Lease Update – Help on the Way

It has been two years since the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, *Leases* (Topic 842), which requires lessees to recognize all leases with terms greater than 12 months on their balance sheet. The standard is not effective for public entities[1] until 2019, but as larger companies begin implementation efforts many detailed questions and unexpected operational challenges have arisen. FASB is tackling these issues in a series of separate projects.

FASB recently released a set of technical corrections in ASU 2018-10, *Codification Improvements to Topic 842, Leases*, which provides clarity on several items to prevent possible diversity in practice. These technical corrections do not change any core principles of ASU 2016-02 and are not expected to have a significant effect on current accounting practice or create a significant administrative cost for most entities. See a complete list in the Appendix.

In January 2018, FASB issued a proposed ASU addressing comparative reporting at initial adoption and separating lease and nonlease components. Early adopters identified operational challenges in comparable period reporting requirements under a modified retrospective approach. FASB was sympathetic to the issue and added an additional optional transition method. The proposal would allow entities to apply Accounting Standards Codification (ASC) 842's provisions at the effective date, *e.g.*, for public entities on January 1, 2019, without adjusting the comparative periods presented. If elected, a lessee would not have to measure and recognize leases that expired prior to the effective date, or consider the effects of each modification for leases that were modified more than once during the comparative period presented. This new method would change **when** an entity would be required to initially apply the transition requirements of the new lease standard; it would not change **how** those requirements apply. Under ASC 842, lessees have a practical expedient, by class of underlying assets, to not separate lease and nonlease components. If elected, a lessee is required to account for the lease and nonlease components as a single lease component with special disclosures. FASB's proposal would extend this expedient to lessors. However, the lessor practical expedient would be limited to circumstances in which both:

- The timing and pattern of revenue recognition are the same for the nonlease and related lease component, and
- The combined single lease component would be classified as an operating lease

Feedback on this proposal was overwhelmingly positive, and FASB approved the issuance of a final standard, which is scheduled for issuance in the third quarter of 2018.

In March 2018, FASB added a project to address narrow-scope lessor issues, including taxes collected from lessees and certain lessor costs paid directly by lessees. FASB agreed lessors could analogize to revenue guidance in ASC 606 that allows an accounting policy election to exclude from the transaction price certain sales taxes that the entity collects from a customer. Lessors also could analogize to ASC 606 to exclude certain lessor costs from variable consideration in the lease contract when those lessor costs are paid by the lessee and the uncertainty in the amount paid is not expected to ultimately be resolved. An exposure draft with a short comment period is planned for the third quarter of 2018. A final standard should be issued before year-end.

[1] *A public entity is defined as any one of these:*

- *A public business entity*
- *A not-for-profit entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market*
- *An employee benefit plan that files or furnishes financial statements to the U.S. Securities and Exchange Commission*

ASU 2016-02
Leases (Topic 842)

ASU 2018-01
Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842

ASU 2018-10
Codification Improvements to Topic 842, Leases

Proposed ASU
Leases (Topic 842): Targeted Improvements

Project
Lessor Narrow-Scope Improvements

Final standards are planned before 2018 year-end and all will have the same effective date and transition requirements as the leases standard:

Effective Dates
ASU 2016-02

Public Entities
Annual and interim periods beginning after December 15, 2018

All Others
Annual periods beginning after December 15, 2019

The adoption of ASC 842 will be complex and likely will require significant hours to correctly implement. BKD can help educate your team, provide implementation tools and assist with analysis and documentation. If you would like assistance in complying with the new leases standard, contact your trusted BKD advisor. BKD has prepared a library of **BKD Thoughtware®** on this issue. Visit our Hot Topics page to learn more.

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Appendix

The technical corrections generally are not expected to have a significant effect on current accounting practice or create a significant administrative cost for most entities.

ASU 2018-10, Technical Corrections
Issue 1: Residual Value Guarantees
Incorrect cross-reference
Issue 2: Rate Implicit in the Lease
Could the application of Topic 842 to certain sales-type leases with significant variable payments result in a negative rate implicit in the lease, rather than a loss at the commencement date of the lease? The rate implicit in the lease cannot be less than zero. A day 1 loss is the intended accounting outcome and, accordingly, the use of a negative rate implicit in the lease is not appropriate.
Issue 3: Lessee Reassessment of Lease Classification
Should the lessee reassess lease classification on the basis of the facts and circumstances existing as of the date the reassessment is required ***or*** *whether the lessee could continue to use the fair value and remaining economic life of the underlying asset as determined at the commencement date of the lease (or the most recent modification not accounted for as a separate contract)?* An entity (lessee or lessor) should reassess lease classification on the basis of the facts and circumstances—and the modified terms and conditions, if applicable—as of the date the reassessment is required, *e.g.*, on the basis of the fair value and the remaining economic life of the underlying asset as of the date there is a change in the lease term or in the assessment of a lessee option to purchase the underlying asset or as of the effective date of a modification not accounted for as a separate contract.
Issue 4: Lessor Reassessment of Lease Term & Purchase Option
Why should a lessor account for a lessee exercise of purchase options in a manner similar to a lease modification when the exercise of those options is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date of the lease (or the most recent effective date of a modification that is not accounted for as a separate contract)? A lessor should account for the exercise by a lessee of an option to extend or terminate the lease or to purchase the underlying asset as a lease modification unless the exercise of that option by the lessee is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date of the lease (or the most recent effective date of a modification that is not accounted for as a separate contract).
Issue 5: Variable Lease Payments That Depend on an Index or a Rate
Is there inconsistency in the guidance about remeasurement of the lease payments when a contingency upon which some or all of the variable lease payments are based is resolved that might be perceived as applying to any variable lease payments, including those that depend on an index or rate? A change to a reference index or rate upon which some or all of the variable lease payments in the contract are based does not constitute the resolution of a contingency. Variable lease payments that depend on an index or a rate should be remeasured, using the index or rate at the remeasurement date, only when the lease payments are remeasured for another reason.

Issue 6: Investment Tax Credits
Is there an inconsistency in terminology used about the effect that investment tax credits have on the fair value of the underlying asset between the definition of the term rate implicit in the lease and the lease classification guidance? The differences could result in differences in application between the determination of the rate implicit in the lease and lease classification, which did not exist under Topic 840. FASB did not intend to change practice—terminology will be aligned.
Issue 7: Lease Term & Purchase Option
The description about lessor-only termination options is not consistent with the description about the noncancellable period of a lease. A lessor-only option to terminate the lease is an input to the determination of the lease term and does not affect the noncancellable period of the lease.
Issue 8: Transition Guidance for Amounts Previously Recognized in Business Combinations
The transition guidance for lessors is unclear because it relates to leases classified as direct financing leases or sales-type leases under Topic 840, while the lead-in sentence provides transition guidance for leases classified as operating leases under Topic 840. The transition guidance applies to lessors for leases classified as direct financing leases or sales-type leases under Topic 842, not Topic 840. It would apply when an entity does not elect the package of practical expedients and, for a lessor, an operating lease acquired as part of a previous business combination is classified as a direct financing lease or a sales-type lease when applying the lease classification guidance in Topic 842.
Issue 9: Certain Transition Adjustments
Why should nonqualifying costs be charged to equity when such costs are incurred after the beginning of the earliest period presented in the financial statements in which an entity adopts Topic 842? The amendments clarify whether to recognize a transition adjustment to earnings rather than through equity, if an entity chooses full retrospective adoption. For example, for an operating lease under Topic 840, a lessee that does not elect the practical expedient package should write off the initial direct costs that do not meet the definition of initial direct costs under Topic 842 as a transition adjustment to equity (if incurred before the beginning of the earliest period presented) or to earnings of the comparative period presented (if incurred on or after the beginning of the earliest period presented). Similarly, a lessor with an existing operating lease that is reclassified as a sales-type or direct financing lease under Topic 842 should recognize the selling profit or loss on that lease as an adjustment to equity only if the commencement date of the lease was before the beginning of the earliest period presented.
Issue 10: Transition Guidance for Leases Previously Classified as Capital Leases Under Topic 840
Incorrect cross reference
Issue 11: Transition Guidance for Modifications to Leases Previously Classified as Direct Financing or Sales-Type Leases Under Topic 840
Incorrect cross reference

Issue 12: Transition Guidance for Sale & Leaseback Transactions

The heading above the transition guidance on sale and leaseback transactions appears to suggest that there is no transition guidance for sale and leaseback transactions that occur after the earliest comparative period presented in the financial statements in which an entity adopts Topic 842 but before the effective date.

The transition guidance on sale and leaseback transactions applies to all sale and leaseback transactions that occur before the effective date.

Issue 13: Impairment of Net Investment in the Lease

Does the guidance, as written, accelerate and improperly measure the loss allowance because the cash flows associated with the unguaranteed residual asset appear to be excluded from the evaluation?

The net investment in the lease is a single unit of account in determining the loss allowance. Lessors would evaluate the net investment in the lease using the cash flows that the lessor expects to receive from the lease receivable and the unguaranteed residual asset during the remaining lease term.

The amount that the lessor expects to derive from the unguaranteed residual asset would be based on the expected value of the residual asset following the end of the lease term (excluding any amounts guaranteed by the lessee or any other third party unrelated to the lessor because those expected cash flows would already be considered as part of the lease receivable), effectively incorporating residual asset risk into the loss allowance analysis, together with credit risk. Even though the risk associated with the residual asset is risk related to the end-of-lease value of that asset (rather than credit risk), the credit risk assessment model is used to measure the residual asset risk, thereby accomplishing FASB's objective of using a single impairment approach for the entire net investment in the lease.

Issue 14: Unguaranteed Residual Asset

As currently written, if a lessor sells the lease receivable associated with a direct financing lease or a sales-type lease and retains an interest in the residual value of the asset, the lessor should not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term. Did FASB intend to change practice since existing guidance (which will be superseded by ASU 2016-02) requires a lessor to continue to recognize interest resulting from accretion of the unguaranteed residual asset to its estimated value unless the lessor sells substantially all of the minimum rental payments?

A lessor should not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term to the extent that the lessor sells substantially all of the lease receivable associated with a direct financing lease or a sales-type lease, consistent with Topic 840.

Issue 15: Effect of Initial Direct Costs on the Rate Implicit in the Lease

Order of illustrations in Case C will be updated

Issue 16: Failed Sale & Leaseback Transaction

Does the current language prevent negative amortization of the financial liability recognized by a seller-lessee in a failed sale and leaseback transaction?

A seller-lessee in a failed sale and leaseback transaction should adjust the interest rate on its financial liability as necessary to ensure that the interest on the financial liability does not exceed the total payments (rather than the principal payments) on the financial liability.