ASC 842 Implementation: What does it mean for you?

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Overview

You have most likely read an article or heard some discussion of the new leases standard, Accounting Standards Codification Topic 842 (ASC 842) since the FASB introduced the ASC. Now that it is time to implement the standard, what does that really mean for your entity?

Key Impacts

- Effective Date: The new standard is effective for private entities for annual periods beginning after December 31, 2021.
- Leases must now be recorded on the balance sheet.
- Lease identification will be essential as entities must determine they have identified all leases, including those embedded in service contracts.
- Lease classification will involve more judgment and will impact financial statement presentation of lease expenses.
- Expanded disclosures will be required in the financial statements.
- Additional considerations under the new standard include lease reassessments, incorporation of executory costs into lease accounting, consideration of collectability and variable lease payments in calculating lease components, as well as changes in what qualifies as lease origination costs.
- Entities will be able to choose from different transition methods in addition to choosing from a package of practical expedients when implementing the new standard.

Primary Changes and Related Considerations

Balance Sheet Recognition

- All leases, including operating leases, will be recognized on the balance sheet via a right-of-use (ROU) asset and lease liability, unless the lease is a short-term lease (i.e., one with an accounting lease term of 12 months or less).
- Measurement of the Lease Liability and the ROU Asset:
    - Lease Liability: Initially measured at present value of future lease payments. Lessees must determine the appropriate discount rate to apply in the present value calculation, often requiring considerable judgment.
    - ROU Asset: Equal to the lease liability + Initial direct costs + prepaid lease payments – lease Incentives
- **Key Takeaway:**

- Accumulating the lease data necessary to apply the new guidance will likely require considerable time and effort. Depending on the volume of leases, the calculations will need to be tracked either in a spreadsheet or using a lease accounting software.

Lease Identification

- The definition of a lease is the new test for whether a transaction is on or off the balance sheet. The new definition is similar to the previous U.S. GAAP definition and will yield similar results in most cases. However, some arrangements that currently contain a lease will no longer contain a lease under the new definition. In addition, a new requirement to determine whether the customer has the right to direct the use of the identified asset will require significant new judgments.
- Embedded leases: The requirement to search for embedded leases is not new, but because companies are now required to record nearly all leases on the balance sheet, the implications of identifying, or failing to identify, all contracts containing leases become much more significant.
- **Key Takeaway:**
    - Completeness of leases: A substantial effort may be required to identify all of an entity's leases. Contracts must be reviewed to ensure all embedded leases are identified and accounted for appropriately.

OBSERVATION: The determination of whether an arrangement contains a lease will be much more important given the balance sheet implications. It will also make the allocation of contractual consideration between lease and non-lease elements a critical component of the accounting analysis for many entities.

Lease Classification

- Under previous U.S. GAAP, classification of the lease as either operating or capital included bright line tests related to the lease term and the present value of minimum lease payments. Under ASC 842, these bright lines are removed, requiring additional judgment in lease classification as either operating or finance. In addition, a new criterion is added related to highly specialized assets; under this test, if the leased asset is so specialized that at the end of the lease term it will have no alternative use to the lessor, then the lease is classified as a finance lease.
- Under the new standard, classification of the lease as operating or financing has no impact on balance sheet recognition – both are recognized on the balance sheet, and there are no differences in measuring the lease liability and ROU asset. The primary impact of the determination is on the income statement.

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    - Operating Lease: Lessee records a single lease expense made up of an interest component and an amortization component. Interest is calculated using the discount rate implicit in the lease based on the outstanding lease liability (which has been adjusted for lease payments). Recognition of lease expense is based on the lessee's expectation to benefit from the right to use the asset (e.g., if the lessee expects to benefit from the asset evenly over the lease period, lease expense will be recognized evenly over the life of the lease).

    - Finance Lease: Lessee recognizes interest and amortization expense as separate components in the income statement. A lessee amortizes the ROU asset from the commencement date to the earlier of the end of the useful life of the ROU asset or the end of the lease term. However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee amortizes the ROU asset to the end of the useful life of the underlying asset.

Lessee Reassessments

- Leases are no longer "set it and forget it." Entities will be required to reassess, and potentially change, aspects of their accounting for leases (e.g., assessments of the lease term, lessee purchase options, and lease classification) during the lease term, and remeasure lease assets and lease liabilities even if there is not a lease modification.

Executory Costs

- All (or a portion of) fixed payments by the lessee to cover lessor costs related to ownership of the underlying asset (e.g., property taxes or insurance—also referred to as executory costs) that do not represent payments for a good or service will be considered lease payments and reflected in the measurement of lease assets and lease liabilities by lessees (and in the lessor's net investment in the lease for sales-type and direct financing leases). Under previous U.S. GAAP, payments for executory costs, including those to reimburse lessors for costs related to the underlying asset, were excluded from minimum lease payments and, therefore, from lease accounting.

Collectability Considerations and Variable Payments

- While the new lessor accounting guidance is generally consistent with previous U.S. GAAP, the new standard changes how lessors account for leases in which collectability of the lease payments is uncertain. Lessors may now have to recognize some lease payments received as liabilities in those cases. The new standard also may affect leases for which there are significant variable payments because they no longer will be classified as operating leases solely due to the extent of variable payments. This may result in a negative implicit rate for the lease or loss recognition at lease commencement.

Lease Origination Costs

- The new standard has a narrow definition of initial direct costs that will require lessors and lessees to recognize more lease origination costs as expenses when incurred. Only incremental costs incurred as a result of the lease being executed (e.g., commissions) meet the new definition and can be capitalized. Accordingly, cost incurred to negotiate and arrange a lease that are not incurred only as a result of executing the lease (e.g., legal fees and certain internal employee costs)—some of which were capitalized under previous U.S. GAAP—will now be expensed when incurred. This could particularly affect lessors that incur significant costs in the lease origination process.

Expanded Disclosures

- The new standard requires lessees and lessors to disclose more qualitative and quantitative information about their leases than current U.S. GAAP does. Entities should consider whether they have appropriate systems, processes, and internal controls to capture completely and accurately the lease data necessary to provide those expanded disclosures.

Sale-Leaseback Accounting

- The new standard essentially eliminates sale-leaseback accounting as an off-balance sheet financing proposition. This is because seller-lessees will recognize a ROU asset and lease liability in place of the underlying asset (and any asset financing repaid with the sale proceeds).

Transition

- Lessees and lessors may elect between two different transition methods when initially adopting ASC 842.
    - Transition Method A utilizes retrospective application to each prior reporting period presented with a cumulative-effect adjustments recognized as the beginning of the earliest period presented

- Transition Method B utilizes retrospective application to the beginning of the period of adoption through a cumulative-effect adjustment recognized as of the beginning of the period of adoption.
- Under either method above, lessees and lessors may also elect from several different practical expedients when transitioning to ASC 842.
    - These must be elected as a package and applied consistently to all leases that commenced before the effective date of the new standard.
        - No need to reassess whether any expired or existing contracts are or contain leases
        - No need to reassess the lease classification for any expired or existing leases
        - No need to reassess initial direct costs for any existing leases
    - An entity may elect to use hindsight in determining the lease term and in assessing impairment of the right-of-use asset.
    - An entity may elect to not assess whether existing or expired land easements that were not previously accounted for as leases under Topic 840 are or contain a lease under Topic 842.

Practical Expedients

Transition relief

- *Hindsight:* This transition relief practical expedient must also be applied consistently to all leases (including both lessee and lessor contracts). An entity may use hindsight in:
    - determining the lease term (i.e. when considering lessee options to extend or terminate the lease or option to purchase the underlying asset)
    - assessing impairment of the entity's right-of-use assets
- *Transition Relief package:* The following transition relief practical expedients must be elected as a package for all leases (including both lessee and lessor contracts). For all contracts which commenced prior to the effective date of implementation, entities are not required to reassess:
    - whether any expired or existing contracts are leases or contain leases
    - the lease classification of any expired or existing leases (note that leases identified as capital leases under ASC 840 will be redefined as finance leases under ASC 842)
    - initial direct costs for any existing leases
- *Land easements*: This transition relief practical expedient must also be applied consistently to all leases that were not previously accounted for as leased under Topic 840. Entities may elect to not

assess whether existing or expired land easements are or contain a lease if the land easements were not previously accounted for as leases under Topic 840.

Short term leases

- An entity may make a policy election not to apply the requirements of ASC 842 to short-term leases.
- A short-term lease has a lease term of 12 months or less at the commencement date and does not include an option to purchase the underlying asset with a reasonably certain likelihood of exercise.

Discount rates

- For entities that are not public business entities, a lessee may elect to use a risk-free rate as its discount rate by class of underlying asset.
- The practical expedient includes a requirement to disclose the class or classes of underlying assets to which it has applied the risk-free rate.
- This may not be applied to leases where the rate implicit in the contract is readily determinable, even if the risk-free rate election has been made.

Combining lease and non-lease components

- An entity may make a policy election to not separate non-lease components from lease components and instead account for them together as a single lease component.
- While this is applicable to both lessee and lessor contracts, the lessor may only elect this practical expedient if the non-lease component would otherwise be accounted for under ASC 606, and:
  - The timing and pattern of transfer for the lease component and the associated non-lease components are the same
  - The lease component, if accounted for separately, would be classified as an operating lease.
- This practical expedient is elected by class of underlying assets.