Centri's Focus On: FASB

ASC 842, *Leases*

FASB Clarifies Accounting for Leases

Details

The Financial Accounting Standards Board ("FASB") issued ASU 2016-02 in February of 2016 to create ASC 842, *Leases*, and supersede the leases requirements in ASC 840, *Leases*. The objective of ASC 842 is to establish the principles that lessees and lessors shall apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease. The ASU is available here, and becomes effective for all public entities for fiscal years beginning after December 15, 2018. The update is effective for all private companies for fiscal years beginning after December 15, 2019.

Background

For entities who are engaged in lease agreements, the FASB identified the "core principle" of ASC 842 as the recognition of lease assets and lease liabilities in the statement of financial position. The guidance in ASC 842, requires lease agreements with contract terms greater than one year to recognize lease payment liabilities and a corresponding right-of-use ("ROU") asset.

While lessor accounting still remains consistent with previous U.S. GAAP, it has been updated to ensure greater consistency with the new lessee accounting model and with the new standard, ASC 606.

1515 Market Street | Suite 1525 | Philadelphia, PA
405 Lexington Ave | 26th Floor | New York, NY
8310 South Valley Highway | 3rd Floor | Englewood, CO

main: 215-654-6850 | fax: 888-389-4958
www.centriconsulting.com

Scope

The scope of the new standard is generally consistent with prior guidance, and limits the definition of a lease to physical assets. This standard applies to all leases, including subleases. Because 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", this standard does *not* apply to any of the following:

- Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources
- Leases of biological assets
- Leases of inventory
- Leases of assets under construction

Effective Date

Public Entities

- First interim period within annual reporting periods beginning after December 15, 2018.

Nonpublic Entities

- Annual reporting periods beginning after December 15, 2019 and interim periods within annual periods beginning after December 15, 2020.

Early Adoption

- Early application is permitted for all entities.

Main Provisions

ASC 842 clarifies that an entity must recognize lease assets and liabilities for lease agreements that extend greater than one year. This update applies to all lease agreements, including operating leases which did not require balance sheet disclosure under the former guidance. The key provisions within the update include the following:

1. **Specified Assets** - In order to be considered an identified asset, a lease must either explicitly or implicitly specify the asset subject to the lease. Under prior requirements, an asset is not considered specified if the lessor has the right to substitute similar assets during the term of the lease. However, the new standard clarifies that in order to preclude an arrangement from being deemed a lease, substitution rights must be substantive. Substantive is defined under ASC 842 as "the lessor's practical ability to substitute alternative assets throughout the term and derive economic benefit from the substitution."

2. **Short-Term Leases** - For leases with a term of 12 months or less, and that do not include an option to purchase the underlying asset which is reasonably certain to be exercised, a lessee is permitted to apply a practical expedient. This expedient allows the lessee to make an accounting policy election by class of underlying asset to not recognize lease assets and lease liabilities. Under this election, the lessee should recognize lease payments on a straight-line basis over the lease term, consistent with current accounting standards.

3. **Unit of Account** - If a contract includes the lease of multiple assets, it should be separated into multiple lease components if the lessee can benefit from the right to use each asset on its own, or in conjunction with other readily available resources, and the right of use is neither highly dependent on nor highly interrelated with the other rights to use assets in the contract. This is similar to the guidance in ASC 606-10-25-19 through 25-21 on determining whether a good or service promised in a revenue contract is distinct, and therefore represents a separate performance obligation.

4. **Portfolio Approach** – The standard permits both a lessee and a lessor to apply the leases guidance at a portfolio level by grouping lease contracts together and accounting for them in aggregate versus individually. The portfolio approach is permitted for leases with similar characteristics, as long as the use of the portfolio approach would not differ materially from the application of the new standard to the individual leases in the portfolio.

5. **Lease Classification** – For lessees, leases are classified as either an operating lease or a finance lease, while for lessors, leases are classified as sales-type, direct financing, or operating. The one exception under the new standard, is that ASC 842 no longer allows leveraged lease treatment for leases that are entered into or modified after the effective date of the standard. As a result, new or modified leases that previously met the definition of a leveraged lease will be accounted for as one of the other three types of leases. Existing leveraged leases are grandfathered into the standard, and should continue to be accounted for by the lessor under prior guidance until they expire or are modified.

   Criteria required for classification as a finance lease and a sale-type lease by a lessor are as follows:

   a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

   b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

   c. The lease term is for the major part of the remaining economic life of the underlying asset. However, this criterion is not used if the lease commences at or near the end of the asset's economic life.

   d. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.

   e. 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.

6. **Initial Direct Costs** - Defined as incremental costs that would not have been incurred if the lease had not been obtained (i.e. commissions or payments made to an existing tenant to incentivize that tenant to terminate its lease) and can be capitalized. The defining of initial direct costs are aligned with the definition of incremental costs of obtaining a contract under the new revenue recognition guidance (see ASC 340-40-25-1 through 25-3). All other expenses (i.e. internal legal fees and fixed departmental expenses) are no longer considered initial direct costs and therefore must be expensed as incurred.

7. **Lessor Accounting** - For Lessors, collectability is no longer a criterion to be assessed when determining whether a lease is classified as a sale-type lease or not. If one of the five criteria in ASC 842-10-25-2 is met, then the lease must be classified as a sales-type lease. If the lessor determines that it is not probable that the lease payments will be collected, then the arrangement is accounted for under the deposit method, as noted in ASC 320-20.

8. **Impairment** - Under the new standard, ROU assets must be monitored for impairment, similar to other long-term nonfinancial assets. Impairments of both operating lease ROU assets and finance lease ROU assets are accounted for in accordance with ASC 360-10-35 on impairment or disposal of long-lived assets. The new standard indicates that a sublease arrangement in which the sublease revenue is less than the original lease cost is an indicator that the carrying amount of the ROU asset associated with the original lease may not be recoverable and thus must be assessed for impairment.

9. **Sale Leaseback** - When an entity transfers an asset to a third party and subsequently leases the asset back, the entity must first follow the guidance in ASC 606-10-25-1 through 25-8 on identifying a contract and in ASC 606-10-25-30 on determining whether a performance obligation is satisfied at a point in time to evaluate whether it should account for the original transfer as a sale or not. One of the key criteria in determining whether the contract represents a sale is whether the buyer obtains control of the asset or not. As such, if the leaseback would be classified as a finance lease by the seller-lessee or a sales-type lease by the buyer-lessor, then the buyer does not obtain control. In addition, if the leaseback agreement provides the seller-lessee with an option to repurchase the asset, the buyer is also deemed not to obtain control unless the exercise price of the option is the fair value of the asset at the time the option is exercised, and there are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

Transition

The standard provides multiple practical expedients in order to simplify adoption, including the following:

- An entity need not reassess whether any expired or existing contracts are or contain leases.
- An entity need not reassess the lease classification for any expired or existing leases. Instead, any leases previously classified as operating leases will continue to be classified as operating leases, while any leases previously classified as capital leases will be classified as finance leases.
- An entity need not reassess initial direct costs for any leases.
- An entity may use hindsight in determining the lease term, including consideration of renewal, termination and purchase options, and in assessing impairment of ROU assets.

The first three practical expedients may only be elected as a package, while the fourth practical expedient may be elected alone or in conjunction with the other three.

Presentation

A lessee is required to present ROU assets resulting from finance leases separately from ROU assets resulting from operating leases and separately from other assets, either on the face of the balance sheet or in the footnotes. The same presentation is required for lease liabilities. In addition, ROU assets and related lease liabilities are subject to current and long-term presentation requirements in a classified balance sheet. If the lessee chooses to report ROU assets and liabilities within a line item on the balance sheet rather than in a separate caption, the lessee is prohibited from reporting finance lease ROU assets or finance lease liabilities in the same caption as operating lease ROU assets and operating lease liabilities.

A lessor is required to present lease assets resulting from sales-type and direct financing leases separately from other assets in the balance sheet. Lease assets are subject to current and long-term presentation requirements in a classified balance sheet. Lessors must classify all cash receipts from leases as operating activities in the statement of cash flows. Income arising from leases should be presented separately in the income statement or in the footnotes. If presented in the footnotes, a lessor must also disclose which line items include lease income. Revenue and cost of goods sold related to profit or loss on leases recognized at the commencement date should be presented on a gross basis if the lessor uses leases as an alternative means of realizing value from goods that it would otherwise sell. If the lessor uses leasing as a means of providing finance, profit or loss should be presented on a net basis (i.e., as a single line item).

Disclosure

The objective of the disclosure requirements is to enable users of the financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. The following information is required to be disclosed:

Disclosure Requirement:	**Lessee**	**Lessor**
General description	X	X
Basis and terms and conditions related to variable lease payments	X	X
Terms and conditions of any options to extend or terminate the lease, including narrative disclosure about those that are included in the measurement of ROU assets and lease liabilities and those that are not	X	
Terms and conditions of any purchase options		X
Terms and conditions of any residual value guarantees	X	
Restrictions or covenants imposed by leases, such as relating to dividends or incurring additional financial obligations.	X	
Information about significant assumptions, including:		
- The determination of whether a contract contains a lease	X	X
- Allocation of consideration between lease and nonlease components	X	X
- Determination of the amount of any residual value		X
- Determination of the discount rate for the lease.	X	
A maturity analysis of finance lease liabilities/sales-type and direct financing lease receivables separately from operating lease liabilities/operating lease payments on an undiscounted basis for each of the first five years and in total for the periods thereafter, including a reconciliation of the undiscounted amount to the amount recognized in the balance sheet.	X	X
Lease transactions between related parties.	X	X

Centri’s Insights

As part of several joint projects between the FASB and the International Accounting Standards Board (“IASB”), leases project is aimed at converging U.S. GAAP and International Financial Reporting Standards (“IFRS”). In an effort to increase transparency and comparability among organizations, the updated leases guidance recognizes lease assets and lease liabilities on the balance sheet and discloses key information about leasing arrangements. The new guidance is intended to address stakeholder concerns that previous leases guidance did not result in a faithful representation of leasing transactions, specifically that the rights and obligations associated with operating leases were not recognized on the balance sheet.

The new leasing standard better aligns aspects of the lessor accounting model with the lessee accounting model through standardizing certain glossary terms and more closely aligning the guidance for lessors to the revenue recognition guidance in ASU 2014-09. Such changes include determining whether a lease is a sale is based on the notion of transfer of control, which is the same principle underlying the new revenue guidance; precluding a lessor from recognizing selling profit or sales revenue at lease commencement for a lease that does not transfer control of the underlying asset to the lessee. Additionally, the updated lessor accounting model does not differentiate between leases of real estate and leases of other assets.

Appendix 1 – Frequently Asked Questions – SEC Registrants

Q1: Can an SEC registrant early adopt ASU 2016-02?

A1: Yes. Early adoption is permitted for all entities.

Q2: Is there any accommodation in the transition rules if a company's status changes from "private" to "public" in 2019? For example, what happens if a private company conducts an IPO, is acquired by an SEC registrant under Regulation S-X 3-05 Financial statements of businesses acquired or to be acquired, or becomes an equity method investee of a public company in 2019?

A2: No. In each of the situations noted above, a "private" company would meet the definition of a public business entity for purposes of an SEC filing that includes its financial statements. We believe the same is generally true for situations in which an SEC registrant records its share of an equity method investee's income or loss, when the investee is otherwise privately-held. That is, the investee would likely need to prepare its financial statements as if it was public in order to meet the needs of its public investor.

Q3: Are any disclosures required prior to adoption of the new revenue standard?

A3: Yes. SEC registrants will need to make disclosures under Staff Accounting Bulletin No. 74 (codified in SAB Topic 11-M) in their next annual and interim filings. SAB 74 addresses disclosure of the impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period. Companies will understandably need time to assess the standard's effects on their financial statements. Accordingly, the initial SAB 74 disclosures about the standard's effect may be general in nature. These disclosures will be expected to evolve over time as companies begin to better understand how the standard will impact their financial statements. As encouraged by SAB 74, registrants should also consider making disclosure of the potential impact of other significant matters that may result from the adoption of the standard (e.g. technical violations of debt covenants or planned changes in business practices).

Q4: Do SEC registrants have to recast the 5-year Summary of Selected Financial Data in accordance with the new lease standard?

A4: Not in periodic filings. At the March 21, 2016 SEC Regulations Committee Joint Meeting with SEC Staff, the SEC staff indicated that the selected financial data table should follow the transition provisions of the ASU, which requires the new standard to be applied as of the beginning of the earliest comparative period presented in the financial statements. For example, if a registrant adopts the new standard for its year ending December 31, 2019, then the beginning of the earliest comparative period presented in the financial statements included in its 2019 Form 10-K would be January 1, 2017. Therefore, the registrant would only apply the new standard to 2019, 2018 and 2017 in the selected financial data table. The selected financial data for 2016 and 2015 will be prepared using the prior lease accounting guidance. Consistent with Instruction 2 to S-K Item 301, the registrant must provide disclosure regarding the lack of comparability of data presented in the selected financial data table if material. If a registrant files a registration statement during 2019, it may need to apply the standard to all periods presented, which would include the annual period of 2016 in addition to 2017 and 2018, plus the interim periods in 2019. The SEC has not yet concluded on whether it will provide relief for the 2016 period in this situation.

Q5: Does the SEC plan to rescind or otherwise amend the staff observer comments codified in ASC 840-30-S99 and ASC 840-40-S99?

A5: At this time, the SEC staff has not indicated its plans for existing lease-related staff observer comments.

Q6: Are there any internal control implications related to adopting and implementing the new leases standard?

A6: Yes. Registrants should ensure they have the appropriate controls in place with respect to implementing new accounting standards, including the new leases standard. This is prior and in addition to any internal control changes related to leases after adoption.