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Grant Thornton

# New Developments Summary

## Leases in transition

**New leasing standard provides detailed transition guidance**

### Summary

For most entities, one of the more complex aspects of implementing the FASB's new lease accounting guidance, codified in ASC 842, *Leases*, will be calculating, recording, and disclosing the adjustments necessary to transition from the legacy lease accounting guidance codified in ASC 840.

With a focus on prospective accounting, and recognizing that transitioning from ASC 840 to ASC 842 could be labor intensive for many entities, the FASB designed the transition guidance with the goal of easing the transition burden for financial statement preparers. Accordingly, the transition guidance includes a number of practical expedients, such as allowing entities to forgo reassessing certain conclusions reached under legacy GAAP for existing leases. Although ASC 842 originally included only a single modified retrospective method of adopting the new guidance, the Board is in the final stages of issuing an optional transition method to further ease implementation, permitting entities to initially apply ASC 842 as of the effective date rather than at the beginning of the earliest period presented.

Even with this transition relief, we believe that many entities will still find implementing the new leasing guidance a significant undertaking, especially given the major changes in lessees' accounting for operating leases under ASC 842.

This bulletin examines in detail the transition guidance in ASC 842 in an effort to help entities prepare to adopt the new leasing guidance. The views expressed are based on our evaluation of implementation questions raised by practitioners to date. As implementation efforts proceed, our views could evolve, and we expect that new issues and positions will emerge as the effective date of the new leasing guidance draws near.

The ASU codifying the alternative transition method described herein is not yet final. The content in this bulletin is based on the proposed ASU, and is subject to change upon issuance of the final ASU.

### Contents

# A. Effective date

For public business entities (PBEs); not-for-profit entities that are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or over-the-counter market; and employee benefit plans that file or furnish statements with or to the SEC, the new guidance in ASC 842 is effective for financial statements issued for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

For all other entities, ASC 842 is effective for financial statements issued for fiscal years beginning after December 15, 2019 and for interim periods within fiscal years beginning after December 15, 2020.

All entities are permitted to early adopt ASC 842.

### GT insights: Early adoption of ASC 842

All entities are permitted to early adopt ASC 842, but certain entities might especially benefit from early adoption. For instance, early adoption would allow lessors to align their accounting for leases with their accounting for other revenue contracts under ASC 606, *Revenue from Contracts with Customers.* In addition, early adoption would allow lessees with assets on their books from certain failed build-to-suit arrangements (projects where construction is completed prior to the effective date) to accelerate the derecognition of those assets upon transition to ASC 842. See the "Build-to-suit arrangements" section for more information.

### ASC 842-10-65-1 (excerpt)

The following represents the transition and effective date information related to Accounting Standards Update No. 2016-02, *Leases (Topic 842),* and Accounting Standards Update No. 2018-01*, Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

a. 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, and an employee benefit plan that files or furnishes financial statements with or to the U.S. Securities and Exchange Commission shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Earlier application is permitted.

All other entities shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Earlier application is permitted.

### ASC Master Glossary

**Public business entity:** A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It 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.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

## SEC staff announcement on the definition of 'public business entity'

The SEC staff issued an announcement allowing an entity that meets the definition of a PBE solely because it is required to include its financial statements or financial information in another entity's SEC filing to use the non-PBE effective date (fiscal years beginning after December 15, 2019) to adopt ASC 842. These entities may still elect to adopt ASC 842 at an earlier date.

The SEC staff announcement does not apply to entities that are PBEs as described in ASC 842 for any other reason.

### ASC 842-10-S65-1

The following is the text of SEC Staff Announcement: Transition Related to Accounting Standards Updates No. 2014-09 and 2016-02.

FASB Accounting Standards Updates No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, issued in May 2014 and codified in ASC Topic 606, Revenue from Contracts with Customers, and No. 2016-02, *Leases (Topic 842)*, issued in February 2016 and codified in ASC Topic 842, Leases, provide effective dates that differ for (1) public business entities and certain other specified entities and (2) all other entities. The SEC staff has received inquiries from stakeholders regarding the application of the effective dates of ASC Topic 606 and ASC Topic 842 for a public business entity[1] that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC.

The transition provisions in ASC Topic 606 require that a public business entity and certain other specified entities adopt ASC Topic 606 for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period.[2] All other entities are required to adopt ASC Topic 606 for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.

The transition provisions in ASC Topic 842 require that a public business entity and certain other specified entities adopt ASC Topic 842 for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.[3] All other entities are required to adopt ASC Topic 842 for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

In response to the stakeholder inquiries outlined above, the SEC staff would not object to a public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC adopting (1) ASC Topic 606 for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019, and (2) ASC Topic 842 for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

A public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC may still elect to adopt ASC Topic 606 and ASC Topic 842 according to the public business entity effective dates outlined above.

This announcement is applicable only to public business entities that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC. This announcement is not applicable to other public business entities.

[1] The definition of *Public Business Entity* in the FASB's ASC Master Glossary states, in part, the following:

A public business entity is a business entity meeting any one of the criteria below . . .

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing) . . .

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

[2] Early adoption of ASC Topic 606 is permitted for public business entities and certain other specified entities only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

[3] Early adoption of ASC Topic 842 is permitted for public business entities and certain other specified entities, as well as for all other entities.

### *Private company parent with a PBE subsidiary*

Some stakeholders have asked how a private company parent should account for a PBE subsidiary in its consolidated financial statements during the period between the PBE effective date and the private company effective date for ASC 842. For example, assume that a private company parent plans to adopt ASC 842 on January 1, 2020, and its PBE subsidiary plans to adopt ASC 842 on January 1, 2019. Would the earlier adoption by the PBE subsidiary require the private company parent to accelerate its adoption to January 1, 2019 in the consolidated financial statements?

In Paragraph 34 of the Basis for Conclusions (BC 34) of ASU 2013-12, *Definition of a Public Business Entity*, the FASB explained that a private company that controls and consolidates a U.S. public company should not be considered a PBE. Therefore, a private company parent would not be required to follow the PBE effective dates simply because it consolidates a PBE subsidiary.

**GT insights: Effective date for a private company parent with a PBE subsidiary**

During deliberations leading to the issuance of ASU 2013-12, the Board did not address whether a private company parent would need to "unwind" the effects of a standard adopted by a PBE subsidiary before the parent's adoption date. We believe that in the previous example, it would be acceptable for the parent to include the PBE subsidiary's financial statement amounts in the private company's consolidated financial statements either by using the subsidiary's figures reported in accordance with ASC 842 or by "unwinding" the subsidiary's ASC 842 adoption and including its financial statement amounts measured in accordance with legacy GAAP.

## B. Transition methods

As of the date of this publication, there is one method an entity may use to transition from legacy GAAP to ASC 842. Under this method, an entity applies the transition guidance in ASC 842 as of the beginning of the earliest period presented in the financial statements in which it adopts ASC 842. Under this method, which we will refer to as the "modified retrospective method," a cumulative-effect adjustment is recorded to retained earnings as of the beginning of the earliest period presented.

However, the FASB is nearing issuance of an ASU that will codify an alternative transition method, which is described in the proposed ASU, *Leases (Topic 842): Targeted Improvements,* issued in January 2018. Under this alternative method, which we will refer to as the "proposed current-period adjustment method," an entity would apply ASC 842 as of the beginning of the period in which it adopts ASC 842. Under this proposed method, a cumulative-effect adjustment is recorded to retained earnings as of the beginning of the period in which ASC 842 is adopted.

Throughout this publication, Codification excerpts affected by the proposed addition of the current-period adjustment method are labeled as "proposed," with pending deletions struck-through and additions underlined.

**Proposed[1] FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

[1] The transition guidance presented throughout this publication is based on Proposed Accounting Standards Update (ASU), *Leases (Topic 842): Targeted Improvements*, issued January 5, 2018. As of the date of this publication, we do not expect the final ASU to differ substantially from the proposed ASU with respect to the alternative transition method; however, please note that the guidance described herein as "proposed" is subject to change upon issuance of a final ASU.

c. In the financial statements in which an entity first applies the pending content that links to this paragraph, the entity shall recognize and measure leases within the scope of the pending content that links to this paragraph that exist at the application date, as determined by the transition method that the entity elects ~~beginning of the earliest comparative period presented, using the approach described in (i) through (ee)~~. An entity shall apply the pending content that links to this paragraph using one of the following two methods:

  1. Retrospectively to each prior reporting period presented in the financial statements with the cumulative effect of initially applying the pending content that links to this paragraph recognized at the beginning of the earliest comparative period presented, subject to the guidance in (d) through (gg). Under this transition method, the application date shall be the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease.

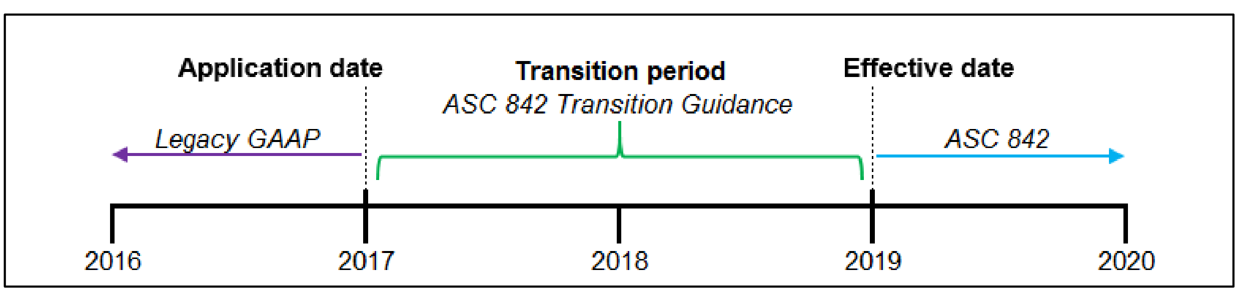
  2. Retrospectively at the beginning of the period of adoption through a cumulative-effect adjustment, subject to the guidance in (d) through (gg). Under this transition method, the application date shall be the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.

d. An entity shall adjust equity and, if the entity elects the transition method in (c)(1) ~~at the beginning of the earliest comparative period presented, and~~ the other comparative amounts disclosed for each prior period presented in the financial statements, as if the pending content that links to this paragraph had always been applied, subject to the requirements in ~~(h)~~ (e) through (gg) ~~(ee)~~.

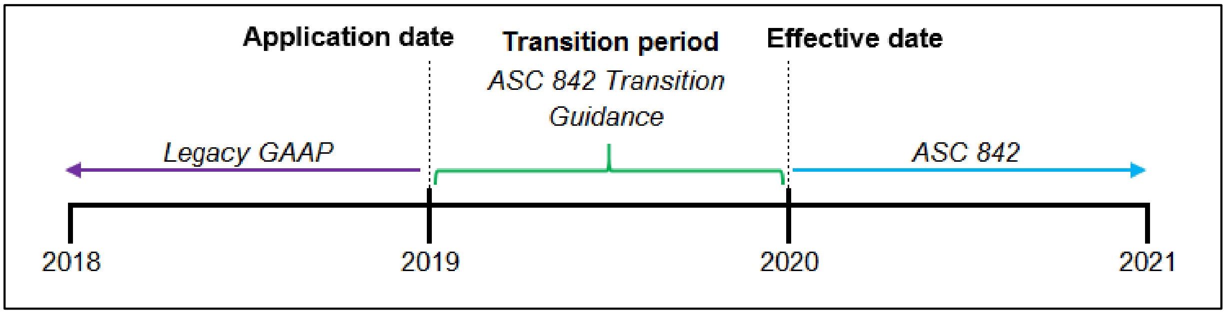
## Modified retrospective method

The application date for an entity applying the modified retrospective method is the later of (a) the beginning of the earliest period presented in the comparative financial statements that include the period in which ASC 842 is first effective, and (b) the commencement date of the lease. Under the modified retrospective method, an entity applies the transition measurement requirements discussed in Sections F and G to all leases existing at, or commencing after, the beginning of the earliest period presented in the financial statements, and records any necessary adjustment to equity at the beginning of the earliest period presented. The transition period is the time between the beginning of the earliest period presented and the effective date of the new leasing guidance, which will be a two-year period for PBEs and a one-year period for most other entities. Leases commencing during the transition period (that is, after the application date and before the effective date of ASC 842) are remeasured under the transition guidance discussed in Sections F and G.

The timeline below illustrates the applicaton date, transition period, and effective date under the modified retrospective method for a calendar-year PBE that has not early adopted ASC 842.



This timeline illustrates the application date, transition period, and effective date under the modified retrospective method for a typical calendar-year non-PBE that has not early adopted ASC 842.




### *Effective date falls between lease inception and commencement dates*

Under ASC 842, leases are classified and measured at the lease's commencement date, whereas under legacy GAAP, leases are classified and measured at the lease's inception date. The *inception date* is the date on which a lease is legally entered into, and the *commencement date* is the date on which the right to use the leased asset is transferred to the lessee.

In transition, an entity might have a lease with an inception date before, and a commencement date after, the effective date of ASC 842. Some stakeholders have questioned whether an entity should account for such leases similarly to leases that commenced before the effective date, or similarly to leases with an inception and commencement date occurring after the effective date.

**Example: Effective date falls between lease inception and commencement dates**

**Scenario 1**

Lessee is a PBE for which ASC 842 is effective January 1, 2019, and Lessee uses the modified retrospective method to transition to the new guidance. Lessee enters into a lease on June 1, 2018 that commences on January 5, 2019. There are no modifications or other events between the inception date and the commencement date that would cause the lease to be remeasured.

Although the inception date of the lease precedes the effective date of ASC 842, the transition guidance applies only to leases that commence before the effective date, regardless of whether an inception date has occurred. Because the lease in this example had not yet commenced as of the effective date of ASC 842, it will be classified, measured, and recorded on its commencement date under ASC 842.

**Scenario 2**

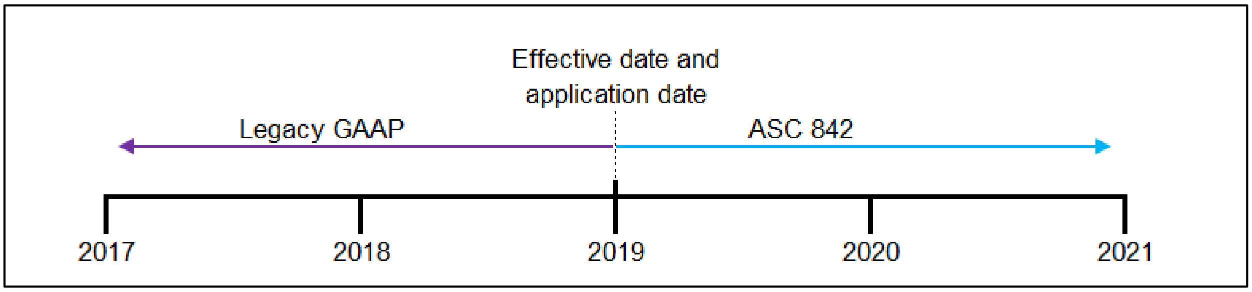
Lessee has a lease with an initial 10-year term that commenced on January 1, 2016 and is classified as a capital lease under legacy GAAP. On July 1, 2018, Lessee negotiates with the lessor to extend the lease term by three years, so that the lease will terminate on December 31, 2028. In accordance with the guidance in ASC 840, Lessee continues to account for its original capital lease and will separately account for the extension as an operating lease when it commences in 2026.

On the effective date, Lessee elects the package of practical expedients offered under ASC 842 that allows it to forgo reassessing the classification for leases that have already commenced. As a result, Lessee classifies the lease terminating on December 31, 2025 as a finance lease. Lessee effectively "runs off" this lease based on the legacy capital lease guidance. However, Lessee cannot make this election for the new forward-starting three-year lease, which commences on January 1, 2026 and terminates on December 31, 2028, because the lease had not commenced as of the effective date of ASC 842. Therefore, Lessee will apply the guidance in ASC 842 to the forward-starting lease when it commences in 2026.

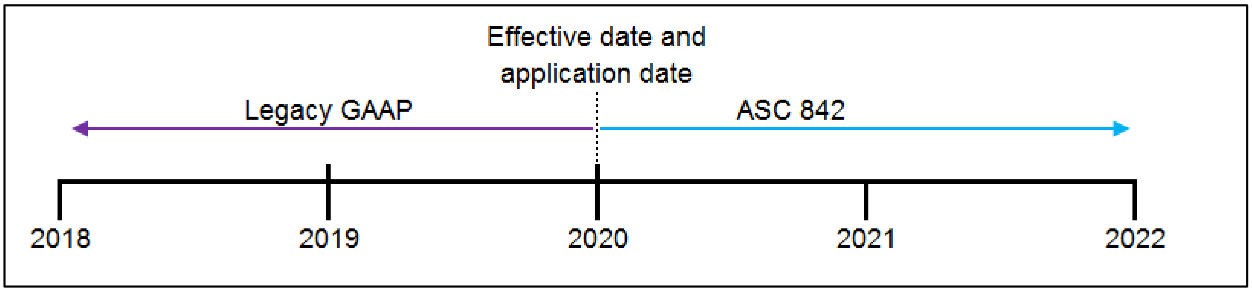
## Proposed current-period adjustment method

The application date for an entity applying the proposed current-period adjustment method is the same as the effective date of ASC 842. Therefore, there is no transition period between the application date and the effective date under the proposed current-period adjustment method, unlike the modified retrospective method. Any adjustment necessary under the transition requirements described in Sections F and G is recorded at the application date. Prior comparative periods are presented under legacy GAAP, including disclosures in the notes to the financial statements.

The timeline below illustrates the application date and effective date under the proposed current-period adjustment method for a calendar-year PBE that has not early adopted ASC 842.




The timeline below illustrates the application date and effective date under the proposed current-period adjustment method for a typical calendar-year non-PBE that has not early adopted ASC 842.




## Transition for short-term leases

A lessee may make an accounting policy election to forgo applying the guidance in ASC 842 to short-term leases. A short-term lease has a term of 12 or fewer months at commencement and does not have a purchase option that the lessee is reasonably certain to exercise. If a lessee makes this accounting policy election, no transition adjustment is required for short-term leases because short-term leases under ASC 842 are accounted for in the same manner as under legacy GAAP.

**ASC 842-10-65-1 (excerpt)**

e. If a lessee elects not to apply the recognition and measurement requirements in the pending content that links to this paragraph to short-term leases, the lessee shall not apply the approach described in (k) through (t) to short-term leases.

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## C. Practical expedients

The Board made the following practical expedients available to all entities to aid their transition from legacy GAAP to ASC 842:

- A package of expedients that must be elected together allowing an entity to forgo reassessing (1) whether a contract contains a lease, (2) classification of leases, and (3) whether capitalized costs associated with a lease meet the definition of "initial direct costs" in ASC 842
- An expedient allowing an entity to use hindsight to determine the lease term and impairment of right-of-use assets
- An expedient allowing an entity to continue applying legacy GAAP to land easements not previously accounted for under the legacy leasing guidance in ASC 840

An entity may elect any one, none, or all three of these expedients.

### Package of practical expedients

A lessee or lessor may elect a package of transition expedients that allows an entity to forgo reassessing certain conclusions reached under legacy GAAP. All expedients in this package must be applied together for all leases that commence before the effective date of ASC 842. In transitioning to ASC 842, an entity electing this package of practical expedients would not need to assess

- Whether any expired or existing contracts are leases or contain leases under ASC 842
- Classification of any expired or existing leases under ASC 842
- Whether unamortized initial direct costs for existing leases meet the definition of initial direct costs under ASC 842

This package of expedients effectively allows an entity to "run off" existing leases, meaning an entity can continue to account for existing leases based on judgments made under legacy GAAP. As the Board notes in BC 393(a) of ASU 2016-02, *Leases (Topic 842)*, the expedients are not intended to grandfather incorrect assessments made under legacy GAAP. Therefore, if an entity identifies an error made under legacy GAAP, it should be corrected in accordance with ASC 250, *Accounting Changes and Error Corrections*.

**ASC 842-10-65-1 (excerpt)**

f. An entity may elect the following practical expedients, which 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 the pending content that links to this paragraph to leases that commenced before the effective date:

1. An entity need not reassess whether any expired or existing contracts are or contain leases.
2. An entity need not reassess the lease classification for any expired or existing leases (that is, all existing leases that were classified as operating leases in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as finance leases).
3. An entity need not reassess initial direct costs for any existing leases.

### *Reassessing lease classification*

If an entity does not elect the package of practical expedients that would allow it to forgo reassessing lease classification, a question arises about which date should be used to reassess lease classification when transitioning to ASC 842.

**GT insights: Reassessing lease classification**

We believe an entity that does not elect the package of practical expedients should reassess lease classification under ASC 842 as of either the most recent date that it was required to reassess lease classification under legacy GAAP or the lease commencement date if the entity was never required to reassess classification under legacy guidance.

**Example: Reassessing lease classification**

Lessee, a PBE, signed a lease on November 15, 2015, which commenced on January 1, 2016. Lessee modified the lease on November 30, 2016. ASC 842 is effective for Lessee on January 1, 2019, and Lessee applies the modified retrospective method for transition. As Lessee presents two prior comparative periods in its financial statements, its application date for ASC 842 is January 1, 2017.

Lessee does not elect the package of practical expedients, and therefore must reassess the classification of its lease when transitioning to ASC 842. Since Lessee was required under legacy GAAP to reassess lease classification as of November 30, 2016, the most recent modification date, Lessee must assess the lease's classification under ASC 842 as of November 30, 2016.

## Hindsight practical expedient

ASC 842 offers another practical expedient that allows an entity to use hindsight in determining the lease term and assessing impairment of right-of-use assets when transitioning to ASC 842. An entity electing this expedient may use its actual knowledge or current expectation as of the effective date, instead of its knowledge and expectations as of the latest date when it assessed lease classification under legacy GAAP, in assessing the likelihood that a lessee will exercise its option to extend or terminate a lease or to purchase the underlying asset. An entity electing this expedient may also use its most up-to-date information as of the effective date to evaluate impairment of its right-of-use assets in the transition period.

**ASC 842-10-65-1 (excerpt)**

g. 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 (that is, when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of the entity's right-of-use assets. This practical expedient may be elected separately or in conjunction with either one or both of the practical expedients in (f) and (gg).

**GT insights: Use caution when considering the hindsight practical expedient**

When an entity applies the hindsight practical expedient to assess the term of a lease, it must undertake a "fresh" assessment of the facts and circumstances as of the effective date of ASC 842. The entity not only uses hindsight to incorporate actual decisions to extend or terminate a lease that were made during the transition period into the measurement of the lease term on the application date of ASC 842, but it must also reassess the lease term of each lease based on the guidance for establishing the lease term of a new lease under ASC 842.

Therefore, for all leases, an entity that elects the hindsight practical expedient must consider contract-based, asset-based, market-based, and entity-based factors as of the effective date to assess the lease term as of the application date. We believe this could be a significant undertaking for entities with large lease portfolios, which could be avoided by choosing not to elect the hindsight practical expedient.

For entities that choose to elect the hindsight practical expedient, there are a couple of limitations to keep in mind.

First, hindsight is applied only up to the effective date of ASC 842. For example, a change in circumstances that occurs after the effective date, such as a change in market rental rates that causes an entity to determine that a renewal option is reasonably certain to be exercised, would not be reflected in the entity's assessment of the lease term, despite the election of the hindsight practical expedient.

Second, an entity would not apply the hindsight practical expedient to retrospectively reflect the terms of a contract modification in its initial accounting for a lease under the ASC 842 transition provisions. Only options that were part of the contract as of the application date of ASC 842 should be assessed under this expedient.

### *Hindsight practical expedient and impairment of the right-of-use asset*

In response to technical inquiries, the Board has stated that entities should not reallocate impairment losses among assets in an asset group in transition periods. Therefore, it is unclear how the use of hindsight would allow an entity to recognize impairment of a right-of-use asset during the transition period.

For example, if an entity using the modified retrospective method to apply ASC 842 as of January 1, 2017 determined that an asset group was impaired as of June 30, 2017, the entity could not, based on the Board's comments, use hindsight to recognize the effect of the June 30, 2017 impairment on the right-of-use asset that becomes part of the impaired asset group upon the initial application of ASC 842, since that would require a reallocation of the impairment loss among the assets in that asset group.

**GT insights: Hindsight practical expedient and impairment of the right-of-use asset**

While the hindsight practical expedient allows entities to use hindsight in determining both the lease term and right-of-use asset impairment, we believe the expedient effectively applies only to evaluations of the lease term.

Accordingly, with respect to the above example, we believe that any impairment of the right-of-use asset during the transition period would be recognized at the effective date.

## Land easement practical expedient

The FASB provided an additional transition-related practical expedient under which entities with existing or expired land easements not previously accounted for under legacy leasing GAAP may forgo assessing whether those contracts contain leases under ASC 842. This practical expedient allows entities that did not account for land easements as leases under legacy GAAP to carry forward that treatment for existing or expired land easements as of the effective date of ASC 842.

A land easement is a contract that provides a right to use, access, or cross another entity's land for a specified purpose, and is often used for railroad tracks or pipelines crossing over land not owned by the railroad or pipeline company. There was diversity in practice under legacy GAAP, whereby some entities accounted for land easements as leases, and others accounted for them as intangible assets based on an interpretation of Example 10 in ASC 350-30-55, *Intangibles – Goodwill and Other*, which describes perpetual easements as intangible assets.

Any land easements entered into or modified after the effective date of ASC 842 must be assessed under ASC 842 to determine whether they contain a lease.

**ASC 842-10-65-1 (excerpt)**

gg. An entity also may elect a practical expedient to not assess whether existing or expired land easements that were not previously accounted for under Topic 840 on leases are or contain a lease under this Topic. For purposes of (gg), a land easement (also commonly referred to as a right of way) refers to a right to use, access, or cross another entity's land for a specified purpose. This practical expedient shall be applied consistently by an entity to all its existing and expired land easements that were not previously accounted for under Topic 840. This practical expedient may be elected separately or in conjunction with either one or both of the practical expedients in (f) and (g). An entity that elects this practical expedient for existing or expired land easements shall apply the pending content that links to this paragraph to land easements entered into (or modified) on or after the date that the entity first applies the pending content that links to this paragraph as described in (a) and (b). An entity that previously accounted for existing or expired land easements under Topic 840 shall not be eligible for this practical expedient for those land easements.

### Combining lease and nonlease components in transition

Under ASC 842, lessees and lessors must separately account for lease components and nonlease components within a contract. However, the guidance includes a practical expedient that lessees may elect, and the Board has proposed a practical expedient that lessors may elect for qualifying contracts, allowing them to combine lease and associated nonlease components. ASC 842's transition guidance does not specifically address whether entities can apply the practical expedient to combine lease and nonlease components during the transition period.

**GT insights: Combining lease and nonlease components in transition**

Lessees (and, as proposed, lessors) may make an accounting policy election to combine lease components and associated nonlease components by class of underlying asset.

We believe that an entity may apply the practical expedient to combine lease and nonlease components during the transition period, even though the transition guidance does not specifically address the issue. We also believe that an entity that elects to combine lease components and nonlease components in transition is not required to continue this practice after the ASC 842 effective date, and vice versa.

## D. Amounts previously recognized in business combinations

An entity may have recognized an asset or liability for a favorable or unfavorable lease under ASC 805, *Business Combinations*. When transitioning to ASC 842, all entities, except for lessors with respect to operating leases, should derecognize assets and liabilities for favorable or unfavorable leases acquired in a business combination.

When derecognizing a favorable or unfavorable lease asset or liability in transition, a lessee should reflect the offsetting debit or credit as an adjustment to the right-of-use asset associated with that lease. A lessor in a sales-type lease or a direct financing lease should reflect the offsetting debit or credit as an adjustment to equity at the beginning of the earliest comparative period presented.

A lessor that previously recognized an asset or liability for a favorable or unfavorable operating lease in a business combination under ASC 840 should continue to recognize that asset or liability after adopting ASC 842.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

h. If an entity has previously recognized an asset or a liability in accordance with Topic 805 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 that are classified as sales-type leases or direct financing leases in accordance with Topic 842 ~~840~~ for which the entity is a lessor. Also see (w).

## E. Disclosures

In the financial statements in which it first applies ASC 842, an entity must provide the disclosures required for a change in accounting principle in accordance with ASC 250, with one exception: An entity is not required to disclose the effect of the change on each financial statement line item and per-share amount presented for the current period or for prior periods that are retrospectively adjusted. For example, an entity adopting ASC 842 on January 1, 2019 would not be required to disclose what the results in 2019 would have been under legacy GAAP, or the incremental impact of applying ASC 842 to the prior comparative periods, if the entity is using the modified retrospective method. An entity using the proposed current-period adjustment method for transition would disclose the cumulative effect of the change in retained earnings as of the beginning of the period of adoption instead of the beginning of the earliest period presented as required by ASC 250-10-50-1(b)(3).

If an entity issues interim financial statements, it must provide the required ASC 250 disclosures in the financial statements of both the interim and annual periods of the change.

**ASC 842-10-65-1 (excerpt)**

i. An entity shall provide the transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraph 250-10-50-1(b)(2).

   Note: See paragraph 250-10-S99-6 on disclosure of the impact that recently issued accounting standards will have on the financial statements of a registrant.

**ASC 250-10-50-1**

An entity shall disclose all of the following in the fiscal period in which a change in accounting principle is made:

a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.

b. The method of applying the change, including all of the following:

   1. A description of the prior-period information that has been retrospectively adjusted, if any.

   2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.

   3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

   4. If retrospective application to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).

c. If indirect effects of a change in accounting principle are recognized both of the following shall be disclosed:

   1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable

   2. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

**ASC 250-10-50-2**

An entity that issues interim financial statements shall provide the required disclosures in the financial statements of both the interim period of the change and the annual period of the change.

**ASC 250-10-50-3**

In the fiscal year in which a new accounting principle is adopted, financial information reported for interim periods after the date of adoption shall disclose the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and related per-share amounts, if applicable, for those post-change interim periods.

## Disclosures under the proposed current-period adjustment transition method

An entity electing the proposed current-period adjustment method would apply the full guidance in ASC 842 beginning on the application date (that is, January 1, 2019 for a calendar-year PBE). Comparative periods presented in the financial statements for the period of adoption would be prepared and presented under legacy GAAP, including all required disclosures. This includes the future minimum rental payments for operating leases required under ASC 840-20-50-2.

## Disclosure of election of practical expedients

An entity that uses any of the practical expedients is required to disclose its election of those expedients in the notes to the financial statements.

**ASC 842-10-65-1 (excerpt)**

j. If an entity uses one or more of the practical expedients in (f), (g), and (gg), it shall disclose that fact.

## SEC reporting and transition

SEC Staff Accounting Bulletin (SAB) Topic 11.M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*, explains that a registrant should evaluate ASUs that have not yet been adopted and disclose information to assist the financial statement user in assessing the impact that the guidance will have on the registrant's financial statements once adopted.

At the September 2016 EITF meeting, the SEC observer reminded registrants that when a registrant does not know, or cannot reasonably estimate, the impact of adopting a new standard, it should

- Make a statement indicating this fact
- Consider additional qualitative disclosures to help users assess the impact of the new guidance on the financial statements when adopted, including a description of
  - The effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies
  - The status of its process to implement the new standards
  - The significant implementation matters yet to be addressed

SAB Topic 11.M also provides SEC staff views on disclosures that registrants should consider including in both Management's Discussion & Analysis (MD&A) and the notes to the financial statements. These discussions in MD&A may include cross-references to the disclosures in the notes to the financial statements.

At the 2017 AICPA National Conference on Current and PCAOB Developments, SEC Chief Accountant Wesley R. Bricker reminded financial statement preparers of the importance of robust disclosures about the effect of recently issued accounting standards required by SAB Topic 11.M. He emphasized the need for companies to inform the marketplace about the anticipated effect of new accounting standards so that investors have sufficient time to absorb the information prior to the standard's adoption.

### ASC 250-10-S99-6

The following is the text of SEC Staff Announcement: Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Such Standards Are Adopted in a Future Period (in accordance with Staff Accounting Bulletin [SAB] Topic 11.M).

> This announcement applies to Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*; ASU No. 2016-02, *Leases (Topic 842)*; and ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.[1]
>
> SAB Topic 11.M provides the SEC staff view that a registrant should evaluate ASUs that have not yet been adopted to determine the appropriate financial statement disclosures[2] about the potential material effects of those ASUs on the financial statements when adopted. Consistent with Topic 11.M, if a registrant does not know or cannot reasonably estimate the impact that adoption of the ASUs referenced in this announcement is expected to have on the financial statements, then in addition to making a statement to that effect, that registrant should consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. In this regard, the SEC staff expects the additional qualitative disclosures to include a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies. Also, a registrant should describe the status of its process to implement the new standards and the significant implementation matters yet to be addressed.

[1] This announcement also applies to any subsequent amendments to guidance in the ASUs that are issued prior to a registrant's adoption of the aforementioned ASUs.

[2] Topic 11.M provides SEC staff views on disclosures that registrants should consider in both Management's Discussion & Analysis (MD&A) and the notes to the financial statements. MD&A may contain cross references to these disclosures that appear within the notes to the financial statements.

## F. Lessee transition

The transition guidance for lessees adopting ASC 842 is based on the classification of each lease under legacy GAAP and, if the lessee does not elect the package of practical expedients, the classification of each lease under ASC 842. The table below summarizes the transition accounting for lessees.

| Classification | ASC 842 operating lease | ASC 842 finance lease |
|---|---|---|
| Legacy operating lease | Recognize a lease liability at the present value of<br>• Remaining minimum rental payments | Recognize a lease liability at the present value of<br>• Remaining minimum rental payments |

| Classification | ASC 842 operating lease | ASC 842 finance lease |
|---|---|---|
| | • Amount probable of being owed under residual value guarantee<br>Recognize a right-of-use asset equal to the lease liability adjusted for<br>• Prepaid or accrued lease payments<br>• Remaining balance of lease incentives<br>• Unamortized initial direct costs<br>• ASC 420 liability<br>• Asset or liability for a favorable or unfavorable lease recognized under ASC 805 | • Amount probable of being owed under residual value guarantee<br>Recognize a right-of-use asset at the proportionate amount, based on lease term, of the liability at commencement, adjusted for<br>• Prepaid or accrued lease payments<br>• ASC 420 liability<br>• Asset or liability for a favorable or unfavorable lease recognized under ASC 805 |
| Legacy capital lease | Derecognize capital lease asset and liability<br>Recognize right-of-use asset and lease liability based on ASC 842 initial or subsequent measurement guidance, depending on whether the lease commenced before or after the application date | Bring forward the previous capital lease asset and capital lease liability carrying amounts as the right-of-use asset and lease liability, respectively |

## Leases classified as operating leases under legacy GAAP

Under legacy GAAP, lessees do not recognize right-of-use assets and lease liabilities for operating leases, but will be required to do so during the transition period to ASC 842 (if using the modified retrospective transition method) and thereafter. When transitioning its operating lease accounting to ASC 842, a lessee recognizes a lease liability measured at the present value of the remaining minimum rental payments, as described under legacy GAAP, plus any amount probable of being owed under a residual value guarantee, as of the later of the application date or the commencement date of the lease. The right-of-use asset is measured based on this liability, and is calculated differently depending on the classification of the lease under ASC 842.

### *Lease liability measurement*

On the application date of ASC 842, the lease liability is measured at the present value of (1) the remaining minimum rental payments, as described under legacy GAAP, and (2) any amount probable of being owed by the lessee under a residual guarantee. The discount rate used in the present value calculation should be established as of the same date that the lease liability is measured—that is, the later of the application date or the commencement date of the lease. As a reminder, for an entity using the modified retrospective transition method, the application date is the beginning of the earliest period presented, and for an entity using the proposed current-period adjustment method, the application date and the effective date would be the same.

On or after the effective date of ASC 842, if a lease is modified and the modification is not accounted for as a separate contract, or if the lease must otherwise be remeasured, the modification or remeasurement should be accounted for under ASC 842.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

k. A lessee ~~should~~ shall initially recognize a right-of-use asset and a lease liability at the application date as determined in (c) ~~later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease~~.

l. Unless, on or after the effective date, the lease is modified (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8) or the lease liability is required to be remeasured in accordance with paragraph 842-20-35-4, a lessee shall measure the lease liability at the present value of the sum of the following, using a discount rate for the lease (which, for entities that are not public business entities, can be a risk-free rate determined in accordance with paragraph 842-20-30-3) established at the application date as determined in (c) ~~later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease~~:

1. The remaining minimum rental payments (as defined under Topic 840).
2. Any amounts probable of being owed by the lessee under a residual value guarantee

### *Variable payments based on an index or a rate in transition*

Under ASC 842, variable payments based on an index or a rate are included in lease payments based on the index or rate in effect at the commencement date of the lease. At the application date of ASC 842, if a legacy operating lease continues to be classified as an operating lease under ASC 842, the lessee should use the index or rate in effect at the commencement of the lease to measure its lease liability. This index or rate would be the same as the index or rate that was used under legacy GAAP to calculate the minimum rental payments for disclosure purposes.

**Example: Variable payments based on an index or a rate in transition**

If a lease with variable payments based on an index or a rate commenced on January 1, 2016, and if the lessee uses the modified retrospective method to apply ASC 842 as of January 1, 2017, the index or rate in place at January 1, 2016 would be used to compute the remaining minimum rental payments as of January 1, 2017 when the lease liability is initially recognized.

### *Determining the incremental borrowing rate in transition*

When measuring the lease liability in transition, a lessee should use its incremental borrowing rate to discount the lease payments, unless it can readily determine the rate implicit in the lease. The incremental borrowing rate used should be a collateralized rate for a term similar to the lease term. The transition guidance does not provide guidance on whether a lessee should determine its incremental borrowing rate based either on the initial term of the lease at lease commencement or on the remaining lease term as of the date ASC 842 is initially applied.

**GT insights: Determining the incremental borrowing rate in transition**

Based on a discussion with the FASB staff, we believe a lessee could apply either method for estimating its incremental borrowing rate when transitioning to ASC 842. For example, assume that Lessee enters into a 10-year lease that commences on January 1, 2016. Lessee applies the proposed current-period transition approach, and its ASC 842 application date is January 1, 2019. Lessee could estimate its incremental borrowing rate for purposes of measuring this lease liability by referencing the rate at which it could borrow an amount equal to the sum of the remaining lease payments for either 7 years, the remaining lease term at the application date, or 10 years, the lease term at commencement, on the application date. Whatever policy Lessee elects should be consistently applied to all of its leases in transition.

### *Right-of-use asset measurement for leases classified as operating leases under ASC 842*

To measure the right-of-use asset for a lease classified as an operating lease under legacy GAAP that is still classified as an operating lease under ASC 842, the lessee adjusts the amount assigned to the lease liability for the following items:

- The items in paragraph 842-20-35-3(b), which consist of the following:
  - Prepaid or accrued lease payments
  - The remaining balance of any lease incentives received, calculated as the gross lease incentives received net of amounts recognized previously as part of the single lease cost under legacy GAAP
  - Unamortized initial direct costs
  - Impairment of the right-of-use asset
- The carrying amount of any liability recognized under legacy GAAP in accordance with ASC 420, *Exit or Disposal Cost Obligations*

If the initial measurement of the right-of-use asset is adjusted for the carrying amount of a liability recognized under ASC 420, the lessee should apply the recognition and subsequent measurement guidance in ASC 842-20-25 and 35, respectively, for impaired right-of-use assets.

### ASC 842-10-65-1 (excerpt)

m. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall initially measure the right-of-use asset at the initial measurement of the lease liability adjusted for both of the following:

   1. The items in paragraph 842-20-35-3(b), as applicable.
   2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease.

n. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall subsequently measure the right-of-use asset throughout the remaining lease term in accordance with paragraph 842-20-35-3(b). If the initial measurement of the right-of-use asset in (m) is adjusted for the carrying amount of a liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease, the lessee shall apply the recognition and subsequent measurement guidance in Sections 842-20-25 and 842-20-35, respectively, when the right-of-use asset has been impaired.

## Operating lease impairment model

The impairment model in ASC 360, *Property, Plant, and Equipment,* applies to right-of-use assets under ASC 842. In response to inquiries about the impairment of right-of-use assets during the transition period, the Board clarified that a lessee should not reallocate an impairment loss recognized during the transition period among an asset group that contains a right-of-use asset under an operating lease.

### GT insights: Operating lease impairment model

We believe that the impairment model in ASC 360 would effectively apply to operating lease right-of-use assets only after the effective date of ASC 842. However, we believe that these right-of-use assets should be assessed for impairment during the transition period based on ASC 420, similar to how operating leases are assessed for impairment based on the occurrence of a cease-use date under legacy GAAP.

The following example illustrates the application of the transition guidance for a legacy operating lease that is classified as an operating lease under ASC 842.

### Example: Lessee transition – operating lease to operating lease

Lessee enters into a five-year lease of equipment that commences on January 1, 2016. The lease payments start at $100,000 in year one, payable annually in arrears, and increase by $50,000 each year of the lease. Lessee records initial direct costs of $25,000 in connection with entering into the lease. The lease is classified as an operating lease at lease inception under legacy GAAP.

Lessee, a PBE, adopts ASC 842 on January 1, 2019 and presents two comparative periods in its financial statements for the year ended December 31, 2019. Therefore, the beginning of the earliest period presented is January 1, 2017. Lessee adopts ASC 842 using the modified retrospective method. Since the later of the commencement date of the lease and the application date of ASC 842 is January 1, 2017, this date will be used as the measurement date for the right-of-use asset and lease liability. Lessee also elects to apply the package of practical expedients, which allows the entity to forgo reassessing both classification of the lease and whether previously deferred initial direct costs continue to qualify for deferral. The discount rate associated with the lease on January 1, 2017 is 5 percent.

Lessee measures the lease liability at the present value of the remaining minimum rental payments at January 1, 2017 (as calculated under legacy GAAP), which is $787,033.[1] Lessee then calculates the right-of-use asset starting with the value of the lease liability, subtracting accrued rent as of January 1, 2017 ($100,000) and adding the unamortized initial direct costs as of January 1, 2017 ($20,000), to arrive at a right-of-use asset carrying amount of $707,033. Lessee records the following journal entry as of January 1, 2017 to recognize the right-of-use asset and lease liability, and to derecognize the accrued rent and deferred initial direct costs that were recorded under legacy GAAP:

DR: Right-of-use asset $707,033

DR: Accrued rent $100,000

CR: Lease liability $787,033

CR: Deferred initial direct costs $ 20,000

If Lessee had chosen the proposed current-period adjustment method for transition, the right-of-use asset and lease liability would be measured as of January 1, 2019. The discount rate associated with the lease on January 1, 2019 is 5 percent. As of that date, Lessee measures the lease liability at the present value of the remaining minimum rental payments, as calculated under legacy GAAP, which is $510,204.[2] Lessee then calculates the right-of-use asset starting with the value of the lease liability, subtracting accrued rent as of January 1, 2019 ($150,000) and adding the unamortized initial direct costs as of January 1, 2019 ($10,000), to arrive at a right-of-use asset carrying amount of $370,204. Lessee records the following journal entry as of January 1, 2019 to recognize the right-of-use asset and lease liability, and to derecognize the accrued rent and deferred initial direct costs that were recorded under legacy GAAP:

DR: Right-of-use asset $370,204

DR: Accrued rent $150,000

CR: Lease liability $510,204

CR: Deferred initial direct costs $ 10,000

[1] Calculated as the present value of the remaining minimum rental payments at January 1, 2017 using a discount rate of 5 percent:

| Year | Payment | Present value at 5% |
|---|---|---|
| 2 | $150,000 | $142,857 |

| | | |
|---|---|---|
| 3 | $200,000 | $181,406 |
| 4 | $250,000 | $215,959 |
| 5 | $300,000 | $246,811 |
| Total | | $787,033 |

[2] Calculated as the present value of the remaining minimum rental payments at January 1, 2019 using a discount rate of 5 percent:

| Year | Payments | Present value at 5% |
|---|---|---|
| 4 | $250,000 | $238,095 |
| 5 | $300,000 | $272,109 |
| Total | | $510,204 |

The following example from the Codification illustrates the application of the transition guidance for a legacy operating lease that is classified as an operating lease under ASC 842.

### Example 29—Lessee Transition—Existing Operating Lease

**ASC 842-10-55-249**

The effective date of the guidance in this Topic for Lessee is January 1, 20X4. Lessee enters into a five-year lease of an asset on January 1, 20X1, with annual lease payments payable at the end of each year. Lessee accounts for the lease as an operating lease. At lease commencement, Lessee defers initial direct costs of $500, which will be amortized over the lease term. On January 1, 20X2 (and before transition adjustments), Lessee has an accrued rent liability of $1,200 for the lease, reflecting rent that was previously recognized as an expense but was not yet paid as of that date. Four lease payments (1 payment of $31,000 followed by 3 payments of $33,000) and unamortized initial direct costs of $400 remain.

**ASC 842-10-55-250**

January 1, 20X2 is the beginning of the earliest comparative period presented in the financial statements in which Lessee first applies the guidance in this Topic. On January 1, 20X2, Lessee's incremental borrowing rate is 6 percent. Lessee has elected the package of practical expedients in paragraph 842-10-65-1(f). As such, Lessee accounts for the lease as an operating lease, without reassessing whether the contract contains a lease or whether classification of the lease would be different in accordance with this Topic. Lessee also does not reassess whether the unamortized initial direct costs on January 1, 20X2, would have met the definition of initial direct costs in this Topic at lease commencement.

**ASC 842-10-55-251**

On January 1, 20X2, Lessee measures the lease liability at $112,462, which is the present value of 1 payment of $31,000 and 3 payments of $33,000 discounted using the rate of 6 percent. The right-of-use asset is equal to the lease liability before adjustment for accrued rent and unamortized initial direct costs, which were not reassessed because Lessee elected the practical expedients in paragraph 842-10-65-1(f).

**ASC 842-10-55-252**

On January 1, 20X2, Lessee recognizes a lease liability of $112,462 and a right-of-use asset of $111,662 ($112,462 – $1,200 + $400).

**ASC 842-10-55-253**

From the transition date (January 1, 20X2) on, Lessee will continue to measure and recognize the lease liability at the present value of the sum of the remaining minimum rental payments (as that term was applied under Topic 840) and the right-of-use asset in accordance with this Topic.

**ASC 842-10-55-254**

Beginning on the effective date of January 1, 20X4, Lessee applies the subsequent measurement guidance in Section 842-20-35, including the reassessment requirements.

### *Foreign-currency-denominated leases in transition*

Lessees transitioning to ASC 842 under the modified retrospective method with leases denominated in foreign currencies must consider the appropriate exchange rate to use in remeasuring the right-of-use asset and lease liability into the lessee's functional currency in the comparative periods presented, as well as the appropriate rates to use in translating lease expense incurred during the comparative periods.

ASC 842-20-55-10 explains that prospectively, for a foreign-currency-denominated lease, the right-of-use asset is remeasured into the lessee's functional currency based on the exchange rate in place at the commencement date of the lease, and the lease liability is remeasured using the current exchange rate at each reporting date.

### GT insights: Foreign-currency-denominated leases in transition

The guidance in ASC 842 does not specifically address the translation of lease cost, but we believe that for both operating and finance leases, a lessee must translate (1) the interest component of lease cost using the average exchange rate during the period, and (2) the amortization component of lease cost using the historical exchange rate used to translate the right-of-use asset. This methodology is necessary even for operating leases for which a single lease cost is presented, so that the right-of-use asset is amortized to zero by the end of the lease term.

There are no specific transition requirements in ASC 842 related to foreign-currency-denominated leases. Therefore, we believe a lessee should follow the general transition guidance in ASC 842-10-65-1(d). This guidance requires that after the application date, entities should reflect leasing activities in the financial statements as if they had always been accounted for under ASC 842. Therefore, the income statement(s) during the transition period should reflect the impact of the changes in foreign exchange rates on the measurement of the entity's right-of-use assets and lease liabilities.

A lessee recognizing a foreign-currency-denominated lease should translate the right-of-use asset using the exchange rate on either the initial application date of ASC 842 or the commencement date of the lease, whichever is later. This treatment is consistent with ASC 830-20-30-1, *Foreign Currency Matters: Foreign Currency Transactions*, which states that

> At the date a foreign currency transaction is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction shall be measured initially in the functional currency of the recording entity by use of the exchange rate in effect at that date.

Since the date when the right-of-use asset is first recognized is the later of the application date of ASC 842 or the commencement date of the lease, the rate in place at that date should be used to initially and subsequently measure a right-of-use asset in the lessee's functional currency during the transition period.

As a monetary liability, the lease liability must be remeasured at the current exchange rate each period. Therefore, the current exchange rate at the later of the application date of ASC 842 or the commencement date of the lease should be used to initially measure a lease liability in the lessee's functional currency, and that rate should be updated to the then-current exchange rate at each subsequent measurement date.

### Example: Foreign-currency-denominated leases in transition

Lessee, a U.S. based PBE, enters into an operating lease for office space in London that commences on January 1, 2016. The lease is denominated in British pounds (GBP), while the functional currency of Lessee is U.S. dollars (USD). The lease has a six-year term, which includes two years under a renewal option that Lessee deems it is reasonably certain to exercise. The lease requires annual payments of £25,000 at the beginning of each year.

ASC 842 is effective for Lessee on January 1, 2019, and Lessee uses the modified retrospective transition method, so that the application date is January 1, 2017, the beginning of the earliest period presented in Lessee's 2019 financial statements.

At the application date of ASC 842, Lessee measures the lease liability at the present value of the five remaining £25,000 payments using a discount rate of 5 percent, and calculates a lease liability of £113,649, which equals the right-of-use asset.

Lessee applies the guidance in ASC 830 to measure this transaction in its functional currency. Following the guidance in ASC 830-20-30-1, Lessee uses the exchange rate in effect on the date when the transaction is recognized, which is the application date of January 1, 2017. At that date, 1 GBP was equal to 1.23 USD. Therefore, Lessee initially measures the lease liability and the right-of-use asset at $139,788.

At each reporting date thereafter, the right-of-use asset will continue to be remeasured using an exchange rate of 1 GBP to 1.23 USD, while the lease liability will be remeasured using the current exchange rate at the reporting date.

### *Right-of-use asset measurement for leases classified as finance leases under ASC 842*

To measure the right-of-use asset for a lease classified as an operating lease under legacy GAAP that is classified as a finance lease under ASC 842, a lessee must calculate the "applicable proportion" of the lease liability at the commencement date. The "applicable proportion" is measured as the remaining lease term at the application date, divided by the total lease term. The lessee recognizes a right-of-use asset equal to the product of the applicable proportion and the commencement-date lease liability. The right-of-use asset is also adjusted by the carrying amount of any prepaid or accrued lease payments as well as the carrying amount of any liability recognized under ASC 420.

The commencement-date lease liability can be imputed based on the liability measured as of the application date of ASC 842. To impute the commencement-date lease liability, the lessee should divide the total remaining minimum rental payments at the application date by the lease term as of the commencement date. That quotient is the imputed periodic minimum rental payment, which can be present valued as if it were incurred on a straight-line basis over the commencement-date lease term, using the discount rate determined as of the ASC 842 application date. See "Example: Lessee transition –- operating lease to finance lease" below for an illustration of imputing the commencement-date lease liability.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

o. For each lease classified as a finance lease in accordance with paragraph 842-10-25-2, 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 determined in accordance with (l). The applicable proportion is the remaining lease term at the application date as determined in (c) ~~beginning of the earliest comparative period presented~~ relative to the total lease term. 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 Topic 420 for the lease.

The following example illustrates the application of the transition guidance for a legacy operating lease that is classified as a finance lease under ASC 842.

### Example: Lessee transition – operating lease to finance lease

Lessee enters into a five-year lease of equipment, which commences on January 1, 2018. The lease payments start at $50,000 a year, payable in arrears, and escalate by $10,000 each year of the lease. Lessee has provided a guarantee to the lessor that the residual value of the underlying asset will be $15,000 at the end of the lease term. As of the application date of ASC 842, Lessee determines it is probable that it will owe $5,000 under the residual value guarantee at the end of the lease term. The lease is classified as an operating lease at lease inception under legacy GAAP.

Lessee, a PBE, adopts ASC 842 on January 1, 2019 using the proposed current-period adjustment method and presents two comparative periods in its financial statements for the year ended December 31, 2019. Since the later of the commencement date of the lease and the application date of ASC 842 is January 1, 2019, this date will be the measurement date for the right-of-use asset and the lease liability. Lessee does not elect the package of practical expedients that would allow it to forgo reassessing classification of the lease, and therefore must reassess lease classification as of the lease's commencement date. Lessee determines that the lease would be classified as a finance lease under ASC 842. The discount rate associated with the lease on January 1, 2019 is 6 percent.

Lessee measures the lease liability at the present value of the remaining minimum rental payments at January 1, 2019 (as calculated under legacy GAAP) and the amount it is probable to owe under its residual value guarantee, which total $261,323.[1]

Lessee measures the right-of-use asset based on the applicable proportion of the lease liability as measured at the commencement of the lease (rather than at the application date of ASC 842). As the remaining lease term at the application date is four years and the total lease term is five years, the applicable proportion is 80 percent (4 years ÷ 5 years).

Lessee measures the commencement-date lease liability based on imputed lease payments over the full term of the lease. The lease payments are imputed by dividing the total remaining minimum rental payments by the remaining lease term as of the application date, which is January 1, 2019. The imputed annual lease payments are $75,000 per year.[2] These payments, along with the amount the lessee is probable to owe under the residual value guarantee, are discounted to the lease commencement date using the January 1, 2019 discount rate of 6 percent, generating a commencement-date lease liability of $319,664.[2]

Therefore, the right-of-use asset at the application date is $255,731 ($319,664 x 80 percent).

The difference between the right-of-use asset and the lease liability is recorded as a transition adjustment to retained earnings at the application date.

Lessee records the following journal entry to recognize the right-of-use asset and lease liability:

| | |
|---|---|
| DR: Right-of-use asset | $255,731 |
| DR: Retained earnings | $ 5,592 |
| CR: Lease liability | $261,323 |

[1] Calculated as the sum of the present value of the remaining minimum rental payments at January 1, 2019 and the present value of the amount probable of being owed under the residual value guarantee using a discount rate of 6 percent:

| Year | Payment | Residual value guarantee | Total | Present value at 6% |
|---|---|---|---|---|
| 2 | $60,000 | $ – | $60,000 | $ 56,604 |
| 3 | $70,000 | $ – | $70,000 | $ 62,300 |
| 4 | $80,000 | $ – | $80,000 | $ 67,170 |
| 5 | $90,000 | $5,000 | $95,000 | $ 75,249 |
| Total | | | | $261,323 |

[2] Calculated as the sum of the present value of the imputed minimum rental payments ([$60,000 + $70,000 + $80,000 + $90,000] ÷ 4) at January 1, 2018 and the present value of the amount probable of being owed under the residual value guarantee using a discount rate of 6 percent:

| Year | Payment | Residual value guarantee | Total | Present value at 6% |
|---|---|---|---|---|
| 1 | $75,000 | $ – | $75,000 | $ 70,755 |
| 2 | $75,000 | $ – | $75,000 | $ 66,750 |
| 3 | $75,000 | $ – | $75,000 | $ 62,971 |
| 4 | $75,000 | $ – | $75,000 | $ 59,407 |
| 5 | $75,000 | $5,000 | $80,000 | $ 59,781 |
| Total | | | | $319,664 |

### *Initial direct costs*

If a lessee has elected the package of practical expedients under ASC 842, allowing it to forgo the reassessment of unamortized initial direct costs, or if the lessee has not elected the package of practical expedients but has determined that its deferred costs continue to meet the definition of initial direct costs under ASC 842, those costs remain capitalized and will continue to be amortized in line with the requirements in the new guidance. If a lessee does not elect the package of practical expedients and determines that some of its deferred costs do not meet the definition of initial direct costs under ASC 842, those costs must be written off. If the lease commenced before the application date of ASC 842, the costs are written off as an adjustment to equity as of the application date. If the costs relate to a lease that commenced during the transition period, they are written off as an adjustment to earnings in the period in which they were incurred.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

p. If a lessee does not elect the practical expedients described in (f), any ~~Any~~ unamortized initial direct costs ~~at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease~~ that do not meet the definition of initial direct costs in this Topic shall be written off as an adjustment to equity ~~at the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease~~ unless the entity elects the transition method in (c)(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 classified as capital leases under legacy GAAP

When transitioning capital leases to ASC 842, a lessee should derecognize its legacy capital lease assets and capital lease liabilities, and should recognize right-of-use assets and lease liabilities measured based on each lease's classification under ASC 842.

### *Leases classified as finance leases under ASC 842*

A lessee with a lease classified as a capital lease under legacy GAAP that is classified as a finance lease under ASC 842 should account for the lease in transition as follows:

- The lessee recognizes a right-of-use asset and a lease liability at the carrying amount of the capital lease asset and the capital lease liability, respectively, under legacy GAAP at the application date.
- The lessee includes any unamortized initial direct costs that meet the definition of initial direct costs under ASC 842 in the measurement of the right-of-use asset. If the lessee has elected the package of practical expedients, then the lessee includes all unamortized initial direct costs in the measurement of the right-of-use asset.
- If the lessee has not elected the package of practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842 are written off. Refer to the "Initial direct costs" section above for a discussion of accounting for initial direct costs in transition.

- Under the modified retrospective transition method, the lessee applies the subsequent measurement guidance for capital leases under ASC 840-30-35 to remeasure the right-of-use asset and the lease liability before the effective date of ASC 842.
- After the effective date of ASC 842, the lessee applies the subsequent measurement guidance in ASC 842-20-35 to remeasure the right-of-use asset and lease liability. When applying the remeasurement guidance for a lease liability in ASC 842-20-35-4, a lessee does not apply the requirement to remeasure the lease payments due to changes in amounts probable of being owed under residual value guarantees.
- For presentation and disclosure purposes, the assets and liabilities associated with capital leases under legacy GAAP should be classified as right-of-use assets and lease liabilities arising from a finance lease.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

r. For each lease classified as a finance lease in accordance with this Topic, 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 lease asset and the capital lease obligation in accordance with Topic 840 at the application date as determined in (c) ~~later of the beginning of the earliest comparative period presented or the commencement date of the lease~~.
2. Include any unamortized initial direct costs that meet the definition of initial direct costs in this Topic in the measurement of the right-of-use asset established in (r)(1).
3. If a lessee does not elect the practical expedients described in (f), write ~~Write~~ off~~, as an adjustment to equity,~~ any unamortized initial direct costs ~~at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease~~ that do not meet the definition of initial direct costs in this Topic and that are not included in the measurement of the capital lease asset under Topic 840 ~~(unless the lessee elects the practical expedients described in (f))~~ as an adjustment to equity unless the entity elects the transition method in (c)(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.
4. If an entity elects the transition method in (c)(1), subsequently ~~Subsequently~~ measure the right-of-use asset and the lease liability in accordance with Section 840-30-35 ~~840-20-35~~ before the effective date.
5. Regardless of the transition method selected in (c), apply ~~Apply~~ the subsequent measurement guidance in paragraphs 842-20-35-4 through 35-5 and 842-20-35-8 after the effective date. However, when applying the pending content in paragraph 842-20-35-4, a lessee shall not remeasure the lease payments for amounts probable of being owed under residual value guarantees in accordance with paragraph 842-10-35-4(c)(3).
6. Classify the assets and liabilities held under capital leases as right-of-use assets and lease liabilities arising from finance leases for the purposes of presentation and disclosure.

The following example from the Codification illustrates the application of the transition guidance for a legacy capital lease classified as a finance lease under ASC 842.

### Example 28—Lessee Transition—Existing Capital Lease

**ASC 842-10-55-244**

The effective date of the guidance in this Topic for Lessee is January 1, 20X4. Lessee enters into a 7-year lease of an asset on January 1, 20X1, with annual lease payments of $25,000 payable at the end of each year. The lease includes a residual value guarantee by Lessee of $8,190. Lessee's incremental borrowing rate on the date of commencement was 6 percent. Lessee accounts for the lease as a capital lease. At lease commencement, Lessee defers initial direct costs of $2,800, which will be amortized over the lease term. On January 1, 20X2 (and before transition adjustments), Lessee has a lease liability of $128,707, a lease asset of $124,434, and unamortized initial direct costs of $2,400.

**ASC 842-10-55-245**

January 1, 20X2 is the beginning of the earliest comparative period presented in the financial statements in which Lessee first applies the guidance in this Topic. Lessee has elected the package of practical expedients in paragraph 842-10-65-1(f). As such, Lessee accounts for the lease as a finance lease, without reassessing whether the contract contains a lease or whether classification of the lease would be different in accordance with this Topic. Lessee also does not reassess whether the unamortized initial direct costs on January 1, 20X2, would have met the definition of initial direct costs in this Topic at lease commencement.

**ASC 842-10-55-246**

On January 1, 20X2, Lessee recognizes a lease liability at the carrying amount of the capital lease obligation on December 31, 20X1, of $128,707 and a right-of-use asset at the carrying amount of the capital lease asset of $126,834 (which includes unamortized initial direct costs of $2,400 that were included in the capital lease asset). Lessee subsequently measures the lease liability and the right-of-use asset in accordance with Subtopic 840-30 until the effective date.

**ASC 842-10-55-247**

Beginning on the effective date, Lessee applies the subsequent measurement guidance in Section 842-20-35, including the reassessment requirements, except for the requirement to reassess amounts probable of being owed under residual value guarantees. Such amounts will only be reassessed if there is a remeasurement of the lease liability for another reason, including as a result of a lease modification (that is, not accounted for as a separate contract)

### *Leases classified as operating leases under ASC 842*

A lessee with a lease classified as a capital lease under legacy GAAP that is classified as an operating lease under ASC 842 should account for the lease in transition as follows:

- The lessee derecognizes the capital lease asset and the capital lease liability at the application date, and records any difference between the asset and liability in the same manner as prepaid or accrued rent.

- If the lease commenced before the application date, the lessee recognizes a right-of-use asset and a lease liability at the application date in accordance with the subsequent measurement guidance for operating leases in ASC 842-20-35-3. This guidance requires measuring a lease liability at the present value of unpaid lease payments and measuring the right-of-use asset at the amount of the lease liability, adjusted for prepaid or accrued lease payments, the remaining balance of lease incentives received, unamortized initial direct costs, and any impairment of the right-of-use asset.
- If the lessee applies the modified retrospective transition method and the lease commenced after the beginning of the earliest period presented but before the effective date, the lessee recognizes a right-of-use asset and a lease liability in accordance with ASC 842-20-30-1 at the commencement date of the lease.
- The lessee subsequently measures the right-of-use asset and the lease liability using the subsequent measurement guidance for operating leases in ASC 842-20-35.
- If the lessee has not elected the package of practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842 are written off. Refer to the "Initial direct costs" section above for a discussion of accounting for initial direct costs in transition.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

s. For each lease classified as an operating lease in accordance with this Topic, a lessee shall do the following:

1. Derecognize the carrying amount of any capital lease asset and capital lease obligation in accordance with Topic 840 at the application date as determined in (c) ~~later of the beginning of the earliest comparative period presented or the commencement date of the lease~~. 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.

2. If an entity elects the transition method in (c)(1) and the lease commenced before the beginning of the earliest period presented in the financial statements or if the entity elects the transition method in (c)(2), recognize ~~Recognize~~ a right-of-use asset and a lease liability in accordance with paragraph 842-20-35-3 ~~if the lease commenced before the beginning of the earliest period presented in the financial statements~~.

3. If an entity elects the transition method in (c)(1) and the lease commenced after the beginning of the earliest period presented in the financial statements, recognize~~Recognize~~ a right-of-use asset and a lease liability in accordance with paragraph 842-20-30-1 at the commencement date of the lease ~~if the lease commenced after the beginning of the earliest period presented in the financial statements~~.

4. Account for the operating lease in accordance with the guidance in Subtopic 842-20 after initial recognition in accordance with (s)(2) or (s)(3).

5. If a lessee does not elect the practical expedients described in (f), write ~~Write~~ off~~, as an adjustment to equity,~~ any unamortized initial direct costs ~~at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease~~ that do not meet the definition of initial direct costs in this Topic as an adjustment to

<u>equity unless the entity elects the transition method in (c)(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</u>.

## Lessee modifications in transition

A lease that is modified on or after the effective date of ASC 842 in a manner that does not result in a new contract for accounting purposes, or a lease that is remeasured for any reason, is accounted for under the guidance in ASC 842 from the modification or remeasurement date. For an entity using the modified retrospective transition approach, the accounting for a modification that occurs during the transition period is not specified in the transition guidance.

### ASC 842-10-65-1 (excerpt)

q. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not result in a separate contract in accordance with paragraph 842-10-25-8, or the lessee is required to remeasure the lease liability for any reason (see paragraphs 842-20-35-4 through 35-5), the lessee shall follow the requirements in this Topic from the effective date of the modification or the remeasurement date. …

t. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not result in a separate contract in accordance with paragraph 842-10-25-8, or the lessee is required to remeasure the lease liability in accordance with paragraph 842-20-35-4, the lessee shall subsequently account for the lease in accordance with the requirements in this Topic beginning on the effective date of the modification or the remeasurement date.

### GT insights: Accounting for lease modifications in transition

We believe that a lessee using the modified retrospective transition method should account for lease modifications that occur during the transition period based on (1) the lease's classification under legacy GAAP and (2) whether lease classification changes in transition.

A lease modification that occurs during the transition period and does not change the lease's classification should be accounted for using the modification provisions of legacy GAAP. However, legacy GAAP does not address how to account for the effect of a modification on the right-of-use asset and lease liability associated with an operating lease, as operating leases are accounted for off-balance sheet under legacy GAAP. Therefore, we believe a lessee that modifies a lease during the transition period that is classified as an operating lease both before and after the application of ASC 842 should apply legacy GAAP to determine how to account for the modification, and ASC 842 to determine how to adjust the right-of-use asset and lease liability.

If a lessee does not apply the package of practical expedients and if the lease classification changes in transition, the modification guidance in ASC 842 should be applied during the transition period.

## Build-to-suit arrangements

Under legacy GAAP, a lessee involved in the construction of an asset that it will lease must evaluate whether its involvement causes it to bear substantially all of the construction-period risks. These types of arrangements are referred to as "build-to-suit" arrangements. If it is determined under legacy GAAP that the lessee is subject to substantially all of the construction-period risks, then the lessee is deemed to be the owner of the construction project and must capitalize the construction project in accordance with ASC 360. When construction is completed, the lessee must apply the sale-leaseback guidance under legacy GAAP to determine whether it should derecognize the constructed asset. If a lessee does not qualify to derecognize the constructed asset, the arrangement is referred to as a "failed build-to-suit," and the lessee accounts for the arrangement as a financing.

ASC 842 does not carry forward this guidance and establishes a new control-based model for assessing build-to-suit arrangements. A lessee that accounts for a failed build-to-suit arrangement as a financing under legacy GAAP should derecognize those assets and liabilities when it transitions to ASC 842.

A lessee that applies the modified retrospective transition method should derecognize the assets and liabilities associated with a legacy failed build-to-suit arrangement at the later of (1) the beginning of the earliest period presented, or (2) the date when the lessee was determined to be the accounting owner of the assets in accordance with legacy GAAP. A lessee using the proposed current-period adjustment transition method would derecognize the assets and liabilities at the beginning of the reporting period in which the lessee first applies ASC 842. Any difference between the assets and liabilities derecognized would be recorded as an adjustment to equity at the derecognition date. The lessee then applies the general transition requirements of ASC 842 discussed in this section to the lease. ASC 842 does not specifically address the transition for build-to-suit arrangements if construction is incomplete at the effective date.

A lessee with a build-to-suit lease for which the construction period ended before the ASC 842 application date that was accounted for as a sale-leaseback transaction under legacy GAAP should follow the general lessee transition requirements.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

**Build-to-suit lease arrangements**

u. A lessee shall apply a modified retrospective transition approach for leases accounted for as build-to-suit arrangements under Topic 840 that are existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements <u>(if an entity elects the transition method in (c)(1)) or that are existing at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2))</u> as follows:

1. If an entity has recognized assets and liabilities solely as a result of a transaction's build-to-suit designation in accordance with Topic 840, <u>the entity shall do the following:</u>

   <u>i.</u> <u>If an entity elects the transition method (c)(1),</u> the entity ~~should~~ <u>shall</u> derecognize those assets and liabilities at the later of the beginning of the earliest comparative period

presented in the financial statements and the date that the lessee is determined to be the accounting owner of the asset in accordance with Topic 840.

ii. If an entity elects the transition method in (c)(2), the entity shall derecognize those assets and liabilities at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.

iii. Any difference ~~should~~ in (i) or (ii) shall be recorded as an adjustment to equity at ~~that~~ the date that those assets and liabilities were derecognized in accordance with (u)(1)(i) or (ii).

iv. The lessee shall apply the lessee transition requirements in (k) through (t) to the lease.

2. If the construction period of the build-to-suit lease concluded before the beginning of the earliest comparative period presented in the financial statements (if the entity elects the transition method in (c)(1)) or if it concluded before the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if the entity elects the transition method in (c)(2)), and the transaction qualified as a sale and leaseback transaction in accordance with Subtopic 840-40 before that ~~the~~ date ~~of initial application~~, the entity shall follow the general lessee transition requirements for the lease.

**GT insights: Build-to-suit arrangements in transition**

Under the build-to-suit guidance in legacy GAAP, a lessee involved in the construction of an asset may be required to recognize that asset as if it were the owner. However, in transition, when the construction of the asset in a build-to-suit arrangement is completed before the effective date of ASC 842, a lessee must derecognize the asset even if it concludes that it would continue to recognize the asset after construction is completed under legacy GAAP.

If a lessee is not the deemed to be the owner of a construction project under legacy GAAP but the construction project is still in progress as of the effective date of ASC 842, the lessee should review the guidance in ASC 842-40-55-4 to determine whether it should be considered the deemed owner under the new standard.

For lessees using the modified retrospective transition method, if construction is in progress as of the effective date and the lessee is deemed to control the asset based on ASC 842-40, the asset should be recognized at the later of the beginning of the earliest period presented or the date when control was established.

## G. Lessor transition

Transition accounting for lessors is based on the classification of each lease under legacy GAAP and, if the lessor does not elect the package of transition practical expedients, under ASC 842. For leases that are reclassified upon transition to ASC 842, the objective is for the lessor to account for the lease as if it had always been accounted for under the new guidance. The table below summarizes the transition accounting for lessors.

| Classification | ASC 842 operating lease | ASC 842 sales-type or direct financing lease |
|---|---|---|
| Legacy operating lease | Bring forward carrying amounts of the underlying asset and any assets or liabilities related to the lease<br><br>Account for securitized receivables as secured borrowings<br><br>Write off unamortized initial direct costs that do not meet the definition in ASC 842 | Derecognize the underlying asset recorded under legacy GAAP<br><br>Recognize the net investment in lease as if the lease had always been classified as sales-type or direct financing<br><br>Record any difference as an adjustment to equity |
| Legacy sales-type or direct financing lease | Recognize the underlying asset as if the lease was always classified as operating<br><br>Derecognize the net investment in the lease recorded under legacy GAAP<br><br>Record any difference as an adjustment to equity | Bring forward the net investment in the lease<br><br>Before effective date, continue to apply legacy GAAP<br><br>Beginning at effective date, apply ASC 842 guidance for lessors on recognition, subsequent measurement, presentation, and disclosure |

### GT insights: Application date of ASC 606 when a contract no longer qualifies as a lease

Some contracts that qualified as a lease under legacy GAAP will no longer qualify as a lease under ASC 842 and will be accounted for instead under other applicable guidance, such as ASC 606. For contracts previously accounted for under legacy leasing GAAP that will prospectively be accounted for under ASC 606, a question arises: As of which date should ASC 606 be applied, assuming an entity adopts ASC 606 using the modified retrospective transition approach?

For example, assume that Lessor, a PBE, adopts ASC 842 on January 1, 2019 using the modified retrospective transition method. Therefore, the application date is the beginning of the earliest period presented, or January 1, 2017. Since Lessor is a PBE, its adoption date of ASC 606 is January 1, 2018. Assume Lessor adopted ASC 606 using the modified retrospective transition method. Lessor has one contract accounted for as a lease under legacy GAAP that no longer meets the definition of a lease under ASC 842.

Because the contract no longer qualifies as a lease under ASC 842, we believe it must be accounted for under the revenue guidance that was effective during the transition period when Lessor recasts its comparative periods upon adopting ASC 842. As the entity adopted ASC 606 on January 1, 2018 under the modified retrospective transition method, Lessor should apply ASC 605 to this contract for the recasted year ended December 31, 2017 and should thereafter apply ASC 606. Also, Lessor should recognize the cumulative effect of applying the guidance in ASC 606 to the contract as part of its cumulative-effect adjustment to retained earnings on January 1, 2018.

Since ASC 606 was not effective until January 1, 2018, we believe it would be inappropriate for Lessor to apply ASC 606 during the ASC 842 transition period prior to the effective date of ASC 606 in this circumstance.

## Leases classified as operating leases under legacy GAAP

How a lessor accounts for an operating lease under ASC 842 has not substantially changed from legacy GAAP. If a lease continues to be classified as an operating lease under ASC 842, the lessor should carry forward the amount of the underlying asset, treat any securitized receivables as secured borrowings, and assess initial direct costs under the ASC 842 definition of initial indirect costs (unless the package of transition practical expedients is elected). If the lease is classified as a sales-type lease or direct financing lease under ASC 842, the underlying asset is derecognized and a net investment in the lease is recognized, with any difference recorded as an adjustment to equity.

### *Leases classified as operating leases under ASC 842*

A lessor with a lease classified as an operating lease under legacy GAAP that continues to be classified as operating under ASC 842 carries forward the previously recognized carrying amount of the underlying asset, as well as any associated lease assets and liabilities. Any securitized receivables recorded under legacy GAAP are accounted for as secured borrowings in accordance with other applicable GAAP, such as the guidance in ASC 860, *Transfers and Servicing*.

If a lessor elects the package of practical expedients, or if it does not elect the package of practical expedients but determines that its unamortized initial direct costs continue to meet the definition of initial direct costs under ASC 842, those costs remain capitalized and should continue to be amortized in line with the requirements in ASC 842. If the lessor does not elect the package of practical expedients and determines that some of its deferred costs do not meet the definition of initial direct costs under ASC 842, those costs must be written off. If the lease commenced before the beginning of the earliest period presented, the costs are written off as an adjustment to equity. If the lessor is using the modified retrospective transition method and the lease commenced during the transition period, the lessor writes off the costs to earnings in the period in which they were incurred.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

v. For each lease classified as an operating lease in accordance with this Topic, a lessor shall do all of the following:

1. Continue to recognize the carrying amount of the underlying asset and any lease assets or liabilities at the application date as determined in (c) ~~later of the date of initial application and the commencement date~~ as the same amounts recognized by the lessor immediately before that date in accordance with Topic 840.

2. Account for previously recognized securitized receivables as secured borrowings in accordance with other Topics.

3. If a lessor does not elect the practical expedients described in (f), write ~~Write~~ off, ~~as an adjustment to equity,~~ any unamortized initial direct costs ~~at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease~~ that do not meet the definition of initial direct costs in this Topic ~~(unless the lessor elects the practical expedients described in (f))~~ as an adjustment to equity unless the entity elects the transition method in (c)(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 classified as sales-type or direct financing leases under ASC 842*

A lessor with a lease classified as an operating lease under legacy GAAP that is classified as a sales-type lease or direct financing lease under ASC 842 should account for the lease as if it had always been a sales-type or direct financing lease accounted for under ASC 842, as follows:

- Derecognize the carrying amount of the underlying asset at the application date.
- Recognize a net investment in the lease at the application date as if the lease had been accounted for as a sales-type or a direct financing lease under ASC 842 since lease commencement.
- If the lessor is using the modified retrospective transition method and the lease commenced after the application date, recognize the difference between the amounts recognized and derecognized as an adjustment to earnings in the period the lease commenced. Otherwise, recognize the difference as an adjustment to equity.
- Subsequently account for the lease in accordance with ASC 842.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

w. For each lease classified as a direct financing or a sales-type lease in accordance with this Topic, the objective is to account for the lease, beginning on the application date as determined in (c) ~~later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease~~, as if it had always been accounted for as a direct financing lease or a sales-type lease in accordance with this Topic. Consequently, a lessor shall do all of the following:

1. Derecognize the carrying amount of the underlying asset at the application date as determined in (c) ~~later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease~~.

2. Recognize a net investment in the lease at the application date as determined in (c) ~~later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease~~ as if the lease had been accounted for as a direct

financing lease or a sales-type lease in accordance with Subtopic 842-30 since lease commencement.

3. Record any difference between the amounts in (w)(1) and (w)(2) as ~~an adjustment to equity~~ follows:

   i. If an entity elects the transition method in (c)(1), as an adjustment to equity (if the commencement date of the lease was before the beginning of the earliest period presented or if the lease was acquired as part of a business combination; see also (h)(3)) or earnings (if the commencement date of the lease was on or after the beginning of the earliest period presented).

   ii. If an entity elects the transition method in (c)(2), as an adjustment to equity.

4. Account for the lease in accordance with this Topic after the application date as determined in (c) ~~later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease~~.

## Leases classified as sales-type or direct financing leases under legacy GAAP

If a lease continues to be classified as a sales-type lease or a direct financing lease under ASC 842, the net investment in the lease is brought forward by the lessor. The lease is accounted for under legacy GAAP before the effective date, and under ASC 842 after the effective date. If a lease is classified as an operating lease under ASC 842, the underlying asset is recognized as though it had always been recognized on the lessor's balance sheet, and the net investment in the lease is derecognized, with any difference recorded as an adjustment in equity.

### *Leases classified as sales-type or direct financing leases under ASC 842*

A lessor with a lease classified as a sales-type lease or a direct financing lease under legacy GAAP that is still classified as a sales-type or direct financing lease under ASC 842 should continue to recognize a net investment in the lease at the application date of ASC 842, including any unamortized initial direct costs capitalized as part of the lessor's net investment in the lease under legacy GAAP, as follows:

- Before the effective date, a lessor that elects the modified retrospective transition method accounts for the lease in accordance with legacy GAAP.
- Beginning on the effective date, the lessor accounts for the lease in accordance with the recognition, subsequent measurement, presentation, and disclosure guidance for operating leases in ASC 842-30.
- Beginning on the effective date, the lessor accounts for a modification that does not require accounting for a separate contract in accordance with the appropriate modification guidance in ASC 842-10-25, depending on whether the lease is a sales-type or direct financing lease before and after the modification.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

x. For each lease classified as a direct financing lease or a sales-type lease in accordance with this Topic, do all of the following:

1. Continue to recognize a net investment in the lease at the application date as determined in (c) ~~later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease,~~ at the carrying amount of the net investment at that date. This would include any unamortized initial direct costs capitalized as part of the lessor's net investment in the lease in accordance with Topic 840.

2. If an entity elects the transition method in (c)(1), before ~~Before~~ the effective date, a lessor shall account for the lease in accordance with Topic 840.

3. Regardless of the transition method selected in (c), beginning ~~Beginning~~ on the effective date, a lessor shall account for the lease in accordance with the recognition, subsequent measurement, presentation, and disclosure guidance in Subtopic 842-30.

4. Beginning on the effective date, if a lessor modifies the lease (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8), it shall account for the modified lease in accordance with paragraph 842-10-25-16 if the ~~modified~~ lease is classified as a direct financing lease ~~after~~ before the modification or paragraph 842-10-25-17 if the ~~modified~~ lease is classified as a sales-type lease ~~after~~ before the modification. A lessor shall not remeasure the net investment in the lease on or after the effective date unless the lease is modified (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8).

### *Leases classified as operating leases under ASC 842*

A lessor with a lease classified as a sales-type lease or a direct financing lease under legacy GAAP that is classified as an operating lease under ASC 842 should record transition adjustments to reflect the lease as if it had always been accounted for as an operating lease under ASC 842, as follows:

- Recognize the underlying asset at an amount equal to what the carrying amount would have been if the lease had always been classified as an operating lease under legacy GAAP.
- Derecognize the carrying amount of the net investment in the lease.
- If the lessor is using the modified retrospective transition method and the lease commenced after the application date, recognize the difference between the amounts recognized and derecognized as an adjustment to earnings in the period the lease commenced. Otherwise, recognize the difference as an adjustment to equity.
- Subsequently, account for the lease in accordance with ASC 842.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

y. For each lease classified as an operating lease in accordance with this Topic, the objective is to account for the lease, beginning on the application date as determined in (c) ~~earliest comparative period presented in the financial statements and the commencement date of the lease~~, as if it had always been accounted for as an operating lease in accordance with this Topic. Consequently, a lessor shall do all of the following:

1. Recognize the underlying asset at what the carrying amount would have been had the lease been classified as an operating lease under Topic 840.
2. Derecognize the carrying amount of the net investment in the lease.
3. Record any difference between the amounts in (y)(1) and (y)(2) as ~~an adjustment to equity~~ follows:
   i. If an entity elects the transition method in (c)(1), as an adjustment to equity (if the commencement date of the lease was before the beginning of the earliest period presented or if the lease was acquired as part of a business combination) or earnings (if the commencement date of the lease was on or after the beginning of the earliest period presented).
   ii. If an entity elects the transition method in (c)(2), as an adjustment to equity.
4. Subsequently account for the operating lease in accordance with this Topic and the underlying asset in accordance with other Topics.

## Leases classified as leveraged leases under legacy GAAP

The Board did not retain the legacy leveraged leasing model in ASC 842. Therefore, no leases that commence or are modified after the effective date of ASC 842 will be accounted for under the leveraged leasing guidance. However, a lease that was classified as a leveraged lease in accordance with legacy GAAP with a commencement date before the effective date of ASC 842 will be accounted for under the guidance in ASC 842-50. Under that guidance, a leveraged lease that is modified on or after the effective date is accounted for as a new lease as of the modification date in accordance with the general lessor leasing guidance in ASC 842, which does not include a leveraged lease accounting model.

**ASC 842-10-65-1 (excerpt)**

z. For leases that were classified as leveraged leases in accordance with Topic 840, and for which the commencement date is before the effective date, a lessor shall apply the requirements in Subtopic 842-50. If a leveraged lease is modified on or after the effective date, it shall be accounted for as a new lease as of the effective date of the modification in accordance with the guidance in Subtopics 842-10 and 842-30.

1. A lessor shall apply the pending content that links to this paragraph to a leveraged lease that meets the criteria in (z) that is acquired in a business combination or an acquisition by a not-for-profit entity on or after the effective date.

## H. Transition for sale-leaseback transactions

An entity does not reassess a transaction that was a successful sale-leaseback transaction under legacy GAAP to determine if it meets the new sale-leaseback criteria under ASC 842. Only a transaction accounted for as a failed sale-leaseback under legacy GAAP that remains a failed sale at the effective date of ASC 842 is reassessed to determine if a sale would have occurred under the new sale-leaseback criteria in ASC 842. The Board explained in BC 396 of ASU 2016-02 that this treatment of a failed sale-leaseback was intended to align with the modified retrospective transition method in ASC 606, whereby an uncompleted contract is reassessed, while a completed contract is not.

An entity using the modified retrospective transition method must reassess a failed sale-leaseback to determine if a sale would have occurred under the guidance in ASC 842 at any point on or after the beginning of the earliest period presented. If the entity determines that a sale has occurred, it accounts for the sale-leaseback on a modified retrospective basis from the sale date. An entity using the proposed current-period adjustment transition method would reassess a failed sale-leaseback at the effective date of ASC 842, and a transaction meeting the sale criteria in ASC 842 would be recorded as an adjustment to equity at the effective date. The leaseback is then accounted for under the lessee guidance in ASC 842-20 after the effective date.

An entity that has an existing leaseback for which the sale is not reassessed accounts for that leaseback using the general lessee and lessor transition guidance.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

aa. If a previous sale and leaseback transaction was accounted for as a sale and a leaseback in accordance with Topic 840, an entity shall not reassess the transaction to determine whether the transfer of the asset would have been a sale in accordance with paragraphs 842-40-25-1 through 25-3.

bb. If a previous sale and leaseback transaction was accounted for as a failed sale and leaseback transaction in accordance with Topic 840 and remains a failed sale at the effective ~~date,~~ <u>date:</u>

1. <u>If an entity elects the transition method in (c)(1),</u> the entity shall reassess whether a sale would have occurred at any point on or after the beginning of the earliest period presented in the financial statements in accordance with paragraphs 842-40-25-1 through 25-3. The sale and leaseback transaction shall be accounted for on a modified retrospective basis from the date a sale is determined to have occurred~~, in accordance with the requirements in (cc) through (dd)~~.

2. <u>If an entity elects the transition method in (c)(2), the entity shall reassess whether a sale would have occurred at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph in accordance with paragraphs</u>

842-40-25-1 through 25-3 and recognize the sale as an adjustment to equity. The entity shall then account for the leaseback in accordance with the guidance in Subtopic 842-20 after the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.

cc. An entity shall account for the leaseback in accordance with the lessee and lessor transition requirements in (k) through (y).

### *Sale and capital leaseback under legacy GAAP*

For a transaction accounted for as a sale and capital leaseback under legacy GAAP, the seller-lessee should recognize any deferred gain or loss that exists at the application date of ASC 842 as follows:

- If the underlying asset is land only, the deferred gain or loss should be recognized on a straight-line basis over the remaining lease term.
- If the underlying asset is not land only and the leaseback is a finance lease, the gain or loss should be recognized in a proportionate manner to the amortization of the right-of-use asset.
- If the underlying asset is not land only and the leaseback is an operating lease, the gain or loss should be recognized in a proportionate manner to the total lease cost.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

dd. If a previous sale and leaseback transaction was accounted for as a sale and capital leaseback in accordance with Topic 840, the transferor shall continue to recognize any deferred gain or loss that exists at the later of the beginning of the earliest comparative period presented in the financial statements ~~or~~ and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)) or that exists at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)), as follows:

1. If the underlying asset is land only, straight line over the remaining lease term.
2. If the underlying asset is not land only and the leaseback is a finance lease, in proportion to the amortization of the right-of-use asset.
3. If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the recognition in profit or loss of the total lease cost.

**At the crossroads: Sale and capital leaseback in transition**

Under legacy GAAP, a sale and capital leaseback was accounted for by the seller-lessee by (1) recognizing a capital lease asset and capital lease liability, and (2) deferring any gain over the lease term. Under ASC 842, a finance leaseback precludes a seller from accounting for a transaction as a sale-leaseback. In BC 396(c) of ASU 2016-02, the Board clarified its decision to allow entities to continue to account for sale-capital leasebacks in transition, noting that the cost of reevaluating and unwinding these transactions would not be worth the benefit.

### *Sale and operating leaseback under legacy GAAP*

If a transaction was accounted for as a sale and an operating leaseback under legacy GAAP, the seller-lessee's treatment of deferred gain or loss on the transaction under ASC 842 depends on whether the gain or loss arose from off-market terms. "Off-market terms" exist when the consideration paid is not equal to the asset's fair value or when the lease payments are not at the market rate.

If the terms are not off-market, the seller-lessee recognizes any deferred gain or loss as an adjustment to equity or prior-period earnings, depending on the transition method selected and when the sale occurred. An entity using the proposed current-period adjustment method, or using the modified retrospective method when the sale date precedes the beginning of the earliest period presented, recognizes the deferred gain or loss as an adjustment to equity. An entity using the modified retrospective transition method when the sale occurs after the beginning of the earliest period presented recognizes the deferred gain or loss in earnings in the period the sale occurred.

When terms are off-market, any gain represents additional financing related to the sale and should not be written off to equity. A deferred gain resulting from off-market terms is recognized as a financial liability at the application date or, if the sale occurs after the beginning of the earliest period presented but before the effective date and the entity elects the modified retrospective transition method, at the date of the sale.

Any deferred loss associated with an off-market transaction is recognized as an adjustment to the leaseback right-of-use asset at the later of the application date or the date of the sale of the underlying asset.

**Proposed FASB Accounting Standards Codification**

**ASC 842-10-65-1 (excerpt)**

ee. If a previous sale and leaseback transaction was accounted for as a sale and operating leaseback in accordance with Topic 840, the transferor shall do the following:

1. Recognize any deferred gain or loss not resulting from off-market terms (that is, where the consideration for the sale of the asset is not at fair value or the lease payments are not at market rates) as a cumulative-effect adjustment ~~at the later of the date of initial application (~~to equity~~) or the date of sale (to earnings of the comparative period presented)~~ unless the entity elects the transition method in (c)(1) and the date of sale is after the beginning of the earliest period presented, in which case any deferred gain or loss not resulting from off-market terms shall be recognized in earnings in the period the sale occurred.

2. Recognize any deferred loss resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as an adjustment to the leaseback right-of-use asset at the ~~date of initial application~~ later of the beginning of the earliest comparative period presented in the financial statements and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)), or at the beginning of

the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)).

3. Recognize any deferred gain resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as a financial liability at the ~~date of initial application~~ later of the beginning of the earliest comparative period presented in the financial statements and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)), or at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)).

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