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FASB ASC 842
Implementation FAQs – Part 4

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In part 4 of this report series, we answer questions frequently asked by CPEA members as they assist clients implementing FASB *Accounting Standards Codification* (FASB ASC) 842, *Leases*. These questions and answers are intended to help our members who may encounter similar issues on engagements. Some questions are blends of multiple CPEA member questions on a similar topic. While the fact pattern in a particular member question below may not exactly match the circumstances that a different member may be dealing with, the answer should, in most cases, be relevant and helpful.

Question #1:

A lessee adopts FASB ASC 842 using the effective date method, which applies FASB ASC 842 on a cumulative catch-up basis as of the effective date (for a calendar year private company, that date would be January 1, 2022) and is presenting comparative financial statements. Under this transition method, is the lessee required to present two future minimum lease payment schedules – one in accordance with FASB ASC 842 for the current year and one in accordance with FASB ASC 840, *Leases*, (the legacy lease standard) for the prior year?

Answer:

If a private company lessee presents comparative financial statements (no statutory requirement to do so) and applies the effective date method of transition, it is required to present the prior year future minimum lease payment schedule under FASB ASC 840-20-50-2 and the current year lease payment schedule under FASB ASC 842. This is obliquely referenced in Basis for Conclusion (BC) 14 of ASU 2018-11, *Leases (Topic 842): Targeted Improvements*, with the parenthetical reference about the comparative period presented under FASB ASC 840 being the "latest balance sheet presented." The requirement is directly referenced in the March 7, 2018 FASB meeting where final decisions were made on ASU 2018-11.

We have observed that some public companies did not satisfy this requirement. In one example, the SEC questioned this omission and the entity responded with their reasoning. The full response can be read here. In that response, the entity indicates:

> "ASC 840 also requires disclosure of future minimum rentals for the latest balance sheet presented. However, we believe that the presentation required under ASC 842 of the future undiscounted cash flows as of December 31, 2018 provides the users of the financial statements with the most relevant information on our current financial position and future obligations; therefore, the similar ASC 840 disclosure was not presented."

We did not identify any SEC response requiring revisions as a result of the omission. Nevertheless, the U.S. generally accepted accounting principles (U.S. GAAP) requirement is very clear and, therefore, we recommend complying with the requirement and presenting the prior year future minimum lease payment schedule under FASB ASC 840-20-50-2. Any entity that omits the disclosure would carry the burden of justification. We also caution members that some peer reviewers focus on disclosure omissions.

Question #2:

In adopting FASB ASC 842, a lessee assesses existing leases accounted for under legacy FASB ASC 840 and determines that the lease term no longer reflects current circumstances. Can the lessee reassess the lease term upon transition to FASB ASC 842?

Answer:

Transitioning to FASB ASC 842 is not itself a reassessment event for the lease term. At transition, unless a lessee elects the hindsight practical expedient (FASB ASC 842-10-65-1(g)), the lessee should be carrying forward the lease term as identified under FASB ASC 840. If a lessee has a lease where the lease term will be extended (perhaps leasehold improvements are significant), consideration can be given to adopting the hindsight practical expedient in determining the lease term at transition. However, it should be noted that the hindsight practical expedient must be applied consistently by an entity to all its leases.

Question #3:

FASB ASC 842-20-50-4(g) requires lessees to disclose supplemental noncash information on lease liabilities arising from obtaining right-of-use (ROU) assets. Does that disclosure encompass existing leases that were transitioned to FASB ASC 842 on the adoption date of January 01, 2022?

Answer:

This issue is not specifically addressed in FASB ASC 842. The CPEA believes that the supplemental noncash information disclosure does not encompass leases transitioned on the adoption date and that the disclosure requirement is intended for new lease activity occurring during the period after the adoption date. Our opinion is that ROU assets and lease liabilities recognized as of the transition adjustment on January 01, 2022 are not required in the supplemental non-cash disclosures for the 2022 reporting year because such amounts are part of the transition adjustment, reflecting revised accounting for prior year balances and transactions. The FASB ASC 842-20-50-4(g) disclosure requirement stems from FASB ASC 230, *Statement of Cash Flows*, specifically FASB ASC 230-10-50-3 which addresses noncash investing and financing activities during *a period* [emphasis added]. ROU assets and lease liabilities recognized at transition are not activities of the current period. Further the transition-related disclosures provide financial statement users with information related to ROU assets and lease liabilities for existing leases recognized at the adoption date of FASB ASC 842. We also note that certain public company financial statements filed with the SEC (10-K filings) appear to be consistent with our position..

Other cash flow disclosures related to the lease would be necessary, but not the disclosure related to the supplemental non-cash information. Note that this question and answer is not related to the non-cash reconciling items used to reconcile net income to cash flow from operations under the indirect method.

Question #4:

For purposes of a lessee measuring the ROU asset and lease liability at the commencement date, can the stated interest rate in the lease agreement be used as the discount rate?

Answer:

As indicated in FASB ASC 842-20-30-3, a lessee should use the rate implicit in the lease whenever that rate is readily determinable. If the rate implicit in the lease is not readily determinable, a lessee uses its incremental borrowing rate. A lessee that is not a public business entity is permitted to use a risk-free discount rate (e.g., the rate of a zero-coupon U.S. Treasury instrument) for the lease, determined using a period comparable with that of the lease term, as an accounting policy election for all leases.

The FASB ASC Master Glossary defines the rate implicit in the lease as follows:

> The rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used.

If an entity can determine that the interest rate indicated in the lease agreement is the rate implicit in the lease, as defined in the FASB ASC Master Glossary, then that is the rate to be used. Keep in mind that in most cases, the rate implicit in the lease will not be readily determinable for a lessee because the rate implicit in the lease is an internal measure, specific to the lessor, and making a determination about whether the indicated rate in the lease contract meets the definition of the rate implicit in the lease can be difficult.

Question #5:

If a lessee terminates a lease before the lease expiration date, what happens to the remaining ROU assets and lease liabilities in the financial statements?

Answer:

Guidance for a lessee's derecognition of a lease is in FASB ASC 842-20-40, which indicates that a termination of a lease before the expiration of the lease term should be accounted for by the lessee by removing the ROU asset and the lease liability, with profit or loss recognized for the difference. If leasehold improvements exist, those would need to be derecognized as well.

As indicated in FASB ASC 842-20-40-2, if the termination of a lease results from the purchase of an underlying asset by the lessee, it is treated as an integral part of the purchase of the underlying asset. If the lessee purchases the underlying asset, any difference between the purchase price and the carrying amount of the lease liability immediately before the purchase should be recorded by the lessee as an adjustment of the carrying amount of the asset. However, this paragraph does not apply to underlying assets acquired in a business combination, which are initially measured at fair value in accordance with FASB ASC 805, *Business Combinations*, specifically FASB ASC 805-20-30-1.

Question #6:

FASB ASC 842-20-30-2 indicates that a lessee should use the rate implicit in the lease whenever that rate is readily determinable. How does a lessee determine whether the rate implicit in a lease is readily determinable?

Answer:

The term “readily determinable” is not defined in the FASB ASC. Readily determinable is not an estimate but something that can be determined. In the case of determining the implicit rate in a lease, the rate would need to be provided by the lessor to the lessee, or the inputs needed to calculate the rate would need to be provided. Those inputs are numerous (e.g., residual value of the leased asset, lessor’s initial direct costs, fair value of the leased asset, etc.) and generally would need to be provided by the lessor. Normally, the lessee will not have access to the implicit rate from the lessor or the inputs needed to calculate it. The implicit rate may be more readily determinable in situations involving related party leases where the lessor is preparing U.S. GAAP financial statements and provides the implicit rate to the lessee.

Question #7:

Can a lessee group lease ROU assets and lease liabilities with other assets and liabilities for financial statement presentation purposes?

Answer:

Yes, ROU assets and lease liabilities can be grouped with other assets and liabilities. However, FASB ASC 842-10-45-3 indicates that, in the statement of financial position, a lessee is prohibited from presenting both of the following:

- Finance lease ROU assets in the same line item as operating lease ROU assets
- Finance lease liabilities in the same line item as operating lease liabilities

Also, FASB ASC 842-20-45-2 indicates that, if a lessee does not present finance lease and operating lease ROU assets and lease liabilities separately in the statement of financial position, the lessee should disclose which line items in the statement of financial position include those ROU assets and lease liabilities.

Question #8:

An existing lease is being transitioned to FASB ASC 842 as of January 01, 2022. During 2022 the lease was modified (e.g., change in lease payments, change in lease term, etc.). As the lessee prepares the December 31, 2022 financial statements, how is that modification accounted for? Can the lessee incorporate it into the transition accounting for the lease?

Answer:

Modifications that occurred after the adoption date of FASB ASC 842 should be accounted for separately from the transition accounting and accounted for according to the guidance in FASB ASC 842 on lease modifications (FASB ASC 842-10-25-8 through 18).

Question #9:

An existing operating lease of a lessee is being transitioned to FASB ASC 842. What happens to deferred rent upon adoption of FASB ASC 842? Is it written-off to retained earnings?

Answer:

Deferred rent is not written-off to retained earnings. FASB ASC 842-20-35-3 indicates that the measurement of the ROU asset should be adjusted for prepaid or accrued lease payments (i.e., deferred rent). Accordingly, the ROU asset is either credited (or debited) for the deferred rent. In other words, at transition the deferred rent account is removed and becomes incorporated in the measurement of the ROU asset.

Question #10:

Are conservation easements (which differ from land easements) within the scope of FASB ASC 842?

Answer:

A conservation easement, in very general terms, is an agreement between a landowner/easement holder in which the landowner voluntarily restricts certain uses of the property. While the CPEA is unaware of any specific guidance related to conservation easements in the context of FASC 842, we believe that a conservation easement meeting the definition of a lease under FASB ASC 842 is unlikely. For example, typical conservation easements provide a perpetual right, whereas FASB ASC 842-10-15-3 indicates that a contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a <u>period of time.</u>

In addition, typical conservation easements still allow the landowner to maintain use of the land, which would, in most cases, not allow the easement holder to obtain substantially all the economic benefits as required by FASB ASC 842-10-15-4. The CPEA recommends that the entity apply the relevant guidance in FASB ASC 842 to determine whether a lease exists, based on the legally enforceable rights and obligations.