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Center for Plain English Accounting

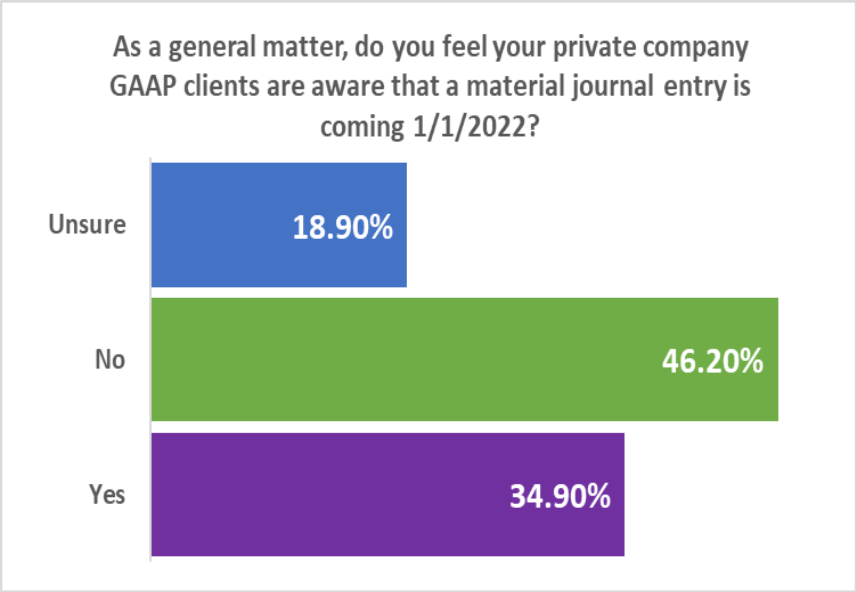
AICPA's National A&A Resource Center

FASB ASC 842 (Leases)
Underestimated Effective Date Adjustment Approaches

You cannot escape the responsibility of tomorrow by evading it today- Abraham Lincoln

By: Thomas Groskopf

In a matter of weeks, calendar year private companies that report under U.S. generally accepted accounting principles (U.S. GAAP) will be required to make a material effective date adjustment to adopt FASB ASC 842, *Leases,* which may have widespread underestimated impacts. We have noted a lack of appreciation for the impact of this adjustment in surveys we have conducted (see survey below, 457 responses) as well as continued procrastination. Further, a 2021 survey from Lease Accelerator & EY noted that "[m]any of the private companies surveyed haven't yet started their compliance journeys since the deadlines shifted out to 2022" while noting that "[e]ven the US public companies surveyed that are three years into the [transition] process are facing [continuing] challenges." LeaseQuery reported in a 2020 survey that 67% of entities experienced difficulty transitioning to FASB ASC 842 in the later stages of the transition process.



The root cause of this situation is not completely clear. This situation potentially could be attributed to mixed messaging about the complexity, distractions caused by the

pandemic, requests for further (now denied) effective date delays, misperception that changes in FASB ASC 842 impact only the balance sheet, and recent experiences with adoption of FASB ASC 606, *Revenue from Contracts with Customers,* that largely did not impact recognition. In this report, we detail the importance of understanding the complexity and nuances in transition to FASB ASC 842 as well as the danger of certain likely misunderstandings and dangerous oversimplifications likely to be seen at some private companies.

Easily Underestimated

As we previously noted, Basis of Conclusion (BC) 10 of ASU 2016-02, *Leases (Topic 842) Section A—Leases: Amendments to the FASB Accounting Standards Codification,* indicates that the FASB concluded, "based on substantial outreach with preparers of financial statements, many entities will be able to apply the requirements in Topic 842 using similar systems and processes to what they used in previous GAAP to meet those reporting and disclosure requirements." A FASB created video titled, *Putting Leases on the Balance Sheet,* still available on the FASB website (as of this writing), has a segment which discusses "how easy it is" to put leases on the balance sheet. Unlike the new revenue standard (primarily codified in FASB ASC 606) and new current expected credit losses model for financial assets (FASB ASC 326, *Financial Instruments–Credit Losses*), the new lease standard does not have a Transition Resource Group (TRG). That decision appears to have been based on an (incorrect) assumption about the relative ease of the transition burden. However, as the public company effective date approached, the FASB noted in ASU 2018-11, *Leases (Topic 842): Targeted Improvements,* BC 7 that, in applying the original transition requirements in ASU 2016-02, preparers encountered "unanticipated costs and complexities." The FASB's prediction that entities will be able to use "similar systems and processes" to comply with the new requirements over FASB ASC 842 has not materialized with dramatic cost consequences for reporting entities which are best evidenced by the booming market for lease accounting software. According to reports, the lease accounting software market is growing exponentially from zero ten years ago and is anticipated to be $1 billion in 2025. In our earlier report, we detailed the reasons for the unanticipated costs and complexities both on a one-time basis at the effective date and an on-going basis thereafter. In this report, we focus exclusively on the rapidly approaching effective date adjustment - January 1, 2022 for a calendar year private company.

Dangerous Oversimplifications and Procrastinations

A feeling that FASB ASC 842 will only impact the balance sheet by just capitalizing remaining term of operating leases is a common rationalization for continued procrastination regarding consideration of the impact of FASB ASC 842 into 2022 and beyond (perhaps until audit fieldwork in 2023). This feeling is also based on the income

statement pattern of recognition for operating leases remaining the same under FASB ASC 842 as compared to the old operating lease guidance in FASB ASC 840. However, we feel it is a dangerous oversimplification to conclude that delaying consideration of adoption of FASB ASC 842 can be done without impact to the income statement in 2022 and 2023. In fact, our experience has been the longer an entity waits to consider adoption of FASB ASC 842 after the effective date the more likely and the more significant income statement adjustments are. We note the more common reasons for significant income statement adjustments caused by delaying consideration of FASB ASC 842 beyond the effective date (January 1, 2022 for a calendar year private company) below:

- The oversimplification assumes that current payments for operating leases will reflect the lease expense in 2022/2023 once the impact of FASB ASC 842 is determined. If the operating lease has fixed non-level payments, the payments will not reflect the lease expense. In these situations, the lease expense typically is higher than the current lease payments.
- The oversimplification also assumes no triggering events to reassess lease term and assumptions about exercising purchase options in the period(s) after the effective date. If assumptions about lease term or purchase option change, a remeasurement event takes place under FASB ASC 842-10-35-4. The remeasurement event will require updating lease payments, generally, the discount rate (FASB ASC 842-20-35-5), and classification between finance/operating lease (FASB ASC 842-10-25-1). All of these updates could impact the income statement.
- A lease modification not treated as a separate contract also is a remeasurement event with required updating of lease payments, discount rate, and classification between finance/operating lease. All of these updates could impact the income statement for lease modifications not treated as a separate contract after the effective date.
- When lease classification must be reassessed (see events described above), a lease may change classification. In particular, a low discount rate (due to use of the risk-free rate practical expedient or low incremental borrowing rate due to the current rate environment) may cause a lease to be classified as a finance lease due to the present value test (future minimum lease payment exceeds substantially all- generally 90%- of the fair value of the underlying asset). The classification of a finance lease will result in a front-ended expense pattern of recognition as compared to an operating lease.
- A survey done by LeaseQuery has noted that 58% of respondents found embedded leases during their audit preparation that presumably were not previously disclosed as operating leases. We have surveyed the same question to CPEA member firms and most feel that 58% is either “just about right” or “too low” of an estimate based on their experiences. In addition to significant balance

sheet impacts, these newly discovered embedded leases also could impact the income statement if the lease payments are non-level or the newly discovered lease is a finance lease.

- FASB ASC 842 transition guidance offers the ability to grandfather previous lease classification under FASB ASC 840 in a package of three practical expedients (discussed in more detail in the effective date adjustment section). Subsequent remeasurement events (discussed above) after the effective date will cause a reassessment of classification between operating/finance lease under FASB ASC 842. While the classification rules between FASB ASC 840 and FASB ASC 842 are similar, they are not identical. As we discuss in the effective date adjustment section below, the differences in classification rules generally tend to classify more leases as finance leases as compared to classification rules under FASB ASC 840. In particular, longer term leases involving land or land/building were afforded more generous classification rules under FASB ASC 840-10-25-36 that caused treatment as operating leases in many cases. The special classification rules were not carried forward to FASB ASC 842. Entities may enter into a variety of transactions in 2022 and/or 2023 that could unknowingly jeopardize grandfathered operating lease classification. These transactions include lease modifications, renewals of leases, or events that cause a reassessment of lease term. Subsequent finance lease classification will cause front-ended pattern of expense recognition compared to operating leases. Other fact patterns could have similar outcomes in the year of transition and, thereafter, based on more expansive criteria for finance leases under FASB ASC 842.
- Entities with related party leases will need to assess the legally enforceable terms and conditions under FASB ASC 842-10-55-12. Oral or expired related party leases may need legal determination (and related legal and accounting expense) about enforceable lease term. It also is possible that expense pattern of recognition could change for leases and related leasehold improvements.
- Some private companies may renegotiate with their bank popular lending covenants such as debt to equity for the impacts of FASB ASC 842 without considering additional embedded leases not previously disclosed as operating leases. The adjustments made to lending covenant ratios may be insufficient to address the additional embedded leases causing a breach of covenants, need for covenant waivers, or more expensive lending terms.
- Management may communicate financial results or interim financial statements during 2022 that may need material adjustment upon consideration of the impact of FASB ASC 842 at the end of 2022 (or in 2023). Suppliers using the financial statements could restrict trade credit if those adjustments are significantly unfavorable. Customers (or potential customers) using the financial statements could limit business opportunities and/or seek alternative suppliers.

- Users interested in current ratios or other liquidity ratios (such as those that regulate contractors) may limit revenue opportunities when current ratio declines below established thresholds based on additions to current liabilities due to current portion of operating lease liabilities without any related additions to current assets. FASB ASC 842-20-45-1 indicates that the distinction between current and non-current assets and liabilities in classified balance sheets is based on the same considerations as nonfinancial assets (all in non-current) and financial liabilities (current portion of long-term liabilities classified as current).

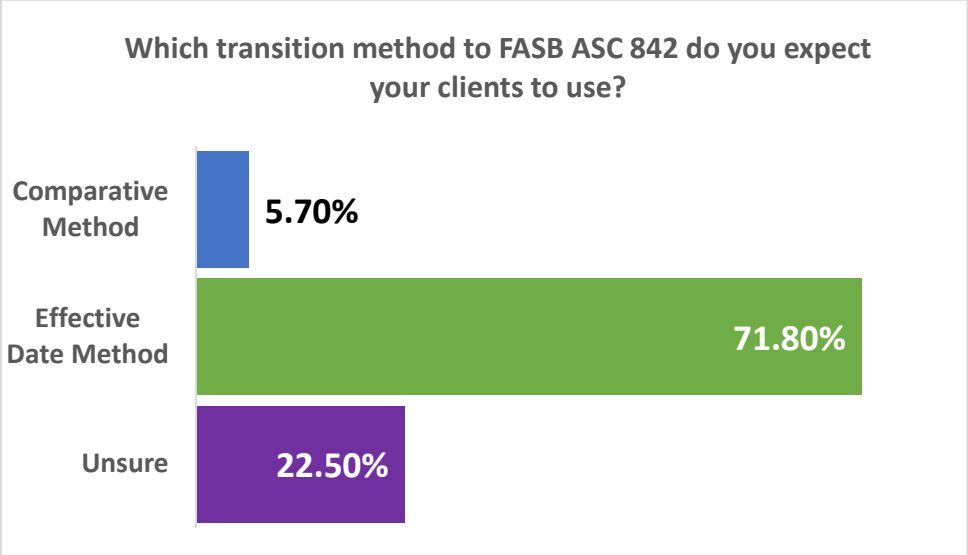
As private companies near the effective date and the required adjustment to transition to FASB ASC 842, the unanticipated costs and complexities combined with oversimplifications and procrastination create a situation which can be proactively managed. However, the procrastinators likely will incur unintended consequences with little ability to manage after the fact. While an effective date adjustment will occur for most private companies on the effective date, a range of correct adjustments to select from will exist. However, we feel that the range of correct effective date adjustments to select from narrows significantly as more time passes from the effective date. In the next section, we discuss the nuances creating the range of correct adjustments including the practical expedients, transition guidance, and matters not addressed by the transition guidance.

The Effective Date Adjustment

The Transition Method

FASB ASC 842 now has two transition methods. The first applies FASB ASC 842 on a modified retrospective basis to all periods presented -- called by many the comparative method. However, it should be noted that many private companies are under no statutory obligation to provide any comparative periods and are permitted to apply the “comparative method” to a single year, current year presentation. The other method is known as 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. Public companies that we reviewed generally used the effective date method and our surveys (see below, 422 responses) have indicated that private companies, generally, are inclined to use the effective date method as well. Entities that elected to use the comparative method, generally, had significant additional operating lease right-

of-use assets and liabilities (United Airlines and JetBlue Airways Corporation are examples).



Entities that elect the effective date method at adoption and present comparative financial statements for prior periods will need to make all the required disclosures under the new lease standard (FASB ASC 842) for the year of adoption and the old lease standard for prior periods presented (FASB ASC 840) in annual financial statements. FASB ASC 842-10-65-1(jj) requires that FASB ASC 840 disclosures for all periods that continue to be in accordance with FASB ASC 840 are provided. Therefore, all FASB ASC 842 and FASB ASC 840 lease disclosures will be necessary in annual financial statements for all entities presenting comparative statements electing the effective date method at adoption.

We would caution practitioners against merely copying prior year FASB ASC 840 disclosures and pasting the disclosures into the current year disclosures. Measurement differences for operating leases and terminology differences in FASB ASC 840 vs. FASB ASC 842 (finance lease vs. capital lease, contingent rent vs. variable lease payments, short-term leases) could confuse users. Further, FASB ASC 842 has additional disclosures that are not found in FASB ASC 840 including weighted average lease term, weighted average discount rate, short-term lease cost, and variable lease cost. A review of public company financial statements in the initial year of adoption (generally the 2019 year-end) found inconsistencies in compliance with the prior year FASB ASC 840 disclosure requirement using the effective date method. These inconsistencies did raise questions with regulators (example here) which could easily be relived with private company peer reviewers with the 2022 year-end. In some cases, the regulator questions caused updated disclosures as well as examination about whether the impact of the

overlapping FASB ASC 842 disclosures where sufficient to cover the requirement to present FASB ASC 840 disclosures for the prior years.

Practice Note

FASB ASC 840-20-50-2 requires disclosure of the future minimum rental payments as of the latest balance sheet date presented. BC 14 of ASU 2018-11 notes that the balance sheet that continues to be reported under FASB ASC 840 should be considered the latest balance sheet presented for purposes of applying the FASB ASC 840 disclosure requirements.

CPEA Observation

As noted above, a non-SEC registrant is not required under U.S. GAAP to provide comparative financial statements. Comparability between periods for those entities that recognize significant new operating lease right-of-use assets and liabilities appeared to be a significant factor for those entities that did NOT elect the effective date method. However, non-SEC registrants have the additional option to present single year statements using either transition method at adoption and provide information to selective users about the pro-forma (unaudited) impact of FASB ASC 842 on any prior periods.

Package of Three Practical Expedients -- Considerable Nuances at Transition and Thereafter

At transition, an entity has the choice to apply certain practical expedients. The first set of practical expedients are a package of three at FASB ASC 842-10-65-1f that must be elected in an all or none fashion (package of three practical expedients). The package of three practical expedients permits an entity upon transition to not reassess under FASB ASC 842 each of the following—

- Whether any expired or existing contracts are or contain leases
- The lease classification for any expired or existing leases
- Initial direct costs for any existing leases

We noted that substantially all public companies we reviewed elected the package of three practical expedients. The ability to carryforward existing lease classification is likely the driver for many to elect the package of three practical expedients. While the cost of reassessment of leases between operating and finance may have been sufficient justification for many entities, nuanced differences also exist between the new and old

classification rules that could cause lease classification under FASB ASC 842 to change from FASB ASC 840. These include:

- The purchase option test is based on a purchase option reasonably certain to be exercised in FASB ASC 842 vs. a bargain purchase option in FASB ASC 840.
- FASB ASC 840-10-25-1d does not apply the present value test (minimum lease payments exceeding 90% of fair value of underlying asset) if the lease term starts in the last 25% of the leased property's estimated economic life. This exception was not carried forward to FASB ASC 842 for purposes of the FASB ASC 842 present value test.
- Leases involving land only apply the transfer of ownership criterion and bargain purchase criterion under FASB ASC 840. Under FASB ASC 842, leases involving land only apply the same criteria as all other leased assets (including the lease term test and present value test).
- In a lease with land and building under FASB ASC 840, if the fair value of the land is less than 25% of the total fair value of the leased property at lease inception, the lessee shall consider the land and the building as a single unit for purposes of applying the lease term test in FASB ASC 840-10-25-1(c) and the present value test in FASB ASC 840-10-25-1(d). FASB ASC 842 did not carryforward this exception and leases of land (including implied leases of land) need to be treated as a separate lease component per FASB ASC 842-10-15-29 unless the financial reporting impact is insignificant.

We note above certain differences in lease classification rules that could cause a difference in classification of a lease upon adoption of FASB ASC 842 if the package of three practical expedients is not elected. We feel that the new classification criteria under FASB ASC 842 will produce more finance leases than the old criteria under FASB ASC 840, all else equal.

The nuanced differences in lease classification are particularly important for longer-term leases involving land and buildings as the new classification rules are likely to be a potential source of newly classified finance leases. After adoption of FASB ASC 842, any modifications to leases not treated as separate contracts will cause a reassessment between finance and operating leases. This reassessment of classification requirement under FASB ASC 842-10-25-1 also applies if a change in lease term occurs or a change in the assessment of whether, or not, it is reasonably certain a purchase option will be exercised. Grandfathered operating lease treatment of longer-term land and building leases need to be carefully managed to be maintained by reporting entities as modifications and reassessment triggering events for lease term and purchase options after the effective date of FASB ASC 842 could cause these leases to become finance leases. An example of proactive management could include addressing potential

modifications to leases and term extensions prior to the effective date of FASB ASC 842. While FASB ASC 840-10-35-4 contains a requirement to reassess classification for modifications of leases not treated as separate contracts (it does not for lease term extensions), the reassessment under FASB ASC 840 will be able to take advantage of the specialized classification rules for land and buildings in FASB ASC 840. These specialized classification rules will not be available after the effective date of FASB ASC 842 and may unknowingly create finance lease treatment with certain events.

We note above the potential for future finance lease classification under FASB ASC 842 for poorly managed existing operating leases of land and building. The same situation also could occur with other types of currently classified operating leases under FASB ASC 840 due to nuanced differences (such as leased assets at or near the end of the economic life or purchase options that are reasonably certain but not a bargain) in the classification rules in FASB ASC 842 as compared to FASB ASC 840.

Practice Note

FASB ASC 842 classification regime also does not use explicit quantitative thresholds. However, anecdotally, our experience is that the quantitative thresholds are being maintained by nearly all entities. FASB ASC 842 classification regime also added a new fifth test related to an asset of such a specialized nature that it would be of no alternative use to the lessor. As anticipated by BC 71(e) of ASU 2016-02, we are not aware of a large volume of leases that are now finance leases solely due to the new fifth factor. Said another way, to the extent the new fifth factor applies, it is likely another factor already required the lease to be treated as a finance lease.

CPEA Observation

Given broad election of the package of three practical expedients, in this report, we are not detailing impacts and adjustments when an entity does not elect the package of three practical expedients and lease classification changes with the effective date adjustment. Our November 3, 2021 webcast on transition to FASB ASC 842 covered detailed examples and methodology for these circumstances. An archive of that webcast can be accessed here.

Minimum Rental Payments Composition Policies

FASB ASC 842 has transition guidance for previously classified operating leases under FASB ASC 840 where classification is not reassessed. FASB ASC 842-10-65-1l notes

that a lessee shall measure the lease liability at the present value of the sum of the following, using a discount rate for the lease established at the application date as determined by [the adoption method selected]:

- The remaining minimum rental payments (as defined under FASB ASC 840)
- Any amounts probable of being owed by the lessee under a residual value guarantee

The use of “remaining minimum rental payments” in transition above for existing operating leases that will remain operating leases presents questions about whether certain payments constitute “minimum rental payments” under FASB ASC 840. These questions include whether variable lease payments based on a rate or index and executory costs are included in “minimum rental payments” under FASB ASC 840?

“Minimum rental payments” is not defined by FASB ASC Master Glossary. However, FASB ASC 840-10-25-4 is clear that minimum LEASE payments (emphasis added) do NOT include increases in rental payments caused by increases in a rate or index (such as those based on the change in the Consumer Price Index). Nonetheless, many entities chose to present in operating lease disclosures increased minimum rental payments caused by increases in a rate or index. Thus, the question for existing operating leases at the adoption date under FASB ASC 842 is -- should the discounted lease liability at transition include increases in rental payments caused by a change in a rate or index?

Example A

At January 1, 2012, an entity enters into a 20-year operating lease that provides for annual payments of $100,000 with additional payments based on the change in the Consumer Price Index (CPI). At January 1, 2022, the entity adopts FASB ASC 842. At that time, the annual lease payment is comprised of $100,000 plus an additional $50,000 caused by the change in the Consumer Price Index since January 1, 2010. For simplicity, assume a 0% discount rate. Is the FASB ASC 842 operating lease liability at the adoption date (January 1, 2020) $1,000,000 ($100,000 x 10 remaining years) or $1,500,000 ($150,000 x 10 remaining years).

Answer A

FASB ASC 842 transition guidance does not address this question. Based on responses to technical inquiries of FASB staff reported by numerous firms, the operating lease liability at the adoption date should NOT include increased lease payments caused by variable lease payments. Thus, the operating lease liability at the adoption date in the example above is $1,000,000. However, the SEC staff has indicated that, if a registrant has previously disclosed increased operating lease payments caused by a change in a rate or index, it is permissible for the registrant to continue its accounting practice and, thus, record the operating lease liability at the adoption date in the example above at $1,500,000.

Since FASB ASC 842 transition guidance is based on FASB ASC 840's concept of "minimum rental payment", it also is not clear as to whether, or not, executory costs that are included in fixed lease payments should be included in the transition adjustment. Accordingly, for what is commonly termed a "gross lease" (for example, a lease that has a fixed lease payment for the use of the leased asset, taxes, insurance, and common area maintenance), FASB ASC 840 is not clear whether a lessee should exclude from "minimum rental payments" in a gross lease, payments for executory costs. We believe it would be appropriate for an entity to continue its historical practice used for disclosure under FASB ASC 840, with respect to whether executory costs are included in the transition lease liability.

Practice Note

While FASB ASC 840 is not clear regarding minimum rental payment composition in the aforementioned areas, FASB ASC 842 does provide clarity in these areas. As a result, new and remeasured leases after the effective date adjustment, will apply FASB ASC 842 in full (without respect to transition guidance) and these questions will no longer apply. Fixed lease payments -- including those in gross leases -- are part of the lease right-of-use asset and liability regardless of whether they pertain to executory costs. Payments based on a rate or index are measured as part of the lease right-of-use asset and lease liability at lease commencement (or remeasurement) based on the rate or index at lease commencement (or remeasurement). Subsequent changes in the rate or index (assuming no remeasurement event) are variable lease payments and are not recognized as part of the right-of-use asset or lease liability.

Discount Rate at Transition

The transition guidance at FASB ASC 842-10-65-1l for operating leases requires use of a discount rate at the application date which would be the effective date for the effective date method or beginning of earliest comparative period presented under the comparative method. This was a practical concession by the FASB to avoid entities having to determine the discount rates at various lease commencement dates for existing leases at transition. However, the guidance does not specify whether that rate should be based on the original term of the lease or the remaining term of the lease. Typically, a discount rate based on the original term of the lease would be higher and, thus, yield a lower lease liability. As a result, lessees will have a policy choice here as well that will have an impact on the operating lease liability recognized at the transition date. This view also is consistent with the view expressed by the SEC staff at the 2017 AICPA Conference on SEC and PCAOB Developments.

Hindsight Practical Expedient- Limited Use but Potential Strategic Benefits

FASB ASC 842-10-65-1g permits an entity to also elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the lease term (that is, when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of the entity's right-of-use assets. This practical expedient may be elected independently of the package of three practical expedients or the land easement practical expedient.

The guidance in FASB ASC 842 on the hindsight practical expedient is limited to what is noted above. When FASB ASC 842 originally was issued as ASU 2016-02, the comparative method was mandatory. Using hindsight for determination of lease term for a comparative period presented leading up to the effective date appeared to be the primary aim of providing the practical expedient as noted in ASU 2016-02, BC 394. Nevertheless, when the effective date method was established in ASU 2018-11 the hindsight practical expedient was not limited to only those applying the comparative method. Given the lack of authoritative guidance, interpretative guidance has filled in the voids regarding application of the hindsight practical expedient. The consensus interpretations indicate:

- Entities consider all facts and circumstances through the effective date in applying hindsight
- When applying the comparative method at transition, contract modifications occurring between start of earliest period presented and effective date of the standard are included at the date of the modification
- Events after effective date but prior to issuance of financials reflecting adoption of FASB ASC 842 are not considered in the hindsight practical expedient
- In considering hindsight related to lease term, entities are not limited to only discrete events (a renewal of a lease)
- Must also consider changes in facts and circumstances in FASB ASC 842-10-55-26 regarding what is reasonably certain regarding an option to extend a lease term
- All economic facts should be considered individually and jointly
    - Strategic shifts, changes in market rental rates, changes in the industry
    - Factors to consider are NOT limited to those that are triggering events for lease term reassessment (significant event or changes in circumstances in the control of the lessee)
- Lease terms also need to be evaluated
    - Renewal options, contingent and variable amounts, purchase options, etc.

The use of the hindsight practical expedient would seem more beneficial for entities that use the comparative method to transition. With widespread use of the effective date method, many may wonder about the utility of the hindsight practical expedient, given that the period to use hindsight would be one day -- January 1, 2022 for a calendar year end private company. It is important to remember that consensus interpretative guidance indicates that hindsight is not limited to discrete events such as a renewal of a lease. In essence, when using the effective date method the hindsight practical expedient creates a reassessment date for lease term as of the effective date.

Practice Note

Under FASB ASC 842, reassessments of lease term and purchase options are NOT continual, rather, reassessments only take place upon the occurrence of certain triggering events in FASB ASC 842-10-35-1. These triggering events typically are within the control of the reporting entity. Accordingly, in many cases, events outside the control of an entity (such as an increase or decrease in market lease rates that makes a renewal option favorable or unfavorable) generally, WOULD NOT, by themselves, trigger a reassessment of lease term or purchase option assumptions. However, entities that elect the hindsight practical expedient WOULD consider ALL events (events that the entity controls and does not control) that impact a lease term extension or purchase option exercise.

Use of the hindsight practical expedient has been limited in public company filings we reviewed. This finding is consistent with a Deloitte survey showing only 4% used the hindsight practical expedient. This is likely due in part to widespread use of the effective date method which narrows its utility. Further, the hindsight practical expedient must be applied for all leases which increases transition cost causing additional effort. However, savvy application of the transition provisions using the hindsight practical expedient in specific situations may produce a more favorable financial reporting outcome.

We would envision limited but significant circumstances where the hindsight practical expedient may be beneficial even when using the effective date method. These circumstances may include leases where remeasurement events are anticipated to take place in the year of adoption (2022 for a calendar year private company) which could be avoided by application of the hindsight practical expedient. The election of the hindsight practical expedient could retain grandfathered operating lease treatment on the package of three practical expedients. Another reason to apply the hindsight practical expedient would be to avoid remeasurement of payments based on a rate or index at a current rate (such as a change in CPI clause) by capturing a lurking remeasurement event in the hindsight evaluation at the effective date. Illustrations of these type of situations are presented in Example B and Example C below.

CPEA Observation

Entities also could benefit from the hindsight practical expedient if lease accounting software systems are challenged in handling the lease term and purchase option remeasurement events.

FASB ASC 842 does not address the ordering of application of practical expedients available on transition. Accordingly, it is not clear in FASB ASC 842, if an entity could retain lease classification under the package of three practical expedients if the application of the hindsight practical expedient would change the classification. The consensus interpretative guidance that we agree with indicates that entities which elect the package of three practical expedients need not change lease classification due to application of the hindsight practical expedient. The basis for such a view, in our opinion, rests with the FASB's stated intention in the BC 390 to ASU 2016-02 that, "entities will, in effect, 'run off' existing leases, as described, unless the lease is either modified (and that modification is not accounted for as a separate contract) or, for lessees only, the lease liability is remeasured in accordance with the subsequent measurement guidance…on or after the effective date."

Example B

A private company manufacturing entity has a logistics division. In 2021, due to a shortage of trucks, the entity leases used trucks near the end of the useful life at relatively high rental payments. The terms of the lease are a 2-year initial term with a 3-year lessee option to renew. At lease inception on June 30, 2021, the lessee renewal is not reasonably assured. The trucks are 15 years old at lease inception and have a 20-year useful life (5 years remaining). The private company manufacturing entity classifies the truck lease as operating leases as the useful life test and minimum lease payment test do not apply in FASB ASC 840 to leased assets in the last 25% of useful life. The private company manufacturing entity adopts FASB ASC 842 at January 1, 2022. At that time, the private company has not exercised the 3-year renewal option. However, due to events beyond the entity's control (such as semiconductor shortages) it is now, at least, reasonably certain that the entity will exercise the 3-year renewal.

Answer B

Case A- Entity elects hindsight practical expedient and package of three practical expedient at January 1, 2022

The renewal is reassessed using hindsight at January 1, 2022 and the lease term for the truck lease now includes the 3-year renewal as that renewal is reasonably certain for the reasons discussed above. The lease is measured for balance sheet recognition using the remaining period of the initial term- 1.5 years- and the 3-year renewal for a total of 4.5 years. The entity can retain the operating lease classification for the truck lease due to electing the package of three practical expedients including when the entity elects to exercise the 3-year renewal option during the beginning of 2023.

Case B- Entity does not elect hindsight practical expedient and does elect package of three practical expedient at January 1, 2022

Truck lease remains an operating lease as package of three practical expedients is elected. The lease is measured using the remaining period of the initial term only- 1.5 years. However, when the entity elects to exercise the 3-year renewal option at the beginning of 2023, a remeasurement and reassessment event occurs. The lease is remeasured adding the 3-year renewal term with an updated incremental borrowing rate. Since the lease term changed, the entity must now also reassess lease classification between finance lease and operating lease. The present value of the future minimum lease payments exceeds substantially all (90%) of the fair value of the leased assets. Accordingly, the truck lease now is classified as finance leases and no longer has straight line pattern of expense recognition.

Example C

A land lease has a 30-year initial term with two 20-year renewal options by the lessee. The lease does not contain a bargain purchase option nor does title revert to the lessee. Based on this, the lease is properly classified as an operating lease under FASB ASC 840 at lease inception. The renewal options are not reasonably assured to be exercised at lease inception. The land is located in a key area for the lessee's business. The entity uses the hindsight practical expedient and determines that the two 20-year renewal options now should be included in the lease term based on the key location for the business. The entity also elects the package of three practical expedients.

Answer C

While not addressed explicitly in FASB ASC 842, we feel the entity is able to grandfather the existing classification of an operating lease in transition to FASB ASC 842. The lease term now includes the renewal option periods and will not change. If the hindsight practical expedient was not elected, the lease term would not include the renewal option periods. Since the lease term does include the renewal option periods, it is possible that such a lease under FASB ASC 842 would become a finance lease when the renewals are exercised and lease term changes. The lease term change causes reassessment under FASB ASC 842 classification rules including the present value test.

Short-term Leases at Transition

The short-term lease exemption allows entities not to capitalize short-term leases and record them on the balance sheet for FASB ASC 842. The entity would continue to treat them in the same manner as operating leases under FASB ASC 840 with required disclosure. The FASB ASC Glossary definition indicates that distinction of a short-term lease is applied at the commencement date of the lease. The short-term lease exception is not an explicit transition practical expedient. Therefore, a lease would need to qualify based on original commencement date or reassessment date based on FASB ASC 840-20-25-3 to be a short-term lease at transition.

Example D

A private company enters into an equipment lease on January 1, 2018 with an initial term of five years and no renewals. The private company adopts FASB ASC 842 on January 1, 2022.

Answer D

The remaining term of the equipment lease at the January 1, 2022 transition date is 12 months. However, this equipment lease does not qualify for using the short-term lease policy election as the lease term at lease commencement was five years- more than 12 months.

Practical Expedient to Combine Lease and Nonlease (Service) Components at Transition

While not explicit in the transition guidance, we believe that lessees are able to elect to apply at transition, by underlying class of asset, for existing leases the practical expedient

to choose not to separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component. Our view is consistent with other interpretative guidance on this question.

Private companies that elect the practical expedient to combine lease and nonlease components in FASB ASC 842-10-15-37 should be aware that the combined lease component payments are what will be used for measuring the lease payments for the finance lease present value test. This could cause finance lease treatment for contracts that have more consequential service elements.

Other Matters

In this report, we are focusing on transition and effective date adjustment areas of broadest impact to private company lessees. Accordingly, other areas of more limited applicability on transition to FASB ASC 842 should be researched if relevant. These include but are not limited to -- lessor accounting, practical expedient for existing or expired land easements, treatment of existing sale-leasebacks, impairment considerations, leveraged leases, amounts previously recognized in respect of business combinations, subleases, foreign currency leases, and built to suit leases. Inquiries on these matters can be directed to cpea@aicpa.org.

Conclusion

The imminent effective date for FASB ASC 842 generally will require a material journal entry. For a calendar year private company the effective date adjustment will be recognized on January 1, 2022 irrespective of when the entity begins to consider adoption. Typically, the effective date adjustment only will impact the balance sheet, however, for reasons we discuss, the longer private companies wait to consider the impact of FASB ASC 842 beyond the effective date the more likely significant income statement impacts will occur as well. Unfortunately, these balance sheet and income statement impacts could have commercial consequences. Previous adopters have frequently cited significantly underestimating the difficulties. While an effective date adjustment likely will be required, due to practical expedients and loose transition guidance, a range of correct answers to select from will exist. However, we note that the range will narrow considerably as private companies move further and further away from the effective date. The time for action is here.

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