional guidance. The following applies in transition depending on whether the entity elects the package of practical expedients:

Entity Elects Package	Entity Does Not Elect Package
The entity does not reassess classification of its expired or existing leases under ASC 842 but carries 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 carries forward that classification when applying the transition requirements of ASC 842.	The entity must reassess lease classification under ASC 842 at the later of the commencement date of the lease or the most recent lease modification that required the entity to reassess lease classification. If the classification changes, there are specific recognition and measurement requirements that generally result in the entity revaluing the lease.

Lease Classification Not Expected to Change Significantly

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 (for example, there is no longer prescriptive lease classification guidance for real estate under 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.

NOT REASSESSING INITIAL DIRECT COSTS

Under ASC 842, initial direct costs are defined as the incremental costs of a lease that would not have been incurred if the lease had not been obtained. This means that lease commissions and payments made to an existing tenant to incentivize that tenant to terminate its lease meet the definition of initial direct costs under ASC 842. 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, to obtain legal or tax advice, or to 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 earlier article, Lease Classification and Key Terms for additional guidance.

The following applies in transition depending on whether the entity elects the package of practical expedients:

Entity Elects Package	Entity Does Not Elect Package
The entity does not reassess capitalized initial direct costs of existing leases under ASC 842. Instead, the entity includes existing unamortized initial direct costs under ASC 840 in the initial measurement of the lease. For example, assume an entity (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 application date. If the entity elects the package of practical expedients, the entity includes that $5,000 balance in the initial measurement of the right-of-use asset for that operating lease.	The entity should reassess all existing capitalized initial direct costs under ASC 842. The entity should write off those that do not meet the definition of initial direct costs under ASC 842 as an adjustment to retained earnings, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings in the period in which they are incurred.

Definition of Initial Direct Costs Narrower Under ASC 842 Compared to ASC 840

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 under 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 ASC 842, those costs will generally be expensed as incurred.

An entity expecting to be significantly impacted by this change in definition 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 or contains 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

FACTS

- 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 payable in advance plus one percent of sales during the initial five-year term. Base rent increases by 10% in each five-year renewal period (for example, rent is $55,000 per month for the first 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 noncancelable period 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 $7,000 in broker commissions.
- There were no modifications to the lease agreement.

ACCOUNTING UNDER ASC 840

- Susie's concluded that the contract was a lease under ASC 840.
- Susie's determined that the lease term was ten years (the initial five-year term plus one five-year renewal period). This is because the unamortized leasehold improvements at the end of the noncancelable period were significant to Susie's, and therefore Susie's concluded it was reasonably assured to exercise the first renewal option.
- Susie's determined that the lease was an operating lease and therefore Susie's did not recognize this lease on balance sheet under ASC 840.
- Susie's recognized straight-line lease expense of $630,000 during 2018 (the sum of the lease payments over the 10-year lease term, divided by 10), which resulted in an accrued rent balance of $30,000 as of 12/31/2018 on balance sheet.
- Unamortized initial direct costs at 12/31/2018 are $19,800 ($22,000 / 10 years X 9 years remaining) and are comprised of $13,500 unamortized legal fees and of $6,300 unamortized broker commission.
- In its financial statements for the year ended 12/31/2018, Susie's provided all required ASC 840 disclosures, including disclosure of rental expense with separate amounts for minimum rentals and contingent rent. Susie's also disclosed future minimum rental 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).

ADOPTION OF ASC 842

- On 1/1/2019, Susie's adopts ASC 842.
- Susie's did not elect the practical expedient to use hindsight.
- Susie's initial application of ASC 842 depends on which transition method it elects and whether it elects the package of practical expedients.

Susie's Adopts ASC 842 Using the Transition Alternative	
Susie's recognizes the above operating lease on balance sheet 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: ▶ Whether this contract is a lease (i.e., it is a lease for purposes of adopting ASC 842), ▶ Lease classification (i.e., it is an operating lease for purposes of adopting ASC 842), ▶ Initial direct costs capitalized (i.e., the $22,000 continue to be capitalized). Therefore, the amount of unamortized initial direct costs of $19,800 at 12/31/2018 is included in the initial measurement of the right-of-use asset on 1/1/2019.	Accordingly, Susie's reassesses: ▶ Whether this contract is a lease. In this case, Susie's concludes the contract is also a lease under 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. In this case, Susie's determines that a portion of initial direct costs (legal fees) capitalized under ASC 840 does not meet the definition of initial direct costs under ASC 842. Therefore, the unamortized portion of these costs ($13,500 at 12/31/2018) is written off as an adjustment to retained earnings on 1/1/2019. The remaining unamortized portion of initial direct costs ($6,300 unamortized commission) is added to the initial measurement of the right-of-use asset on 1/1/2019.

Susie's Adopts ASC 842 Using the Modified Retrospective Approach	
Susie's recognizes the above operating lease on balance sheet 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: ▶ Whether this contract is a lease (i.e., it is a lease for purposes of adopting ASC 842), ▶ Lease classification (i.e., it is an operating lease for purposes of adopting ASC 842), ▶ Initial direct costs capitalized (i.e., the $22,000 continue to be capitalized). Therefore, the entire amount of initial direct costs of $22,000 is included in the initial measurement of the right-of-use asset on 1/1/2018.	Accordingly, Susie's reassesses: ▶ Whether this contract is a lease. In this case, Susie's concludes the contract is also a lease under 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. In this case, Susie's determines that a portion of initial direct costs (legal fees) capitalized under ASC 840 do not meet the definition of initial direct costs under ASC 842. As such, the $15,000 must be written off as an expense (rather than retained earnings) when incurred because those costs were incurred during a period for which an income statement is presented. The remaining costs ($7,000 commission) is added to the initial measurement of the right-of-use asset on 1/1/2018.

HINDSIGHT PRACTICAL EXPEDIENT

An entity may use hindsight in determining the lease term (when considering lessee options to renew or terminate and to purchase the underlying asset) and in assessing impairment of right-of-use assets. This expedient:

- If elected, must be applied by the entity to all of its leases (for example, the 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),
- May be elected separately or in conjunction with either or both the package of practical expedients and the land easements practical expedient.

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

Considerations for Electing Hindsight Practical Expedient

The hindsight practical expedient was initially intended to provide relief when the modified retrospective approach was the only transition method available. Specifically, it was intended to allow an entity to avoid reassessing lease term and impairment of right-of-use assets during each of the prior periods presented. However, electing the hindsight practical expedient may be time consuming depending on the volume of leases that an entity has and may result in additional complexity in applying the transition requirements (for example, if the entity elects the package of practical expedients and therefore retains the same lease classification, but the lease term changes based on the use of hindsight). Also, the hindsight assessment should be performed at the date of adoption (for example, January 1, 2022 for a calendar year-end private company). 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, and the lack of benefits when a company elects the transition alternative, many entities have not or do not plan to elect it.

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 various industries, such as in the energy, utilities, transportation and telecom industries. For example:

- A midstream energy company may acquire a land easement for the right to pass a pipeline over, under, or through an existing area of land while allowing the landowner continued use of the land for other purposes (farming, hunting, etc.) if the landowner does not interfere with the rights of the midstream energy entity.
- An electric utility might acquire a series of contiguous easements so that it can construct and maintain its electric transmission system on land owned by others.

Terms of land easements can vary greatly between agreements. For example, 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. The grantor (landowner) also may retain rights associated with access and use of the land area, or it may be restricted in its ability to access and use the land area.

Diversity has historically existed in U.S. GAAP in the accounting for land easements before the introduction of ASC 842. For example:

- Some entities have accounted 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 have applied ASC 360 and considered 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 have applied 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, *Land Easement Practical Expedient for Transition to Topic 842*, to clarify that land easements are in the scope of ASC 842. However, considering the existing diversity in accounting, ASU 2018-01 allows entities that previously did not account for 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. This approach is intended to reduce the cost and complexity associated with assessing whether existing and expired land easements meet the definition of a lease for entities transitioning to ASC 842. Instead, entities will continue to account for those land easements under other GAAP unless the land easement is modified on or after ASC 842's adoption date. An entity that currently accounts for land easements as leases under ASC 840 cannot elect this practical expedient for those easements.

An entity must apply this expedient consistently to all its existing and expired land easements that were not accounted for as leases under ASC 840, and it may be elected separately or in conjunction with either or both the package of practical expedients and the hindsight practical expedient.

Also, because the Board clarified in ASU 2018-01 that land easements are in the scope of ASC 842, once an entity adopts the new lease standard, it must apply that guidance prospectively to all new or modified land easements to determine whether those arrangements meet the definition of a lease under ASC 842.

Practical Expedient Provided for Cost-Benefit Reasons

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 under ASC 842 because they are not "for a period of time") and that many land easements are prepaid (and therefore already recognized on balance sheet). The Board therefore did not want entities to incur significant time and effort (considering the volume of land easements and age of those agreements) to evaluate them under ASC 842, especially considering that adoption of ASC 842 was generally not expected to have a material impact for these existing land easements.

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

Example 3 - Land Easements in Transition

Electric Company obtained a series of easements years before its adoption of ASC 842. The easements were obtained so that Electric Company could install poles to which its power lines would be attached. In addition to installing its poles, Electric Company has the right to access the poles via a corridor leading from the nearest road to the pole. Electric Company will make payments over time under the easement agreement in return for long-term access rights. Electric Company historically accounted for those land easements along with its poles as property, plant and equipment under ASC 360.

Because Electric Company did not account for those land easements as leases under ASC 840, it can elect the land easement practical expedient. This means that Electric Company will continue to account for those land easements under ASC 360 unless the agreement is modified on or after ASC 842's adoption date, in which case Electric Company will need to assess whether those easements meet the definition of a lease under ASC 842. If elected, the practical expedient must be applied to all of Electric Company's land easements not accounted for as leases under ASC 840.

Alternatively, if Electric Company does not elect the land easements practical expedient, it should evaluate all of its existing land easements when adopting the new standard to determine whether those easements meet the definition of a lease under ASC 842.

TRANSITION – LESSEES

We previously explained *when* entities should recognize leases on balance sheet and noted that the date at which a lease is recognized on balance sheet is the application date, which depends on the transition method selected. We will now explore *how* the entity measures those leases on balance sheet.

The initial 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 ASC 840 AND ASC 842

If an entity elects the package of practical expedients, or the entity does not elect it but lease classification does not change, and the lease is an operating lease, the initial measurement of the lease at the application date is summarized as follows:

LL

A lessee initially measures the lease liability (LL) for a lease classified as an 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 application date. An entity that is not a public business entity may use the risk-free rate. See earlier article, Lease Classification and Key Terms for additional details on the discount rate for the lease and the risk-free rate accounting policy.

ROU

The right-of-use asset (ROU) is initially measured at the amount of the initial measurement of the lease liability, adjusted for the following:

- Any prepaid or accrued rent payments,
- Any unamortized lease incentives,
- 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 do not meet the definition of initial direct costs under ASC 842 should be written off as an adjustment to equity, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings when incurred.

The lease liability then continues to be measured each period like the initial measurement described above. The ROU asset also continues to be measured like the initial measurement described above, except if the carrying amount was adjusted for the carrying amount of an ASC 420 liability, in which case the lessee applies the recognition and subsequent measurement guidance when the ROU asset has been impaired.

The following provides additional subsequent measurement guidance for operating leases:

Initial measurement of 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 expense treatment in the income statement. Instead, the entity will subsequently amortize the ROU asset on typically 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 in operating expenses.
ROU asset is impaired under ASC 360 on or after adoption date	Starting on or after ASC 842's effective date, ROU assets are subject to the impairment guidance under ASC 360. 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.
Contract is modified on or after adoption date, and the modification does not result in a separate contract (see paragraph 842-10-25-8)	In those situations, the lessee must follow the requirements of ASC 842 from the effective date of the modification. This means that, for example, the lessee no longer can use *minimum rental payments* as applied in ASC 840; rather the lessee should use the *lease payments* as defined in ASC 842. See Accounting for Leases - Lessees for a discussion of the modification guidance for lessees.
The lessee is required to remeasure the lease liability in accordance with paragraphs 842-20-35-4 and 35-5	The same applies as for modifications not accounted for as separate contracts. See Accounting for Leases - Lessees for a discussion of the remeasurement guidance for lessees.

See also Accounting for Leases - Lessees for comprehensive guidance on lessee accounting.

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

- Let's continue Susie's lease of retail space in Example 2.
- Assume that Susie's adopts ASC 842 on 1/1/2019 using the transition alternative. Susie's application date is therefore 1/1/2019, which is its adoption date.
- Susie's elects the package of practical expedients but not the hindsight practical expedient.
- 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*. Originally, ten years (five-year noncancelable period plus first five-year renewal period). The remaining lease term at the application date is nine years.
  - *Payment terms*. Rent payments were $50,000 per month plus one percent of sales during the initial five-year term. Payments then increase to $55,000 per month. Future minimum rental payments were $5,700,000 at 12/31/2018. Accrued rent resulting from straight-line recognition at 12/31/2018 was $30,000. The rent payments based on percentage of sales are contingent rents 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 12/31/2018 are $19,800. Because Susie's elected the package of practical expedients, it includes the entire unamortized balance of $19,800 in the initial measurement of the ROU asset.
- Based on the above information, Susie's initially measures the operating lease as follows:

LL

It measures the lease liability at the present value of the unpaid minimum rental payments at 1/1/2019, discounted at 6%. There is no residual value guarantee provided by Susie's.

Based on the present value calculation, Susie's determines the initial measurement of the lease liability is $4,390,078. On the same date, Susie's makes the rent payment of $50,000 and therefore the lease liability is reduced to $4,340,078.

ROU and IDCs

It measures the ROU asset at the following:

Initial amount of the lease liability	$4,390,078
Prepaid (accrued) rent	(30,000)
Less unamortized lease incentives	N/A
Plus unamortized initial direct costs	19,800
Less carrying amount of ASC 420 liability	N/A
Initial measurement of the ROU asset	$4,379,878

- 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.
- Susie's will continue to measure the lease liability and ROU asset in the same way as described above, and Susie's will recognize monthly straight-line lease expense of $52,683 (consistent with the amount recognized under ASC 840) unless the ROU asset is impaired on or after ASC 842's effective date.
- Also, if on or after 1/1/2019 Susie's modifies the lease and it is not accounted for as a separate contract, or Susie's is required to remeasure the lease liability under paragraphs 842-20-35-4 and 35-5, Susie's will follow the requirements in ASC 842 from the effective date of modification or remeasurement date.

EXECUTORY COSTS FOR EXISTING OPERATING LEASES

As previously explained, a lessee is required to use the *minimum rental payments* as determined under ASC 840 when initially measuring existing operating leases in transition. However, because ASC 840 is not clear on whether executory costs (that is, taxes, insurance and maintenance) should be included or excluded as part of minimum rental payments, diversity in practice developed under ASC 840. Some lessees accounted for the entire rental payment as a minimum lease payment while others excluded from the minimum lease payment the portion representing executory costs of the leased asset. Therefore, questions arose about how a lessee should recognize existing operating leases in transition.

The SEC staff addressed those questions at the 2017 AICPA Conference on Current SEC and PCAOB Developments and, more recently, at the 2018 AICPA Conference on Current SEC and PCAOB Developments:

Andrew W. Pidgeon - *Professional Accounting Fellow, Office of the Chief Accountant*

Lessee transition - minimum rental payment composition policies

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*

While discussed in the context of public companies, we believe the above guidance equally applies to private companies.

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 lease inception or using the current value at the application date.

The SEC staff addressed that question at the 2018 AICPA Conference on Current SEC and PCAOB Developments.

Andrew W. Pidgeon - *Professional Accounting Fellow, Office of the Chief Accountant*

Lessee transition - minimum rental payment measurement policies

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 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).

As previously noted, lessees will generally use future minimum rental payments determined in accordance with ASC 840 to calculate the lease liability and right-of-use asset to be recognized upon adoption of ASC 842. Therefore, how one determined future minimum rental payments when the payments are based on an index or rate for purposes of disclosures under ASC 840 should be consistent with how those payments are determined for purposes of adopting ASC 842.

While discussed in the context of public companies, we believe the above guidance equally applies to private companies.

DISCOUNT RATE USED TO INITIALLY MEASURE EXISTING OPERATING LEASES

As previously explained, the transition guidance in ASC 842 provides that existing operating leases should be initially measured using the discount rate for the lease at the application date. 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**, which we believe also applies to private companies.

Michael P. Berrigan - *Professional Accounting Fellow, Office of the Chief Accountant*

Lease Transition — Incremental Borrowing Rate

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).

Example 5 – Determining the Discount Rate for Existing Operating Leases

- In Example 4, Susie's adopted ASC 842 on 1/1/2019 and elected the 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 ASC 842, and Susie's should disclose which approach it applied.
    - **Approach A: Use Remaining Lease Term and Remaining Minimum Rental Payments.** For its lease of retail space above, Susie's would determine the discount rate based on (1) a remaining lease term of nine years, and (2) remaining lease payments of $5,700,000.
    - **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 (1) a total lease term of ten years, and (2) total lease payments of $6,300,000.

LESSEE PRACTICAL EXPEDIENT NOT TO SEPARATE DURING TRANSITION

ASC 842 provides 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 specifically addresses certain practical expedients (for example, the short-term lease exemption), it does not address the lessee practical expedient not to separate. However, while not addressed in transition, we believe an entity may elect, by asset class, the lessee practical expedient to not separate during transition.

- If elected in transition, we believe the entity should apply the lessee practical expedient also to new leases within that asset class that commence on or after the effective date.
- If not elected in transition (and since it is not discussed in transition), the entity may still elect the lessee practical expedient to new leases within that asset class that commence on or after the effective date.

IMPAIRMENT CONSIDERATIONS

Prior to adopting ASC 842, an entity may have recognized an impairment loss on its asset group(s). 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 ASC 842, operating leases did not receive any allocation of the impairment loss at that time. Accordingly, stakeholders questioned whether upon adoption of ASC 842 an entity is required to reallocate prior impairment losses because of the new asset 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 its intent to require entities to reallocate prior impairment losses. The FASB also observed that reallocating prior impairment losses would result in writing up some of the other long-lived assets in the asset group, which is not permitted under U.S. GAAP. Accordingly, the impairment guidance in ASC 360 applies to right-of-use assets starting only at the effective date. See **Accounting for Leases - Lessees** for guidance on impairment of right-of-use assets.

Also, prior to adopting ASC 842, an entity may have recognized an impairment loss for its 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 a remaining and "unused" impairment loss. Had an operating lease in the asset group been recognized on balance sheet at the date of impairment, some or all of the unused impairment losses may have been recognized. Accordingly, stakeholders questioned whether on adoption of ASC 842 an entity is required or permitted to recognize some or all of the prior unused impairment losses.

In those situations, we believe an entity may reduce the amount of the right-of-use asset initially recognized for unused impairment losses with a corresponding adjustment to retained earnings, assuming the asset group to which the operating lease pertains continues to be impaired. We also believe it would be acceptable for the entity to recognize the impairment in earnings on adoption rather than revisiting prior impairments to determine whether unused impairment losses existed. If the entity elects the modified retrospective transition and the impairment occurred during the comparative periods, the adjustment should be recognized in earnings of the relevant period.

SUBLEASE LIABILITIES EXISTING AT ADOPTION DATE

As previously discussed, ASC 842 provides explicit transition guidance for leases with existing ASC 420 liabilities. However, ASC 842 is silent about existing sublease liabilities recognized under ASC 840-20-25-15 when costs expected to be incurred under an operating sublease exceed anticipated revenue on the operating sublease. Because of the lack of guidance, there may be multiple approaches in transition depending on the facts and circumstances, including netting the existing sublease liability against the right-of-use asset (like the treatment of ASC 420 liabilities in transition, in which case the entity applies the guidance on right-of-use assets that are impaired), or writing off the existing sublease liability through retained earnings as part of the cumulative effect adjustment at transition (and evaluating the right-of-use asset for potential impairment).

MEASUREMENT OF EXISTING CAPITAL LEASES UNDER ASC 840 THAT ARE FINANCE LEASES UNDER ASC 842

If an entity elects the package of practical expedients, or the entity does not elect it but lease classification does not change (that is, the lease is a capital lease under ASC 840 and a finance lease under ASC 842), the initial measurement of the lease at the application date is summarized as follows:

LL	A lessee initially measures the lease liability for a lease classified as a capital lease under ASC 840 and classified 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 under ASC 840, plus any unamortized initial direct costs that meet the definition of initial direct costs under ASC 842, or all unamortized initial direct costs if the entity elects the package of practical expedients.
IDCs	Unless the entity elects the package of practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842 and that are not included in the measurement of the capital lease asset under ASC 840 should be written off as an adjustment to retained earnings, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings when incurred.

In short, other than the change in description of the capital lease asset to right-of-use asset and the capital lease obligation to 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:

- If the entity elected the modified retrospective transition, the lessee follows the general subsequent measurement guidance in ASC 840 before the effective date, and
- Irrespective of the transition method elected, the lessee applies ASC 842 on and after the effective date. As an exception, when applying the subsequent measurement guidance in ASC 842 after adoption, a lessee does not remeasure the lease payments for changes in 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.

The entity also classifies the assets and liabilities held under capital leases as right-of-use assets and lease liabilities arising from finance leases for presentation and disclosure purposes.

If the entity modifies the contractual terms and conditions of the lease on or after the effective date and the modification does not result in a separate contract, or the lessee is required to remeasure the lease liability (see Accounting for Leases - Lessees for additional guidance), the lessee follows the guidance in ASC 842 from the effective date of the modification or the remeasurement date.

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 to the lease.
- If classification changes, a lessee should initially recognize those leases at the application date as further described below. However, we believe that changes in classification should be infrequent for most entities considering the similarities in classification guidance between ASC 840 and ASC 842.

LEASES CLASSIFIED AS OPERATING LEASES UNDER ASC 840 AND CLASSIFIED AS FINANCE LEASES UNDER ASC 842

A lessee initially measures a lease classified as an operating lease under ASC 840 and classified as a finance lease under ASC 842 as follows:

LL

The lease liability is measured 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 application date. An entity that is not a public business entity may use the risk-free rate. See Lease Classification and Key Terms for additional details on the discount rate for the lease and the risk-free rate accounting policy.

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 application date relative to the total lease term.

The ROU recognized is then adjusted by the carrying amount of any prepaid or accrued lease payments and the carrying amount of 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 do not meet the definition of initial direct costs under ASC 842 should be written off as an adjustment to retained earnings, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings when incurred.

Also, if the entity modifies the contractual terms and conditions of the lease on or after the effective date and the modification does not result in a separate contract, or the lessee is required to remeasure the lease liability for any reason (see Accounting for Leases - Lessees for additional guidance), the lessee should follow the guidance in ASC 842 from the effective date of the modification or the remeasurement date. This means that the lessee will no longer use the *minimum rental payments* as applied under ASC 840 to account for the lease but rather will use the *lease payments* as defined in ASC 842.

LEASES CLASSIFIED AS CAPITAL LEASES UNDER ASC 840 AND CLASSIFIED AS OPERATING LEASES UNDER ASC 842

A lessee initially measures a lease classified as a capital lease under ASC 840 and classified as an operating lease under ASC 842 as follows:

LL

The initial measurement of the lease liability is the present value of the *lease payments* not yet paid as defined under ASC 842 (not the *minimum rental payments* determined under ASC 840) discounted using the discount rate for the lease determined at the application date.

ROU

The ROU asset is initially measured using the amount of 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
- Any difference between the carrying amount of the capital lease asset and capital lease obligation under ASC 840 that are derecognized at the application date (which are accounted for in the same manner as prepaid or accrued rent).

IDCs

Because the entity did not elect the package of practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842 should be written off as an adjustment to retained earnings, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings when incurred.

The lease is then accounted for under ASC 842 like any new lease would be.

If the entity modifies the contractual terms and conditions of the lease on or after the effective date, and the modification does not result in a separate contract, or the lessee is required to remeasure the lease liability for any reason (see **Accounting for Leases - Lessees** for additional guidance), the lessee applies ASC 842.

TRANSITION - LESSORS

MEASUREMENT

Like lessees, the measurement of existing leases generally depends on whether 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 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 applies.

The following tables summarize the transition provisions for each lease classification scenario:

Existing lease is an operating lease under ASC 840 and ASC 842

- Continue to recognize at the application date the underlying asset along with any related assets or liabilities, such as rent receivables.
- Account for previous securitized receivables as secured borrowings in accordance with other Topics.
- If the entity does not elect the package of practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842 should be written off as an adjustment to retained earnings, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings when incurred.

Existing lease is a sales-type lease or direct financing lease under ASC 840 and ASC 842

- Continue to recognize at the application date the carrying amount of the net investment in the lease. This includes any unamortized initial direct costs capitalized as part of the net investment in the lease for a direct financing lease under ASC 840, regardless of whether the package of practical expedients is elected.
- If the entity elected the modified retrospective transition, the lessor accounts for the lease under ASC 840 before the effective date of ASC 842.
- Regardless of the transition method elected, beginning on the effective date of ASC 842 the lessor applies the recognition, subsequent measurement, presentation, and disclosure guidance in ASC 842.
- Beginning on the effective date, if the lessor modifies the lease and the modification is not accounted for as a separate contract, the accounting depends on the classification of the modified lease. See Accounting for Leases - Lessors for additional guidance.
- A lessor does not remeasure the net investment in the lease on or after the effective date unless the lease is modified and the modification is not accounted for as a separate contract.

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 application date, as if it had always been accounted for as a sales-type lease or direct financing lease under ASC 842. Accordingly, the lessor:

- Derecognizes the carrying amount of the underlying asset at the application date,
- Recognizes a net investment in the lease at the application date as if the lease had been accounted for as a sales-type lease or direct financing lease under ASC 842-30 since lease commencement,
- Records any difference between the two amounts above as an adjustment to:
  - Retained earnings, if the entity elected the transition alternative or the modified retrospective approach (and the lease commenced before the beginning of the earliest period presented, or if the lease was acquired as part of a business combination).
  - Earnings, if the entity elected the modified retrospective approach and the lease commenced on or after the beginning of the earliest period presented.
  - See also guidance below for operating leases acquired as part of a business combination for potential offsetting entries related to favorable and unfavorable terms of the lease.
- Then, the lessor accounts 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 application date, as if it had always been accounted for as an operating lease under ASC 842. Accordingly, the lessor:

- Recognizes the underlying asset at the application date at what the carrying amount would have been had the lease been classified as an operating lease under ASC 840,
- Derecognizes the carrying amount of the net investment in the lease,
- Records any difference between the two amounts above as an adjustment to:
  - Retained earnings, if the entity elected the transition alternative or the modified retrospective approach (and the lease commenced before the beginning of the earliest period presented, or if the lease was acquired as part of a business combination).
  - Earnings, if the entity elected the modified retrospective approach and the lease commenced on or after the beginning of the earliest period presented.
- Then, the lessor accounts for the lease under ASC 842 and the underlying asset under other Topics (e.g., ASC 360).

LEVERAGED LEASES

Unlike the legacy leases guidance, a lessor can no longer classify a lease as a leveraged lease under ASC 842. However, existing leveraged leases that commenced before the effective date of ASC 842 are grandfathered and continue to be accounted for by the lessor like under ASC 840 until they expire or are modified (see ASC 842-50). If a leveraged lease is modified on or after the effective date, it must be accounted for as a new lease as of the effective date of the modification in accordance with ASC 842. A lessor also applies the legacy leases guidance to a leveraged lease that commenced before the effective date and that is acquired in a business combination or an acquisition by a not-for-profit entity, unless that lease is modified.

PRACTICAL EXPEDIENT NOT TO SEPARATE FOR OPERATING LEASES

ASU 2018-11, *Leases (Topic 842) – Targeted Improvements*, provided lessors with an accounting policy by asset class to combine nonlease components with the associated lease component when certain criteria are met. When those criteria are met, the accounting for the combined component is 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 criteria for combination. See **Lease Classification and Key Terms** for additional guidance.

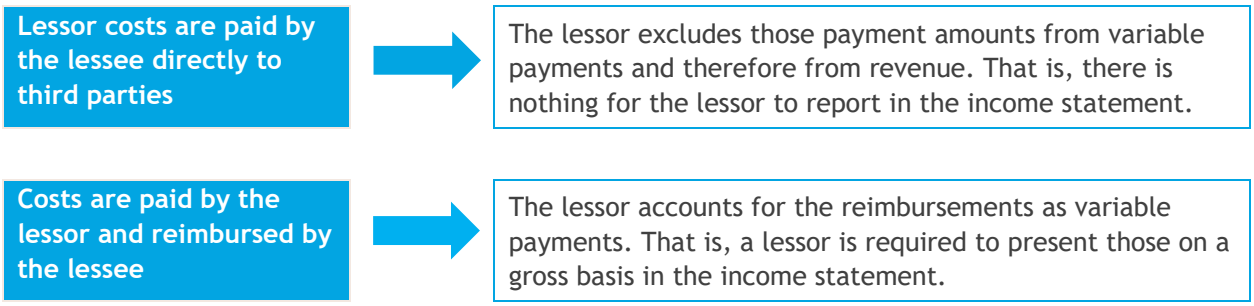
This lessor practical expedient must be elected at the effective date and must be applied to all new *and* existing leases. As a result, the election of the practical expedient may change presentation for some lessor entities. For example, lessor entities that previously presented taxes, insurance and maintenance recoveries separately from rental income can longer present those recoveries separately in the income statement if they elect the lessor practical expedient not to separate (see **Presentation and Disclosures** for additional details).

For entities that adopted ASC 842 before the issuance of ASU 2018-11, refer to paragraph 842-10-65-2 for additional effective dates and transition guidance.

NARROW SCOPE IMPROVEMENTS FOR LESSORS

ASU 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, simplifies lessor's accounting for sales taxes and certain lessor costs, and clarifies the recognition of certain variable payments for contracts with lease and nonlease components.

- **Sales Taxes and Similar Taxes**. A lessor can make an accounting policy election to exclude from the consideration in the contract and from variable payments not included in the consideration all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee. This includes for example sales, use, value added, and some excise taxes. However, taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset (for example, property taxes) are excluded from the scope of this election. When the lessor makes this election, it should comply with the disclosure requirements in paragraph 842-30-50-14.
- **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. ASC 842 initially required a lessor to report those amounts as revenue and expenses (that is, on a gross basis) whether the lessee reimburses the lessor or pays such costs on lessor's behalf to a third-party. However, stakeholders raised concerns with this requirement, including challenges with estimating those costs when the lessee pays the amounts directly to third parties, and noted limited benefits because the amounts in the income statement would net to zero. In response to those concerns, the FASB issued ASU 2018-20 which made the following amendments for this issue.



- **Accounting for Variable Payments in Contracts with Lease and Nonlease Components**. The ASU clarified the requirements in paragraph 842-10-15-40 for lease contracts in which the terms of the variable payment amount (other than those that depend on an index or a rate) relate to a lease component (even partially) when the changes in facts and circumstances on which the variable payment is based occur.

See earlier article, Identifying and Separating Components, for additional details. 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. For entities that adopted ASC 842 before the issuance of ASU 2018-20, refer to paragraph 842-10-65-3 for additional effective dates and transition guidance.

CODIFICATION IMPROVEMENTS

ASU 2019-01, *Leases (Topic 842) – Codification Improvements*, clarifies the application of certain aspects of ASC 842 primarily for financial institutions.

- **Determining Fair Value of the Underlying Asset**. ASC 842 initially did not include an exception that existed under ASC 840 for determining fair value for lessors who are not manufacturers or dealers (generally financial institutions and captive finance companies). In response to feedback from lessors previously qualifying for the exception in ASC 840, the FASB added a similar exception under ASC 842. As a result, for lessors that are not manufacturers or dealers, the fair value of the underlying asset at lease commencement is defined as its cost, reflecting any volume or trade discounts that apply. This exception applies only if there has not been a significant lapse of time between the acquisition of the underlying asset and lease commencement. If there has been a significant lapse of time, the lessor applies the ASC 820 definition of fair value like any other lessor.
- **Cash Flow Classification for Sales-Type and Direct Financing Leases**. ASC 842 initially required lessors to classify all cash receipts from leases as operating activities, regardless of whether the lease was an operating lease, sales-type lease, or direct financing lease. However, the FASB received feedback from lessor stakeholders within the scope of ASC 942, *Financial Services—Depository and Lending*, that they historically have presented principal payments received under leases within investing. Following that feedback, the FASB clarified that lessors that are depository and lending institutions within the scope of ASC 942 should present all "principal payments received under leases" within investing activities.

Refer to paragraph 842-10-65-2 for effective dates and transition guidance.

CERTAIN LEASES WITH VARIABLE LEASE PAYMENTS

ASU 2021-05, *Leases (Topic 842) – Lessors—Certain Leases with Variable Lease Payments*, addressed the recognition of a selling loss at the commencement date (a "day-one loss") for sales-type or direct financing leases because of variable lease payments that do not depend on an index or a rate. The ASU addressed this issue by requiring lessors to classify such leases as an operating lease when the lease includes variable lease payments that do not depend on an index or a rate and that would result in the recognition of a selling loss at lease commencement if the lease were classified as a sales-type lease or direct financing lease. See Lease Classification and Key Terms for additional details. Also refer to paragraph 842-10-65-5 for effective dates and transition guidance.

OTHER TRANSITION REQUIREMENTS

In addition to the above transition provisions applicable to lessees and lessors, ASC 842 includes other transition provisions, including prior sale and leaseback transactions, existing build-to-suit lease arrangements and amounts previously recognized as part of business combinations.

SALE AND LEASEBACK TRANSACTIONS BEFORE THE EFFECTIVE DATE

Previous sale and leaseback transaction was accounted for as a *failed* sale and leaseback under ASC 840 and remains a failed sale at the adoption date

Reassess whether a sale would have occurred under ASC 842 as follows:

- **If the entity elected the modified retrospective approach**. The seller-lessee reassesses whether a sale would have occurred under paragraphs 842-40-25-1 through 25-3 (see Other Topics) at any point on or after the beginning of the earliest period presented. If any such reassessment results in sale accounting, the entity accounts for the sale and leaseback transaction on a modified retrospective basis from the date sale accounting is achieved.
- **If the entity elected the transition alternative**. The seller-lessee reassesses whether a sale would have occurred under paragraphs 842-40-25-1 through 25-3 (see Other Topics) at the beginning of the period of adoption. If that reassessment results in sale accounting, the seller-lessee recognizes the sale as an adjustment to retained earnings. The entity then accounts for the leaseback under ASC 842.
- **Classification of the leaseback**. The transition provisions do not address how a lessee should classify the leaseback. However, we believe that if the entity elected the package of practical expedients, the lessee may perform the classification assessment under either ASC 840 at lease inception or under ASC 842 at lease commencement.

Previous sale and leaseback transaction was accounted for as a sale and leaseback under ASC 840

- The entity does not reassess the transaction. That is, it remains a successful sale and leaseback transaction. We believe this also applies to buyer-lessors that did not apply ASC 840-40 and accounted for the transaction as a successful purchase.
- The entity accounts for the leaseback in accordance with the lessee and lessor transition requirements applicable to existing leases (see previous sections).
- The seller-lessee may also need to make other adjustments depending on the classification of the leaseback and the transition method elected, as further discussed below.

DEFERRED GAINS OR LOSSES ON EXISTING SALE AND LEASEBACK TRANSACTIONS

As discussed above, 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 be 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

- The seller-lessee continues to recognize any deferred gains or losses that exist at:
  - The later of the beginning of the earliest comparative period presented and the date of sale of the underlying asset (if the entity elected the modified retrospective approach),
  - The adoption date (if the entity elected the transition alternative).
- The seller-lessee amortizes 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 right-of-use 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

- The seller-lessee writes off any deferred gains or losses that do not result from off-market terms as an adjustment to retained earnings, unless the entity elects the modified retrospective transition and the date of sale is after the beginning of the earliest period presented (in which case the adjustment is recognized in earnings at the date of sale).
- The seller-lessee recognizes any deferred gains or losses resulting from off-market terms (that is, when the consideration for the sale is not at fair value or the lease payments are not at market rates) as a financial liability or as an adjustment to the leaseback right-of-use asset, respectively.
  - The adjustment is recorded at the later of the beginning of the earliest comparative period presented and the date of sale of the underlying asset if the entity elected the modified retrospective approach.
  - The adjustment is recorded at the adoption date if the entity elected the transition alternative.

Example 6 – 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 also 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 it 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., not as a 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's transition requirements, Susie's does not reassess whether the sale and leaseback transaction would have qualified for sale accounting under ASC 842. Also, because there were no off-market terms, Susie's should 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 transition alternative. If Susie's elects the modified retrospective approach, the adjustment also would be recorded in retained earnings unless the date of sale is after the beginning of the earliest period presented, in which case the adjustment would be 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 the asset (for example, for 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 on a modified retrospective basis 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 paragraph 842-40-55-5 and the earlier article on Other Topics for additional guidance on determining whether a lessee controls the asset under construction under ASC 842 and therefore is considered the accounting owner.

The date at which the lessee derecognizes the build-to-suit assets and liabilities depends on the transition method the entity elects.

- **The entity elects the modified retrospective approach**. The lessee derecognizes those build-to-suit assets and liabilities with an adjustment to retained earnings, if any, at the later of (1) the beginning of the earliest comparative period presented and (2) the date the lessee is determined to be the accounting owner under ASC 840.
- **The entity elects the transition alternative**. The lessee derecognizes those build-to-suit assets and liabilities with an adjustment to retained earnings, if any, at the adoption date.

The lessee then applies the lessee transition requirements to the lease as discussed in the earlier sections. The transition provisions do not address how a lessee classifies the lease in that situation. However, we believe that if the entity elected the package of practical expedients, the lessee may perform the classification assessment under either ASC 840 at lease inception or under ASC 842 at lease commencement.

Also note that if the construction period of the build-to-suit lease concluded before the beginning of the earliest period presented (if the entity elects the modified retrospective approach) or the effective date (if the entity elects the transition alternative) and the transaction qualified as a sale and leaseback transaction under ASC 840, the lessee does not apply the transition provisions for build-to-suit arrangements discussed above but instead applies the general lessee transition requirements for the lease. However, if the transaction did not qualify as a sale and leaseback transaction under ASC 840, the entity applies the build-to-suit transition provisions and derecognizes the asset and related liability. The company does not apply the sale and leaseback transition provisions, and does not assess whether the transaction would qualify as a sale under ASC 842.

Write Off of Assets and Liabilities in a Built-to-Suit Arrangement

The transition provisions of ASC 842 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, they should not be written off but instead included in the initial measurement of the right-of-use asset or as leasehold improvements.

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 (when the lessor entity does not elect the package of practical expedients).

Entity is a lessee	Derecognize any favorable lease asset or unfavorable lease liability with the corresponding adjustment to the carrying amount of the right-of-use asset.
Entity is a lessor and lease classification changes from operating to sales-type or direct-financing lease	Derecognize any asset or liability with the corresponding adjustment to retained earnings. Also apply 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

ASC 842 permits an entity to apply the leases guidance on a portfolio basis. 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 ASC 842 to the individual leases in the portfolio. Paragraphs 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 may 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 with similar characteristics (for example, in terms of lease payments, lease term, and so forth) to determine the discount rate to initially measure those leases.

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