Report
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Center for Plain English Accounting
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FASB ASC 842
Lease Capitalization Policy

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With broader understanding and implementation of FASB *Accounting Standards Codification* (FASB ASC) 842, *Leases,* by private companies, questions are becoming more frequent about the use of a lease capitalization policy. At the April 21, 2022, Private Company Council (PCC) meeting, lease capitalization policies were cited by the FASB chair as something private companies needed to focus on. However, a PCC preparer cautioned that a lease capitalization policy requires some substantiation and analysis as it lacks authoritative basis in the FASB ASC. Capitalization policies historically have been used by entities as an accounting convention to simplify recordkeeping for property, plant & equipment (PP&E). However, they also lack authoritative basis in the FASB ASC. Lease capitalization policies can be a way to mitigate cost burdens but are nuanced and should be implemented thoughtfully and carefully. In this report, we detail the considerations for selection of a capitalization policy for FASB ASC 842.

While the FASB ASC (including FASB ASC 842) is silent on a capitalization policy, the Basis for Conclusions (BC) for ASU 2016-02, *Leases (Topic 842),* does note at BC 122 that:

> [E]ntities will likely be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, which should reduce the costs of applying the guidance. An entity's practice in this regard may be consistent with many entities' accounting policies in other areas of GAAP (for example, in capitalizing purchases of property, plant, and equipment).

The BC for ASU 2016-02 provides no further guidance on what a "reasonable" capitalization threshold would be. Thus, for those reporting under the FASB ASC, a judgment will need to be made on what the capitalization threshold should be.

Practice Note: This contrasts with IFRS 16, *Leases,* p. 5b which explicitly acknowledges a "low value" threshold to avoid lease capitalization in the authoritative text of IFRS 16. BC 100 for IFRS 16 suggests a value of $5,000 for a low value threshold. BC 421 of ASU 2016-02 notes that the "low value" threshold of IFRS 16 was provided, in part, because IFRS 16 did not retain the concept of an operating lease (which FASB ASC 842 did).

Capitalization policies are essentially bookkeeping conventions where entities and their auditors have agreed that avoiding the strict application of the FASB ASC will not create a material misstatement to the financial statements. In many cases with PP&E, these capitalization policies have been carried forward from year to year with little or no reassessment. However, with respect to FASB ASC 842, auditors and preparers will need to initially agree on capitalization policies. In this report, we have factors to consider in setting a lease capitalization policy.

We suspect that some entities will be tempted to blindly set lease capitalization policies to match PP&E capitalization policies. For the following reasons, we do not think this is appropriate:

- PP&E capitalization policies impact only assets, whereas lease capitalization policies impact both assets and liabilities.
- Lease capitalization policies also may impact liability driven debt covenants which PP&E capitalization policies do not.
- Entities and auditors have significant history with the extent of PP&E purchases that are under the PP&E capitalization threshold. No such history exists with a lease capitalization threshold. As we have previously written, many entities are uncovering embedded leases in the audit process.
- The current portion of unrecognized operating lease liabilities could impact popular financial statement user metrics such as current ratio, quick ratio, and working capital. PP&E capitalization thresholds do not impact these metrics.
- The combined impact on the financial statement of PP&E and lease capitalization policies should be considered. Previously determined PP&E capitalization policies did not need to consider operating lease capitalization policies.
- As we previously reported, many entities will apply the practical expedient to combine lease and non-lease components as a single lease component. The amount of additional lease right of use asset and lease liability from the non-lease component in these situations should be considered in determination and application of a lease capitalization policy. No such considerations are needed from PP&E capitalization policies.

Our view is shared by others. Grant Thornton's *Leases- Navigating the Lease Guidance in ASC 842,* indicates on p. 147, that, "[i]n our view, it would not be appropriate for a

lessee to simply apply its current capitalization threshold for property, plant, and equipment to its right-of-use assets and lease liabilities without further analysis." EY's *Lease Accounting (September 2021)*, notes on p. 215 that, "we believe it would be inappropriate for entities to default to using an existing threshold for PP&E because the established threshold does not consider the effect of not recognizing liabilities."

Practice Note: Most lease capitalization thresholds are applied to both the right of use asset and lease liability. Another approach which has been suggested is to only apply a lease capitalization policy to the right of use asset. In this case, the entity would expense amounts under the lease capitalization policy but recognize the lease liability. We have seen limited interest with these asset-side only approaches as tracking cost savings, generally, are not significant since the lease liability will need to be measured throughout the life of the lease under FASB ASC 842.

Auditors are required under AU-C 450, *Evaluation of Misstatements Identified During the Audit,* and more specifically under AU-C 450.05, to accumulate and report to those charged with governance (TCWG) misstatements (including disclosure misstatements) that are more than "clearly trivial" (AU-C 260, *The Auditor's Communication With Those Charged With Governance,* and more specifically AU-C 260.13). Management also is required to formally represent the more than "clearly trivial" uncorrected misstatements are immaterial (AU-C 580, *Written Representations,* and more specifically AU-C 580.14). AU-C 450.A2 indicates that "[c]learly trivial" is not another expression for "not material." Misstatements that are clearly trivial will be of a wholly different (smaller) order of magnitude, or of a wholly different nature, than those that would be determined to be material and will be misstatements that are clearly inconsequential, whether taken individually or in the aggregate and whether judged by any criteria of size, nature, or circumstances. In some firms, the "clearly trivial" threshold is set at 10% of an established materiality benchmark. There is no exception in the AU-C from the various requirements above for more than "clearly trivial" misstatements for capitalization policies.

EXAMPLE: Management sets a lease capitalization policy of $5,000. The auditor determines that the entity has 15 copiers under operating leases that have not been recognized on the balance sheet that should be under FASB ASC 842. Each copier lease has an unrecognized operating lease right of use asset and operating lease liability of $4,750. The total uncorrected misstatement is $71,250. The "clearly trivial" threshold set by the auditor is $50,000. This uncorrected misstatement will need to be accumulated by the auditor, considered with other uncorrected misstatements, and communicated to TCWG. Management's lease capitalization policy of $5,000 does not absolve the auditor of these responsibilities.

***Practice Note**:* $5,000 is not only the amount suggested by BC 100 of IFRS 16 but also the maximum "safe harbor" de minimis amount to expense amounts paid for tangible personal property under the IRS Final Tangible Property Regulations.

To obtain the most cost savings, we think that entities and their auditors also should strive to set a lease capitalization policy where all parties are comfortable that the "clearly trivial" threshold of the auditor will not be tripped. While management is free to set the lease capitalization policy without the involvement of the auditor or consideration of the "clearly trivial" threshold, it likely would not be cost effective to set a lease capitalization policy amount that requires an auditor to annually report a more than "clearly trivial" misstatement to TCWG. If completeness of lease population is a risk area in the audit, we think it may be prudent to defer consideration of lease capitalization thresholds until sufficient analysis has been done regarding the completeness of the lease population.

In the section below, we summarize considerations for establishing a lease capitalization threshold:

- Has the impact on financial statements for omitted right of use assets and lease liabilities been considered on a gross basis? It would not be appropriate to consider impact based on a netting of the omitted right of use asset and lease liability.
- Has the financial statement user impact including liability focused user metrics such as current ratios and leverage ratios been considered?
- How will amounts excluded from recognition and measurement due to a lease capitalization policy be handled for disclosures required under FASB ASC 842 (such as lease cost and short-term lease cost disclosures)?
- Has the lease capitalization policy been developed with a full understanding of the population of contracts that meet the definition of a lease under FASB ASC 842?
- If the FASB ASC 842 practical expedient to combine lease and non-lease components into a single lease component has been elected, does the lease capitalization policy consider the additional amounts from non-lease components that would be required to be capitalized?
- Has the "clearly trivial" threshold of the auditor been considered?

Conclusion

Historically, capitalization policies have been used in preparing financial statements in accordance with U.S. generally accepted accounting principles and may aid preparers to save costs and focus efforts on items that may be materially impacted. However, lease capitalization policies lack authoritative basis in the FASB ASC. Accordingly, they need

to be established with careful thought and analysis. In this report, we have outlined considerations for exercising this judgment.

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