AICPA

Report
December 21, 2022

Center for Plain English Accounting

AICPA's National A&A Resource Center

FASB ASC 842
Implementation FAQs – Part 2

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In part 2 of this report series, we answer questions frequently asked by CPEA members as they assist clients implementing 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:

How does a lease payment that is adjusted at each anniversary period for the consumer price index (CPI) get accounted for under FASB ASC 842?

Answer:

FASB *Accounting Standards Codification* (FASB ASC) 842-10-30-5 indicates variable lease payments that depend on an index or a rate (such as the CPI or a market interest rate) be initially measured using the index or rate at the commencement date. Leases which have payments based on a future change in the index, such as the change in CPI, are excluded from the lease payments to be included, at a discounted amount, in the lease liability. Lease payments that are adjusted at each anniversary period for the CPI would be treated as variable lease payments and recognized in the period in which the obligation for those payments was incurred.

Question #2:

A lease stipulates payments will increase each year by "the lesser of (i) 2% or (ii) 1.25 times the change in the CPI." How is such an increase provision accounted for under FASB ASC 842?

Answer:

Lease provisions that include payments based on multipliers of an index, such as CPI, and a limit or cap on the payment are somewhat different from lease payments that simply depend on the change in an index. Lease payments that depend on an index multiplier and cap may not be completely variable in nature and may include an in-substance fixed payment. If the limit or cap is expected to be paid, such payments would be considered in-substance fixed payments (the payment is effectively unavoidable). Fixed and in-substance fixed lease payments are included in the determination of the lease classification and initial measurement.

If a determination is made that lease payments based on an index or CPI multiplier and cap do not represent in-substance fixed payments, the guidance on embedded derivatives in FASB ASC 815-15, *Derivatives and Hedging – Embedded Derivatives*, would need to be considered in determining whether the index multiplier and cap feature is "clearly and closely related" to the lease or if a scope exception applies. If the feature is not considered to be clearly and closely related to the lease and a scope exception is not applicable, the embedded derivative (index multiplier and cap feature) would need to be bifurcated (separated) from the lease and accounted for separately. We believe that lease payments that depend on CPI generally are clearly and closely related to the host contract and bifurcation (separation) would not be necessary.

Question #3:

How does a lessee account for the impairment of a right-of-use (ROU) asset?

Answer:

ROU assets are within the scope of FASB ASC 360, *Property, Plant and Equipment*, and subject to the impairment accounting requirements in that section. The unit of accounting for impairment analyses of long-lived assets is an asset group. An asset group are assets to be held and used which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. Generally, we expect that ROU assets would be part of an asset group tested for impairment; however, for ROU assets, it is possible that the asset group is the individual asset.

The impairment accounting rules in FASB ASC 360 involve a two-step process. In accordance with FASB ASC 360-10-35-28, an impairment loss for an asset group should reduce only the carrying amounts of a long-lived asset or assets of the group. The loss should be allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group shall not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable without undue cost and effort. As such, a portion of the impairment loss generally would be allocated to the ROU asset.

Question #4:

An entity with long-term leases are restructuring their leases to terms of less than one year to utilize the short-term lease exception in FASB ASC 842 and thus minimize or eliminate the impact of FASB ASC 842. Is this acceptable? What considerations are there?

Answer:

FASB ASC 842 contains no specific provisions that would prevent entities from structuring their leases to terms of less than 12 months. Keep in mind that renewal options that are reasonably certain to be exercised by the lessee are to be included in the lease term. In paragraph 381 of the Basis for Conclusions (BC) in ASU 2016-02, *Leases*, the FASB considered that leases could be structured to obtain short-term lease accounting. However, the FASB concluded that there are significant economic disincentives to both parties to entering into a series of short-term leases in place of longer-term leases such that there is not a significant structuring risk throughout the system. For example, lessees may have to pay a premium rental price to compensate the lessor for its increased residual asset risk, and some lessors will be unable to enter into short-term leases depending on the terms of the financing they obtained to acquire the underlying asset.

Question #5:

How does the accounting policy election to not separate nonlease components from lease components affect the lease classification determination? A substantial portion of a lease payment may relate to nonlease components, such as a copier lease where a large percentage of the payment relates to maintenance, toner, paper, etc.

Answer:

If the policy to not separate nonlease components from lease components is elected, all nonlease components associated with the lease component are treated as a single lease component. Accordingly, any lease payments which may have been allocated to the nonlease component are treated as a lease payment. As a result, the lease payments for purposes of the present value test for finance lease classification under FASB ASC 842-10-25-2 (commonly known as the 90% present value test) likely will be higher than if the practical expedient was not elected. Therefore, since the fair value of the underlying leased asset remains the same, it is more likely that the lease will be classified as a finance lease. We think this is particularly the case with the types of mixed lease/service contracts previously unrecognized as leases prior to the adoption of FASB ASC 842. See the CPEA June 2022 report entitled, *ASC 842: Lease/Non-Lease Practical Expedient – Reporting Consequences,* for additional insights related to this topic.

Question #6:

When a lessee leases an entire building, how does the underlying land get accounted for under FASB ASC 842?

Answer:

FASB ASC 842-10-15-29 indicates that, the guidance in FASB ASC 842-10-15-28 notwithstanding, to classify and account for a lease of land and other assets, an entity should account for the right to use land as a separate lease component unless the accounting effect of doing so would be insignificant (for example, separating the land element would have no effect on lease classification of any lease component or the amount recognized for the land lease component would be insignificant). As such, the consideration in the lease contract should be allocated between the building and the land lease components based on whether the lessee controls the underlying land (see discussion below). In BC 147 of ASU 2016-02, the FASB decided that land, by virtue of its indefinite economic life and non-depreciable nature, is different from other assets, such that it should be assessed separately from other assets regardless of whether the separating lease components criteria are met.

This accounting differs from the legacy rules in FASB ASC 840, *Leases*. Under FASB ASC 840, when the fair value of the land is less than 25% of the combined fair value of the land and building, the land and the building were considered one unit of account (no separation of the land component). That rule was not carried forward in FASB ASC 842. If an entity uses the practical expedient to not reassess the lease classification for any existing or expired leases when transitioning to FASB ASC 842 (see FASB ASC 842-10-65-1), the existing classification of the land lease may be carried forward. That assumes that the legacy guidance in FASB ASC 840 on lease classification was correctly applied.

Multi-tenant Building Leases

In situations where the lessee is not leasing the entire building, such as a multi-tenant building, a determination will need to be made about whether there is a separate land component of the lease. In many cases, leases of a portion of a multi-tenant building will not result in the separation of a land component due to the inability of the lessee to control substantially all of the land that the building occupies. Generally, the determination will depend on the extent of the lessee's control of the building (and, therefore, the underlying land). If the lessee were leasing substantially all of the building capacity, a separate land component may be appropriate; otherwise, it's likely that a separate land component should not be identified in the lease.

Question #7:

How do termination notification periods in lease contracts get accounted for? For example, a lease contains a provision that allows the lessee or lessor to terminate the lease, without significant penalty, with a notice 60-days prior to termination.

Answer:

If both parties have a unilateral right to terminate (or not renew) the arrangement (with no more than an insignificant penalty), then there is not an enforceable agreement at that point in time (FASB ASC 842-10-55-23). After the notification period (in this example, 60 days), there is no longer an enforceable agreement as the lessor or the lessee can unilaterally end the agreement. There would be an enforceable term on a rolling 60-day basis. Such agreements may qualify for the short-term lease exemption (FASB ASC 842-20-25-2) and would be subject to the disclosure requirements in FASB ASC 842-10-50-4 (there is an exception from this disclosure if the lease term is one month or less).

Regarding cancellation penalties, the determination of whether a penalty is significant is not limited to financial penalties within the terms of the arrangement. Non-financial penalties may exist (e.g., loss of significant leasehold improvements).

Question #8:

For finance leases, how does salvage value affect the calculation of the ROU asset amortization?

Answer:

FASB ASC 842 does not explicitly address the use of a salvage value when amortizing the ROU asset from a finance lease. However, we believe that use of a salvage value is consistent with FASB ASC 842 and the FASB's intentions. BC 57 of ASU 2016-02 indicates that the FASB decided that a finance lease is economically similar to an acquisition of the underlying asset. BC 60 indicates that a lessee in a finance lease will recognize and present amortization of the ROU asset consistently with the depreciation or amortization of other nonfinancial assets. The rules for depreciating nonfinancial assets in FASB ASC 360-10-35-4 provide for the use of a salvage value. As the FASB's intent is for the amortization of the lease ROU asset to parallel the depreciation or amortization of other nonfinancial assets, we believe the use of a salvage value in calculating the ROU asset amortization is appropriate.

Question #9:

For an existing lease of land of thousands of acres with a long term (e.g., 30-year term), that was previously recorded under FASB ASC 840 as an operating lease, will the lessee be required now to record a potentially very large ROU asset and lease liability on its balance sheet? Are there options for the lessee to consider with the aim of avoiding this accounting outcome?

Answer:

If the definition of a lease under FASB ASC 842 is met, an ROU asset and lease liability will be recognized, which potentially can be quite significant. The package of practical expedients under FASB ASC 842-10-65-1 can be elected, grandfathering the existing operating lease classification, if desired. As for options to avoid this accounting outcome, the entity could consider modifying the lease to reduce the noncancellable lease term and add renewal options. This may have the effect of reducing the lease term and the corresponding lease liability and ROU asset. However, modification would eliminate the ability to grandfather the existing lease classification. Another option would be to modify the terms of the lease such that the lease payments are determined to be variable rather than fixed and, therefore, would not be included in the initial recognition of a lease liability and ROU asset. Finally, an entity can consider using non-generally accepted accounting principles (GAAP) financial reporting frameworks if it is not required to use GAAP. For example, the Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs) takes a traditional accounting approach, blended with some accrual income tax accounting methods, for leases. Visit the AICPA website for more information.

Question #10:

A lessee outsources the shipping of its products to a transportation company. All payments under the arrangement are based on mileage. The lessee elects the practical expedient not to separate lease and nonlease components. Are all payments considered variable and, therefore, no amounts under the agreement are capitalized under FASB ASC 842? How is the expense classified, as variable lease expense or shipping expense?

Answer:

In accordance with FASB ASC 842-10-30-5 and 842-10-30-6, lease payments at the lease commencement date (used to measure and recognize the lease liability and ROU asset) exclude variable lease payments, except those that depend on an index or a rate initially measured using the index or rate at the commencement date. As indicated in FASB ASC 842-20-25-5, variable lease payments not included in the lease liability are recognized in the period in which the obligation for those payments is incurred. Accordingly, if the lease payments to the transportation company are truly variable payments, none of those payments would be recognized at lease commencement (i.e., the payments would not be recognized in a lease liability and ROU asset).

Practitioners should evaluate whether the payments are variable or whether they are in substance fixed payments. Counterparties, like the transportation company, often require some level of minimum payments, which may take the form of a minimum amount of miles in a payment per mile driven. If some portion of the lease payments are determined to be in substance fixed payments, they would be included in the lease payments at the lease commencement date and recognized in the lease liability and ROU asset.

Since the practical expedient was elected to not separate lease and nonlease components, all variable payments are deemed to be related to a lease component (including those that are contractually stipulated to relate to a nonlease component) and should be classified and disclosed as a variable lease cost.