PacificCPE

COURSE

21501A

# Foundations of the New Lease Standard of ASC 842

Get up to speed on ASC 842 and what changed from legacy GAAP. This course covers the background and basic concepts of ASU 2016-02, walks through how previous lease accounting compared to the new standard on the lessee side, and dives into the critical definitions, scope exceptions, and rules for identifying whether a contract actually contains a lease. Packed with illustrations, it gives practitioners the conceptual grounding they need before tackling the more technical classification and measurement rules.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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## LEARNING ASSIGNMENTS AND OBJECTIVES

## Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

## Course Objectives

- Recognize a key change made to GAAP by the new lease standard.
- Identify a type of lease that exists for a lessee under ASU 2016-02.
- Recall a type of lease for which the ASU 2016-02 rules do not apply.
- Recognize some of the criteria that determine whether a contract is or is not a lease.
- Identify some of the types of economic benefits a lessee can obtain from a leased asset.
- Recognize a right that ASU 2016-02 states does not prevent a lessee from having the right to direct use of an identified asset.

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# Section 1

## IMPLEMENTATION OF THE NEW LEASE STANDARD

*Chapter Objective*

**After completing this assignment, you should be able to:**

- Recognize a key change made to GAAP by the new lease standard.
- Identify a type of lease that exists for a lessee under ASU 2016-02.

## I. BACKGROUND

**Issued:** February 2016

**Effective Date:**

The FASB extended the original effective date of ASU 2016-02 and ASU 2018-01 twice since ASU 2016-02 was issued.

The final implementation date of the lease standard, is as follows:

1. For any of the following entities, the effective date is for fiscal years *beginning after December 15, 2018*, including interim periods within those fiscal years:
   a) A public business entity
   b) A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over the-counter market
   c) An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission (SEC).

   **Exception:** For a not-for-profit entity that has issued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market that *has not yet issued financial statements or made financial statements available for issuance as of June 3, 2020*, the effective date is for fiscal years *beginning after December 15, 2019*, and interim periods within those fiscal years. Earlier application is permitted.
2. For all other entities (including nonpublic entities): ASU 2020-05 extends the effective date to apply to financial statements issued for fiscal years *beginning after December 15, 2021* (calendar year 2022), and interim periods within fiscal years beginning after December 15, 2022. Earlier application is permitted.

*Observation*

The FASB extended the effective date of the new lease standard twice. The final effective date of the lease standard for a nonpublic entity was January 1, 2022, on which date a nonpublic entity was required to measure its lease assets and obligations and bring them onto its balance sheet.

**Objective:**

The objective of ASU 2016-02 is to specify the accounting for leases and to establish the principles that lessees and lessors shall apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease.

The objective of ASU 2018-01 is to provide transition relief for land easements to which previous GAAP for leases had not previously been applied.

Under GAAP, prior to the effective date of the new lease standard, ASC 840, *Leases (formerly FASB No. 13)*, divided leases into two categories: operating and capital leases. Capital leases were capitalized, while operating leases were not. For a lease to qualify as a capital lease, one of four criteria had to be met:

1. The present value of the minimum lease payments must equal or exceed 90% or more of the fair value of the asset,
2. The lease term must be at least 75% of the remaining useful life of the leased asset,
3. There is a bargain purchase at the end of the lease, or
4. There is a transfer of ownership.

Consider the following example reflective of the previous lease standard found in ASC 840.

**Facts:**

Lease 1: The present value of minimum lease payments is 89% and the lease term is 74% of the remaining useful life of the asset.

Lease 2: The present value of minimum lease payments is 90% or the lease term is 75% of the remaining useful life of the asset.

**Conclusion:**

Lease 1 is an operating lease not capitalized, while Lease 2 is a capital lease under which both the asset and lease obligation are capitalized.

**SEC pushes toward changes in lease accounting**

The changes made to lease accounting by ASU 2016-02 were instigated by Enron's collapse. The demise of Enron and a few other entities, such as WorldCom, lead to the passage of the Sarbanes-Oxley Act of 2002. Within Sarbanes Oxley, Congress included a requirement that the SEC perform a study and issue a report on the extent to which public companies had significant off-balance sheet transactions.

In its 2005 report entitled *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes- Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuer*, the SEC targeted lease accounting as one of the areas that resulted in significant liabilities being off-balance sheet.

Per the SEC Report and a U.S. Chamber of Commerce report, prior to the implementation of the new lease standard:

a. 63% of companies recorded operating leases while 22% recorded capital leases.
b. U.S. Companies had approximately $1.5 trillion in operating lease obligations that were off-balance sheet.
c. European companies had a total of approximately $928 billion in operating lease obligations.

Moreover, 73 percent of all leases held by U.S. public companies ($1.1 trillion) involve the leasing of real estate.[1]

In its Report, the SEC noted that because of ASC 840's (formerly FASB No. 13's) bright-line tests (90%, 75%, etc.), small differences in economics have completely changed the accounting (capital versus operating) for leases.

Keeping leases off-balance sheet while still retaining tax benefits, has been an industry unto itself. So- called "synthetic" leases have commonly been used to maximize the tax benefits of a lease while not capitalizing the lease for GAAP purposes.

In addition, lease accounting abuses have been the focus of restatements with approximately 270 companies, mostly restaurants and retailers, restating or adjusting their lease accounting in the wake of Section 404 implementation under Sarbanes-Oxley.

Retailers have the largest amount of operating lease obligations outstanding that are not recorded on their balance sheets.

**FASB-IASB lease project**

Since the Sarbanes-Oxley Act became effective, the FASB has focused on standards that enhance transparency of transactions and that eliminate off-balance-sheet transactions, the most recent of which was the issuance of ASC 810, *Consolidation of Variable Interest Entities* (formerly FIN 46R). The FASB added to its agenda a joint project with the IASB to replace existing lease accounting rules

found in ASC 840 (formerly FASB No. 13) and its counterpart in Europe, IAS No. 17. The FASB and IASB started deliberations on the project in 2007, and issued a discussion memorandum in 2009, following by the issuance of an exposure draft in 2010 entitled *Leases (ASC 840)*.

The 2010 exposure draft was met with numerous criticisms that compelled the FASB to issue a second, replacement exposure draft on May 16, 2013 entitled, *Leases (Topic 842), a revision of the 2010 proposed FASB Accounting Standards Update, Leases (ASC 840)*.

Ultimately, in February 2016, the FASB issued a final standard in ASU 2016-02.

ASU 2016-02 replaces existing lease accounting rules found in ASC 840, *Leases,* with newly issued ASC 842, *Leases*.

The new ASC 842 affects any entity that enters into a lease with a few specified scope exemptions.

The main differences between previous GAAP in ASC 840 and new ASC 842 are:

- Most operating leases previously kept off balance sheet under ASC 840 are now capitalized under the new ASC 842.
- In ASC 842, all leases with a lease term more than 12 months must be capitalized, even if those leases have been expensed as operating leases in existing ASC 840.

ASC 842 retains a distinction between finance leases and operating leases. The classification criteria for distinguishing between finance leases and operating leases are substantially similar to the classification criteria for distinguishing between capital leases and operating leases in the previous leases guidance.

The result of retaining a distinction between finance leases and operating leases is that under the lessee accounting model in ASC 842, the effect of leases in the statement of income and the statement of cash flows is largely unchanged from previous GAAP in ASC 840.

**Issuance of ASU 2018-01**

In January 2018, the FASB issued ASU 2018-01, *Leases (Topic 842)- Land Easement Practical Expedient for Transition to Topic 842*. The amendments made by ASU 2018-01 are effective on the same dates as the underlying changes to lease accounting made by ASU 2016-02.

ASU 2018-01 addresses the applicability of the new lease standard to land easements, such as rights of way that represent the right to use, access, or cross another entity's land for a specific purpose.

Under existing GAAP prior to the application of ASU 842, there is a difference in the way in which entities account for land easements. Some entitles treat them as leases while other account for them as intangible assets or fixed assets under other GAAP sections.

Stakeholders have been concerned that applying the new lease standard to land easements would be costly, complex, and not necessarily useful given that many easements have an unlimited life of use.

To address those concerns, the FASB issued ASU 2018-01 to offer an *optional transition practical expedient* that allows an entity *not to evaluate existing or expired land easements under the new lease standard*, if they were not previously accounted for as leases under the current lease rules.

ASU 2018-01 is addressed further on in this course.

**Issuance of ASU 2023-01- Leases (Topic 842)- Common Control Arrangements**

In March 2023, the FASB issued ASU 2023-01, Leases (Topic 842)- Common Control Arrangements, to provide additional guidance in dealing with common control arrangements (related-party leases).

ASU 2023-01 addresses two key changes related to common control lease arrangements:

1. It provides a practical expedient to address the classification of common control (related party) lease arrangements, particularly those that are month-to-month (tenant-at-will) unwritten lease arrangements.
2. It offers guidance on the accounting for leasehold improvements associated with common control lease arrangements.

Classification of common-control lease arrangements:

ASC 842-10-55-23 states that an entity should determine the noncancellable period of a lease when determining the lease term. When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a contract and determine the period for which the contract is enforceable.

For many related-party month-to-month leases, the period over which the contract is enforceable is unclear because the terms of the lease arrangement are not codified within a formal written lease and the related parties typically can modify the lease terms from time to time.

ASU 2023-01 helps resolve this complexity by providing a practical expedient that can be used and elected by private companies and not-for-profit entities that are not conduit bond obligors, to use the written terms and conditions of a common control arrangement to determine:

- Whether a lease exists and, if so,
- The classification of and accounting for that lease (short-term or long-term).

Thus, under the practical expedient, if parties under common control create a written document to codify the terms of the lease (month-to-month, etc.), those written terms are used to determine if the lease is short-term and excludable from being capitalized under the lease standard. Whether the lease arrangement is “enforceable” is ignored and, instead, the strict terms of the written arrangement prevail.

The practical expedient may be applied on an arrangement-by-arrangement basis.

Leasehold improvements in common control lease arrangements:

The basic rule in ASU 842 is that leasehold improvements are amortized over the **shorter of** a) the remaining lease term, and b) the useful life of the improvements.

Amortizing leasehold improvements related to common control lease arrangements over a period shorter than the useful life may result in financial reporting that does not faithfully represent the economics of those leasehold improvements, particularly in common control leases with short lease terms.

ASU 2023-01 modifies ASC 842's basic rule by requiring that leasehold improvements associated with common control lease arrangements be:

1. Amortized by the lessee over the useful life of the leasehold improvements to the common control group (regardless of the lease term), as long as the lessee controls the use of the underlying asset (the leased asset) through the lease.
2. Accounted for as a transfer between entities under common control through an adjustment to equity (or net assets for not-for-profit entities) if, and when, the lessee no longer controls the use of the underlying asset.

There are transition rules for the two changes made by ASU 2013-01 which are addressed further on in this course.

**Additional Amendments since the Issuance of ASU 2016-02**

Like most major standards, once ASU 2016-02 was passed in 2016, the FASB was inundated with requests for clarifications. Contrary to the revenue standard issued in ASU 2014-09, which created a transitional task force referred to as the Transitional Resource Group (TRG), the FASB chose not to create a similar task force for the lease standard.

Consequently, the onus is placed on the FASB to address unresolved transitional issues surrounding the lease standard by issuing a series of additional accounting standards updates (ASUs) identified as follows: