PacificCPE

COURSE
21505A

Transition, Special Transactions, and Implementation

Wrapping up the series, this course tackles the practical side of adopting ASU 2016-02. It covers transition methods and effective dates, then addresses specialized situations including sale and leaseback transactions and leveraged lease arrangements. The course also examines the broader impact of the new standard on financial statements, unique considerations for nonpublic entities, covenant implications, and strategies some entities use to avoid lease capitalization. A real-world case study for a private company lessee ties the concepts together for immediate application.

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

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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 how certain existing leases are accounted for on the implementation date of ASU 2016-02.
- Identify how deferred income taxes will be treated for lessees under ASU 2016-02.
- Recall the potential impact that the new lease standard might have on a lessee's EBITDA and debt-equity ratios.
- Recall the IRS rules as when an entity should and should not capitalize a lease for tax purposes.

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Section 6

Chapter Objective

After completing this chapter, you should be able to:

- Recognize how certain existing leases are accounted for on the implementation date of ASU 2016-02.

IX. TRANSITION AND EFFECTIVE DATE INFORMATION

A. GENERAL- EXISTING LEASES

A key element of ASU 2016-02 is that it *does not grandfather existing leases*. That means that on the effective date of the ASU, the following must be done:

1. Existing leases that do not qualify for the 12-month short-term lease election:
   a) Existing operating leases must be capitalized under the new ASU by bringing onto the balance sheet a right-of-use asset and lease obligation.
   b) Existing capital lease assets and liabilities must be adjusted to conform with the calculated right-of-use assets and lease obligations.
2. Any existing leases that qualify for the 12-month short-term election on the effective date would not be capitalized under the new lease standard.
3. Disclosures must be expanded to conform with the list of disclosures under ASU 2016-02.

B. TRANSITION TO NEW LEASE STANDARD

The following represents the transition and effective date information related to ASU 2016-02, Leases (ASC 842), as amended by ASU 2018-11, *Leases (Topic 842): Targeted Improvements*.

Effective dates

1. ASU 2020-05's new implementation date of the lease standard, is as follows:
   a) 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 public business entity
      - 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

- An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission (SEC).

Exception: 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.

b) 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.

Methods to implement the lease standard

In the financial statements in which an entity first applies the ASU 2016-02 amendments, the entity shall recognize and measure leases that *exist at the implementation* depending on which method (Method 1 or 2) the entity elects to use as discussed below.

1. An entity shall apply the standard using *one of the following two methods*:

   Method 1: Modified Retrospective Approach

   a) Apply the new standard by recording existing leases retrospectively to the *beginning of the earliest reporting period presented* in the financial statements.

   b) In limited cases, there is a cumulative effect adjustment to retained earnings.

   c) The application date for Method 1 is the *later of*:

   - The beginning of the earliest period presented in the financial statements, and
   - The commencement date of the lease.

   Method 2: Transition Approach[38]

   a) Apply the standard by recording existing leases retrospectively to the *beginning of the period of adoption (application date)*.[39]

   b) In limited cases, there is a cumulative effect adjustment to retained earnings.

   c) The application date for Method 2 is the beginning of the reporting period in which the entity first applies the standard, which is likely to be January 1, 2022.

2. In limited cases, an entity shall *adjust beginning retained earnings for a cumulative effect of certain items* as if the standard had been applied in previous years.

Package of three practical expedients

ASU 2016-02, as amended, offers a *package of three practical expedients* that simplify the implementation of the lease standard. In essence, the practical expedients, used together, shortcut the application of the standard.

In general, most nonpublic entities should elect to use these practical expedients.

1. The three practical expedients *must be elected as a package* and applied consistently by an entity to *all of its leases* (including those for which the entity is a lessee or a lessor), when applying ASU 2016-02 to leases that commenced before the effective date.
    a) Under the practical expedients, in implementing the lease standard, an entity is *not required to reassess* the following three areas:
        1) Whether any expired or existing contracts are or contain leases
        2) Whether initial direct costs for any existing leases would have qualified for capitalization under the new lease standard, and
        3) The lease classification for any expired or existing leases.
            • All existing leases that were classified as operating leases under previous GAAP will automatically be classified as operating (Type B) leases, and
            • All existing leases that were classified as capital leases under previous GAAP will automatically be classified as finance (Type A) leases.

Other practical expedients

ASU 2016-02 also offers a hindsight practical expedient which is rarely used and not useful for most nonpublic entities.

Under this practical expedient:

1. An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the lease term when:
    a) Considering lessee options to extend, terminate the lease, or purchase the underlying asset, and
    b) Assessing impairment of the entity's right-of-use assets. This practical expedient may be elected separately or in conjunction with other practical expedients.

Amounts previously recognized in respect of business combinations

If an entity has previously recognized an asset or a liability in accordance with ASC 805, *Business Combinations*, on business combinations relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination, the entity shall do all of the following:

1. Derecognize that asset and liability (except for those arising from operating leases for which the entity is a lessor).
2. Adjust the carrying amount of the right-of-use asset by a corresponding amount if the entity is a lessee.
3. Make a corresponding adjustment to equity at the beginning of the earliest comparative period presented if assets or liabilities arise from leases classified as sales-type leases or direct financing leases for which the entity is a lessor.

Transition disclosures- lessees and lessors

A lessee or lessor shall provide the transition disclosures required by ASC 250, *Accounting Changes and Error Corrections*, on accounting changes and error corrections.

1. An entity that elects the Method 2 Transition Method shall provide:
   a) Transition disclosures as of the beginning of the period of adoption only (January 1, 2022), and

   b) Previous GAAP disclosures in ASC 840 for all comparative periods that continue to be in accordance with previous GAAP (ASC 840).

   Example: Company X, a lessee, adopts ASU 2016-02 effective January 1, 2022 using the Method 2 transition approach. X adopts the standard in 2022 and includes the new lease disclosures in 2022. If X presents comparative financial statements for 2021, the 2021 statements must include disclosures under previous ASC 840 lease rules. Thus, if comparative financial statements are presented for 2022 and 2021, two sets of disclosures are required: new ASC 842 disclosures for 2022 and the previous ASC 840 disclosures for 2021.
2. If a lessee or lessor uses one more of the practical expedients, it shall disclose that fact.

Lessees transition- existing leases

Leases previously classified as operating leases under ASC 840

1. At the applicable date of the implementation (depending on whether Method 1 or 2 is used), a lessee shall recognize a right-of-use asset and a lease liability for a lease that had been classified as an operating lease under previous GAAP.
   a) Under the *three practical expedients*, a previous operating lease is automatically capitalized and recorded as an operating (Type B) lease under the new standard.
2. For a previous operating lease classified as an operating (Type B) lease under the new standard:
   a) A lessee shall measure the lease liability at the *present value of the sum* of the following, using a discount rate in effect on the applicable date:
      • The remaining minimum rental payments under existing GAAP's ASC 840.

- Any amounts probable of being owed by the lessee under a residual value guarantee.

Note
Entities that are not public business entities, can use a risk-free rate to apply the present value computation established at the application date.

b) A lessee shall initially measure the right-of-use asset at the initial measurement of the lease liability adjusted for both of the following:

- Prepaid or accrued lease payments, remaining balance of any lease incentives, unamortized initial direct costs, and impairment of the right-of-use asset.
- The carrying amount of any liability recognized in accordance with ASC 420, *Exit and Disposal Cost Obligations*, on exit or disposal cost obligations for the lease.

c) A lessee shall subsequently measure the right-of-use asset throughout the remaining lease term.

d) Classify the assets and liabilities held under capital leases as right-of-use assets and lease liabilities arising from operating leases for the purposes of presentation and disclosure.

3. If a previous operating lease is classified as a finance lease (Type A lease), because the entity chooses *not to elect the three practical expedients*, a lessee shall measure the right-of-use asset as the applicable proportion of the lease liability at the commencement date, which can be imputed from the lease liability.

Note
The applicable proportion is the remaining lease term at the beginning of the earliest comparative period presented relative to the total lease term.

a) A lessee shall adjust the right-of-use asset recognized by the carrying amount of any prepaid or accrued lease payments and the carrying amount of any liability recognized in accordance with ASC 420, *Exit or Disposal Cost Obligations*, for the lease.

4. If a lessee does not elect the practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs, shall be written off as an adjustment to equity unless the entity elects Method 1 and the costs were incurred after the beginning of the earliest period presented, in which case those costs shall be written off as an adjustment to earnings in the period the costs were incurred.

Leases previously classified as capital leases under ASC 840

1. At the applicable date of the implementation (depending on whether Method 1 or 2 is used), a lessee shall recognize a right-of-use asset and a lease liability for a lease that

   had been classified as an capital lease under previous ASC 840 GAAP.

   a) Under the *three practical expedients*, a previous capital lease is automatically capitalized and recorded as a finance (Type A) lease under the new standard.

   b) For each lease classified as a finance lease (Type A lease), a lessee shall do all of the following:

      1) Recognize a right-of-use asset and a lease liability at the *carrying amount* of the leased asset and the capital lease obligation at the application date, depending on which transition method is used.

      2) Include any previous unamortized initial direct costs that meet the definition of initial direct costs in the measurement of the right-of-use asset.

Note

If a lessee does not elect the three practical expedients, write off any unamortized initial direct costs that do not meet the definition of initial direct costs and that are not included in the measurement of the capital lease asset, as an adjustment to equity, unless the entity elects Method 1 and the costs were incurred after the beginning of the earliest period presented. In such a case, those costs shall be written off as an adjustment to earnings in the period the costs were incurred.

      3) Regardless of whether Method 1 or 2 transition method is used, apply the subsequent measurement guidance for finance (Type A) leases after the effective date. However, a lessee shall not *remeasure the lease payments* for amounts probable of being owed under *residual value guarantees*.

      4) Classify the assets and liabilities of finance leases for the purposes of presentation and disclosure.

2. For a previous capital lease that is classified as an operating (Type B) lease under the new standard because an *entity does not elect the three practical expedients*, a lessee shall do the following:

   a) Derecognize the carrying amount of any capital lease asset and capital lease obligation at the application date.

      - Any difference between the carrying amount of the capital lease asset and the capital lease obligation shall be accounted for in the same manner as prepaid or accrued rent.