

Snapshot

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ASU 2021-09 amends discount rate guidance for nonpublic lessees

The FASB recently issued ASU 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, which allows lessees that are not public business entities to apply the existing risk-free discount rate expedient by class of underlying asset rather than to all leases.

Background

Under the existing guidance in ASC 842, a lessee must determine a discount rate for calculating the present value of the lease payments when classifying a lease and measuring the lease liability. A lessee must use the rate implicit in the lease as the discount rate when that rate is readily determinable, but, if that rate is not readily determinable, a lessee is required to use its incremental borrowing rate.

Prior to the issuance of ASU 2021-09, ASC 842 provided lessees that are not public business entities with a practical expedient that allows them to use a risk-free rate as the discount rate for **all** leases. The Board intended this expedient to allow lessees that are not public business entities to avoid the costs of estimating the incremental borrowing rate.

As part of its post-implementation review of ASC 842, however, the FASB became aware that eligible entities were reluctant to elect the risk-free rate expedient. Because a risk-free rate (such as the U.S. Treasury rate) is generally lower than the incremental borrowing rate, using a risk-free rate to discount the lease payments would increase the likelihood that a lease is classified as a finance lease instead of an operating lease, and result in a greater lease liability and corresponding right-of-use asset for lessees. The amendments in ASU 2021-09 are designed to address

these concerns by allowing more targeted application of the risk-free rate expedient.

Amendments to ASC 842

Under the amended guidance, a lessee that is not a public business entity may elect the risk-free rate expedient **by class of underlying asset** rather than for all leases. For example, a lessee could use the risk-free rate for an asset class with high volume, low dollar leases (for example, equipment) and the incremental borrowing rate for an asset class with low volume, high dollar leases (for example, real estate).

Entities that make this accounting policy election must disclose this election as well as the class (or classes) of underlying assets to which the election has been applied.

The Board also amended ASC 842 to clarify that the risk-free rate is an alternative only to the incremental borrowing rate. In other words, a lessee must use the rate implicit in the lease if that rate is readily determinable, regardless of whether the lessee has elected the risk-free rate expedient.

Effective date and transition

For entities that have not adopted ASC 842 as of November 11, 2021, the amendments in ASU 2021-09 are subject to the same effective date and transition guidance that applies to ASC 842.

Entities that have adopted ASC 842 as of November 11, 2021 are required to apply the amendments for fiscal years beginning after December 15, 2021 and for interim periods within fiscal years beginning after

December 15, 2022. Earlier application is permitted as of the beginning of the fiscal year of adoption. Entities are required to apply the amendments on a modified retrospective basis to leases that exist at the beginning of the fiscal year of adoption.

Upon adoption of the amended guidance, an entity that has already adopted ASC 842 may choose to either apply or discontinue the risk-free rate expedient for any class of underlying asset. After remeasuring the lease liabilities for affected leases based on a discount rate and the remaining lease term as of the beginning of the fiscal year of adoption, an entity should adjust the carrying amounts of the affected lease liabilities, with an offsetting adjustment to the corresponding right-of-use assets. If such an adjustment would either cause a right-of-use asset to become a credit balance or increase the carrying amount of a previously impaired right-of-use asset, then the offsetting adjustment should be recognized in opening retained earnings.

Adopting the amended guidance alone does not require a lessee to remeasure and reallocate the consideration in the contract, to reassess the lease term or the likelihood of exercising a purchase option, to remeasure the lease payments under ASC 842-10-35-4, or to reassess lease classification under ASC 842-10-25-1.

A change in the application of the risk-free rate expedient after an entity adopts the amendments would be considered a change in accounting policy that would require further evaluation under ASC 250.

Grant Thornton insight

As with any accounting policy available solely to nonpublic business entities, entities that are considering becoming public business entities in the future should carefully consider the implications of adopting the risk-free rate expedient. An entity that has applied the risk-free rate expedient to one or more asset classes would be required to “undo” the expedient when preparing financial statements as a public business entity.

This process could be challenging, as it would involve retroactively estimating the incremental borrowing rate at the later of the lease commencement date or the date at which the lease required remeasurement using an updated discount rate.

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