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FASB ASC 842 Implementation FAQs – Part 1

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In this report, 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.

This report presents ten questions and answers. We will continue to regularly issue reports in this series, addressing additional CPEA member questions.

Question #1:

An entity has a lease with a related party that continues until terminated. There are no renewal or purchase options. The lease is undocumented. How do you determine the lease term and accounting treatment for such an open-ended arrangement? Generally, what considerations are there for related party leases? What if unamortized leasehold improvements (LHI) are material?

Answer:

We recommend reading the following CPEA reports for a more thorough understanding of related party lease accounting:

- CPEA October 2022 [report](#), *FASB ASC 842: Leasehold Improvements at Transition & Related Party Leases Update*
- CPEA February 2022 [report](#), *Related Party Leases: Overview of Interpretations under FASB ASC 842*

The first step, like unrelated party leases, is to identify the enforceable rights and obligations. If it is determined that the arrangement is not enforceable within the applicable jurisdiction, then it is out of the scope of FASB ASC 842. An arrangement that is unwritten or undocumented does not lead to the automatic conclusion that the arrangement is not enforceable. In some jurisdictions, an arrangement does not have to be in writing to be enforceable. A jurisdiction could look at past practice, corroborating behaviors such as occupancies and past payment, and can look at economic substance to infer some type of legally enforceable right, which could include a renewal or termination option. In some jurisdictions, for certain types of personal property, for something to be legally enforceable, the arrangement must be in writing. But that is not the case in every jurisdiction. Enforceability depends on the laws of the jurisdiction in which the contract is governed.

If the arrangement is enforceable, one should identify renewal and termination options within the arrangement. Renewal options to be included in the lease term have to be reasonably certain to be exercised (which is a high threshold) and have some type of significant economic incentive beyond management whim. For lessee termination options, one should determine whether it is reasonably certain or not that the termination option would be exercised. If it is reasonably certain that a lessee termination option would not be exercised, then, the termination option on the lessee side would be disregarded in the determination of lease term. Lessor termination options, where the lessor can unilaterally extend the lease or terminate the lease, are not considered in the determination of lease term as it is assumed that the lessor would not exercise a unilateral lessor termination option (see FASB ASC 842-10-55-24).

FASB Tentative Decisions

On September 21, 2022, the FASB added a project to its technical agenda to address arrangements between entities under common control and made the following tentative decisions:

- For arrangements between entities under common control, the FASB tentatively decided to amend FASB ASC 842 to provide entities within the scope of FASB ASC 842-10-65-1(b) (that is, entities that are not public business entities, not-for-profit bond obligors, or employee benefit plans that file or furnish financial statements with or to the U.S. Securities and Exchange Commission) a practical expedient to use written terms and conditions for determining whether a lease exists and, if so, the classification and accounting for that lease.
 - An entity applying the practical expedient would not be required to determine whether those written terms and conditions are legally enforceable. If no written terms and conditions exist, an entity would apply FASB ASC 842 on the basis of the legally enforceable terms of an

arrangement. If an entity determines that a lease does not exist, other U.S. Generally Accepted Accounting Principles (U.S. GAAP) would apply. The FASB also tentatively decided that the practical expedient could be applied on an arrangement-by-arrangement basis.

- The FASB tentatively decided to amend FASB ASC 842 for all entities with leases between entities under common control to specify that a lessee should account for associated leasehold improvements as follows:
 - Amortize leasehold improvements over the economic life of the improvements as long as the lessee continues to use the underlying asset. If the lessor obtained the underlying asset through a lease with an entity not under common control, the economic life over which the leasehold improvements are amortized by the lessee should not exceed the lease term associated with the lessor's lease with the entity not under common control.
 - Account for any remaining leasehold improvements as a transfer between entities under common control if, and when, the lessee ceases using the underlying asset.
 - The FASB tentatively decided that a lessee should disclose information about leases in which the economic life of the leasehold improvements is longer than the lease term.

IMPORTANT NOTE: All decisions reached at the September 21, 2022 meeting were tentative and may change upon further deliberations. Changes to U.S. GAAP are only effective with a final ASU.

Question #2:

Can an entity adopt capitalization thresholds below which lease assets and lease liabilities are not recognized?

Answer:

Entities can adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, that should reduce the costs of applying FASB ASC 842. However, an appropriate assessment of that threshold needs to be made since capitalization thresholds are a non-GAAP measure. Automatically adopting an entity's existing property, plant, and equipment (PP&E) capitalization threshold or adopting the IRS Tangible Property Regulations threshold as a lease capitalization policy without proper support is not appropriate.

Operating leases and PP&E have different characteristics which suggest different capitalization policies are appropriate. For example:

- Lease capitalization policies impact both sides of the balance sheet, understating liabilities, unlike PP&E policies
- Lease capitalization policies are more likely to impact liability driven debt covenants and ratios based on current liabilities
- FASB ASC 842 being newly implemented, its impact will be uncertain
- If non-lease components are being combined with lease components, higher right-of-use (ROU) assets and liabilities will result and should be considered in setting the policy

When establishing a lease capitalization threshold, considerations include:

- Has the impact on the financial statements for omitted ROU assets and lease liabilities been considered on a gross basis and include the impact of non-lease components that are combined with lease components?
- Has the impact on financial statement users, including liability focused metrics such as current ratios and leverage ratios, been considered?
- How will amounts excluded from recognition and measurement be handled for disclosures such as lease costs and short-term lease costs?
- Has the capitalization policy been developed with a full understanding of the population of contracts that contain leases under FASB ASC 842 (such as newly discovered embedded leases)?

Auditors should consider the “clearly trivial” threshold. If there is a misstatement over the proposed journal entry threshold, auditors are required to continue to report it to those charged with governance and include it in the representation letter even if it is due to a capitalization policy.

Question #3:

An office lease with an unrelated party is currently operating as a month-to-month lease. How does the ability to terminate with 60 days’ notice affect lease term determination?

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). Assuming there are no termination penalties that are more than insignificant, after 60 days, there is no longer an enforceable agreement as the lessor or the lessee can unilaterally end the agreement. This lease would be eligible for the short-term lease exemption.

Question #4:

A consolidated reporting entity has leases among related parties in the group (lessee and lessor). The consolidated financial statements include supplemental consolidating financial information. The auditor is engaged to report on the supplementary information (that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole). How is this handled if FASB ASC 842 is not adopted, but any ROU assets and lease liabilities would eliminate in consolidation?

Answer:

AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, provides the guidance for reporting on supplementary information. The core objective, as referenced in the sample reporting language is to:

1. Evaluate the presentation of the supplementary information in relation to the financial statements as a whole
2. Report on whether the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole

An auditor is not issuing an opinion on the supplementary information being presented compliant with U.S. GAAP, only that the above points are met.

We expect many private company auditors will find that entities have not applied FASB ASC 842 to the consolidating schedules. In those cases, because the auditor is likely aware of a material misstatement in one or more columns of the consolidating information, the auditor is required to follow the requirements of AU-C 725.13. In doing so, the auditor should discuss the matter with management and propose appropriate revision of the consolidating information. If management does not revise the consolidating information, the auditor should either:

- Modify the auditor's opinion on the consolidating information and describe the misstatement in the auditor's report or
- If a separate report is being issued on the consolidating information, withhold the auditor's report on the consolidating information

To avoid issues with U.S. GAAP departures in the consolidating schedules, practical options exist. One option is to eliminate the supplemental schedules, if that is possible with the client. Another option is to consider the guidance in the AICPA's TQA 9160.27, *Providing Opinion on a Schedule of Expenditures of Federal Awards in Relation to an Entity's Financial Statements as a Whole When the Schedule of Expenditures of Federal Awards Is on a Different Basis of Accounting Than the Financial Statements*. That TQA provides that the supplementary information does not need to be presented on the same

basis of accounting used to prepare the financial statements as long as the amounts can be reconciled to the financial statements and to the underlying accounting records used in preparing the financial statements. This provides flexibility in the information presented and the reporting could be provided excluding the application of FASB ASC 842.

If the FASB tentative decisions discussed above are finalized and issued, another option may be to ensure the lease agreements are in writing and established as short-term leases. The short-term lease exemption can be applied, avoiding the need for the recognition of lease assets and liabilities in the consolidating schedules.

The CPEA issued a [report](#) on this topic in March 2022 titled, *Update on Supplemental + Other Information Requirements*.

Question #5:

If clients decide not to follow FASB ASC 842, can the auditor resolve the matter with a U.S. GAAP departure paragraph in the auditor's report?

Answer:

We believe in certain cases it could be appropriate to issue an audit report with an FASB ASC 842 U.S. GAAP departure. We cannot provide specific conclusions on when to use a qualified vs adverse report; however, AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, indicates that pervasive effects are those that, in the auditor's judgment:

- Are not confined to specific elements, accounts or items of the financial statements
- If so confined, represent or could represent a substantial portion of the financial statements; or
- Regarding disclosure, are fundamental to users' understanding of the financial statements

While in many situations the adoption of FASB ASC 842 would not be pervasive, there would be industries or entities in which leasing activity has more significance to their financial results and may be deemed to be pervasive based on the above considerations.

When issuing a qualified report, if it is not practicable to quantify the financial effects, the auditor should indicate that in the "Basis for Opinion" section. If the specific amount of the misstatement cannot be determined, sufficient documentation should be made in the audit file to support the position that the impact would not be pervasive to the financial statements and this likely would involve some level of quantification of the misstatement.

We recommend considering alternatives to the modified report for clients. Those alternatives include opting into another basis of accounting (such as the Financial

Reporting Framework for Small- and Medium-Sized Entities (FRF for SME's) or income tax basis of accounting) which provide users with relevant information and an unmodified report can be issued.

Question #6:

Would an entity, adopting FASB ASC 842 effective January 01, 2022, use the risk-free rate at the date of adoption of FASB ASC 842 or the date of the lease commencement?

Answer:

Regardless of which discount rate is used (whether it's the risk-free rate alternative or the incremental borrowing rate), for existing leases as of the date of adoption, an entity determines the rate based on the rates in effect at the adoption date. This is prescribed in the transition guidance in FASB ASC 842-10-65, paragraph L, noting that the rate is 'established at the application date.'

What is not prescribed in the transition guidance is what lease term to use when determining the rate. For example, if an entity has a lease with an original term of 15 years, but with 3 years remaining at January 1, 2022, there is flexibility in determining if the entity uses a 15-year risk-free rate or a 3-year risk-free rate. Given this is not prescribed, we believe this would be an accounting policy election and an entity should be consistent in application.

Question #7:

On a January 1, 2022 transition date to FASB ASC 842, for leases that originally had multiple year terms and now have less than a year to go, how do they get handled at transition?

Answer:

The term of the lease is to be determined based on the lease commencement date. While the entity would measure the lease liability and ROU asset based on the remaining term, the entity must still use the original lease term at commencement for evaluation of whether the short-term lease exemption applies. A "Short-term lease" is defined in FASB ASC 842 as a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. Remember that the lease term includes periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option.

Question #8:

Is the election to use the risk-free rate to discount leases under FASB ASC 842 made at the reporting entity (consolidated) or legal entity (subsidiary) level?

Answer:

The risk-free rate election under FASB ASC 842 is made at the “class of underlying asset” level. We note that AICPA TQA 1400.23, *Conforming Subsidiary's Inventory Pricing Method to Its Parent Company's Method*, presents a situation in which the subsidiary applies an alternative policy from the parent, with both being in accordance with U.S. GAAP (FIFO vs. LIFO). However, that TQA is not about adopting a new accounting standard. The accounting literature does not provide clear guidance on this matter. Our review of large firm interpretations indicate that they do not appear to support separate consolidated/combined entities having different accounting policies for leases within a single consolidated presentation without valid justification. If the accounting policies of a parent and one or more subsidiaries differ in the parent’s consolidated financial statements, the entity would need to justify that position. We believe that in standalone financial statements, members of the consolidated group could have a different accounting policy, particularly as it pertains to a private company alternative.

Related to the term “underlying class of asset,” FASB ASC 842 does not define the term. Some assess classes of assets based on physical characteristics. Others assess asset classes based on risk characteristics. For example, different kinds of real estate have different risk characteristics - owner-occupied, commercial, residential, industrial, etc. Entities may find it easier to achieve desired outcomes by applying the risk-free rate election using risk characteristics versus attempting to justify a different policy within a consolidated group.

Question #9:

In the event of a lease where both the lessee and lessor can terminate the agreement without permission from the other party and without a significant penalty, is the lease not enforceable and FASB ASC 842 would not apply? What disclosures would be required? How should related “leasehold improvements” be accounted for?

Answer:

If either party can terminate the lease without permission and without significant penalty, the lease would not be enforceable and FASB ASC 842 would not apply (FASB ASC 842-10-55-23). Keep in mind that when considering whether a significant cancellation penalty exists, the penalty is not limited to financial penalties within the terms of the arrangement. Non-financial penalties may exist (e.g., loss of significant leasehold improvements). The existence of a notice period for termination needs to be considered. For example, if the agreement requires a 90-day notice period, then there would be an enforceable term on a rolling 90-day basis. In such a case, the agreement may fall under the short-term lease exemption and would be subject to the disclosure requirement in FASB ASC 842-10-50-

4 (note that there is an exception from this disclosure if the lease term is one month or less).

Assuming there is no notice period and, therefore, nothing is enforceable, then FASB ASC 842 and its disclosures would not apply. If the arrangement is with a related party, the relevant disclosures in FASB ASC 850, *Related Party Disclosures*, would need to be considered.

Related to the “leasehold improvements,” inasmuch as the agreement is not within the scope of FASB ASC 842, the “leasehold improvements” would be accounted for under other U.S. GAAP by each party. For example, on the lessor side FASB ASC 606, *Revenue from Contracts with Customers*, may apply or possibly FASB ASC 705-20, *Cost of Sales and Services -- Accounting for Consideration Received from a Vendor*. On the lessee side, FASB ASC 360, *Property, Plant and Equipment*, could apply.

Question #10:

How are 99-year ground leases accounted for under FASB ASC 842? Are they within the scope of the new standard? If so, how does one determine a discount rate?

Answer:

Long-term land leases (including 99-year leases or 999-year leases) are within the scope of FASB ASC 842. The FASB determined that there is no conceptual basis for differentiating long-term leases of land from other leases.

A very long-term lease of land could be classified as a finance (or sales-type) lease because the present value of the lease payments (plus the present value of any lessee residual value guarantee) could represent substantially all (i.e., 90%) of the fair value of the land. In that case, the accounting applied by the lessee and lessor will be similar to accounting for a purchase or sale of the land.

Entities may find it difficult to determine an appropriate discount rate for long-term land leases. Valuation specialists may be needed. A property yield may be a useful starting point when determining the incremental borrowing rate but would require adjustments (often complicated). Some companies have issued 99-year bonds to refer to, adjusting for the lease term, payment structure, currency, collateral, and credit rating of lessee, etc. Some countries have issued 99-year debt (e.g., Mexico, Austria) that can be referred to, subject to the aforementioned adjustments.

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