LEASING STANDARDS OVERHAULED:
An Overview of ASC Topic 842

KSM KATZ SAPPER & MILLER

ksmcpa.com/lease-accounting

Table of Contents

Introduction

The new lease accounting standards will have a significant impact on nearly every organization that prepares financial statements under generally accepted accounting principles in the United States (U.S. GAAP).

The modified rules are expected to put an estimated $3 trillion of leases on the balance sheets of public companies alone, due to the new requirement to report operating leases on the face of the financial statements rather than only in the footnotes. [1]

For years, financial statement users criticized leasing guidance, pointing out that the standards permitted preparers to furnish an incomplete picture of an entity's leasing activities and related obligations. Users consistently protested the absence of a requirement for lessees to recognize on the balance sheet an asset and liability arising from operating leases. The vast majority of entities that prepare GAAP financial statements engage in leasing, so addressing these concerns is crucial.

In response to the feedback, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)*, in February 2016. Accounting Standards Codification (ASC) Topic 842 – effective for most private entities for annual reporting periods beginning after Dec. 15, 2020 – is intended to increase transparency and comparability related to leasing.

Entities with leasing activities must begin assessing the new standard and determining the impact it will have, including the potential impact to debt covenants. In addition, entities must ensure they have strong systems and processes in place for the implementation of this new guidance.

[1] "A big change in accounting will put $3 trillion in liabilities on corporate balance sheets," CNBC, Feb. 16, 2019.

Impact to Lessee Financial Statements

Any entity that relies substantially on leased equipment, real estate, or other assets could see a dramatic change to its balance sheet.

Before adopting the new lease standard, lessees must ask themselves: *How will users view their financial statements after the adoption of Topic 842?*

The new standard could have a big impact on debt covenants and any other key metrics monitored by users of the financial statements. While operating lease liabilities aren't classified as debt under GAAP, some lenders may still include these lease liabilities in total debt.

If an entity is required to comply with covenants that include debt-based ratios, such as *debt service or debt-to-equity*, then:

- Management should carefully review the provisions of existing agreements, particularly those related to debt covenants, to determine whether the adoption of Topic 842 will cause the failure of any debt covenants or other unintended consequences
- Debt-based ratios should be projected under the new lease standard
- The expected impact should be communicated to lenders in advance

POTENTIAL IMPACT BY FINANCIAL STATEMENT

Balance Sheet

The most significant impact to the balance sheet will be the recognition of the right-of-use (ROU) assets and lease liabilities for operating leases. ROU assets and lease liabilities must be presented on a gross basis, with each class of lease (operating and finance) presented as a separate line item, unless immaterial. ROU assets will be presented entirely as noncurrent assets; however, lease liabilities will be split between current and long-term components.

Income Statement

Finance leases: Interest will generally be presented in the nonoperating section of the income statement, consistent with other items of interest expense. Amortization of the ROU asset is presented as a component of operating income, similar to other items of depreciation or amortization. Both amounts will generally be added back to earnings when calculating earnings before interest, tax, depreciation, and amortization (EBITDA), a commonly used metric monitored by lenders.

Operating leases: A single lease expense continues to be presented as a component of operating income. Operating lease expense would not be added back to earnings when determining EBITDA, because there is no amortization or interest recognized for operating leases under Topic 842.

Statement of Cash Flows

Cash payments on a finance lease for the principal portion of the lease liability are presented as cash outflows from financing activities. Lessees should present all other lease-related cash payments as cash outflows from operating activities, regardless of whether they are associated with finance or operating leases. Cash flows associated with bringing an asset to the condition and location necessary for its intended use should continue to be classified as an investing activity.

Defining a Lease Contract

Applying the new lease guidance first requires determining whether a contract or a contract modification contains a lease. Under the new lease standard, a lease is defined as a contract, or part of a contract, that provides the customer the right to control the use of an identified asset for a period of time in exchange for consideration.

The FASB identifies two terms of significance in this definition: "identified asset" and the "right to control the use" of the identified asset.

IDENTIFIED ASSET

All leases must contain an *explicitly or implicitly* identified asset.

Explicit Asset = Identified Asset

Example: A used SUV with a unique vehicle identification number.

Implicit Asset = Identified Asset

Example: A new SUV from a line of 2018 SUVs, without any rights to substitute the SUV after commencement of the lease, unless a breakdown occurs.

Substitutable Asset ≠ Identified Asset

Substantive substitution rights exist when (1) a contract contains language allowing for the substitution of the asset at the supplier's discretion, (2) the supplier has the practical ability to substitute alternative assets, and (3) the substitution would provide an economic benefit to the supplier, even if the contract specified an asset.

Example: A supplier provides 10,000 square feet of warehouse space to a customer in one of its temperature-controlled warehouses. A month after the agreement commences, the supplier exercises its right to move the customer's product to a different warehousing location on-site to accommodate a new customer who requires cold warehouse space. The supplier benefits from exercising this right. By definition, no identified asset exists, and the contract is simply accounted for as a supply arrangement.

RIGHT TO CONTROL THE USE OF THE IDENTIFIED ASSET

The right to control the use of an identified asset for a period of time lies in the right to the economic benefits from the asset's use and the right to direct the use of the asset. This is a fundamental change from legacy GAAP.

CONTROL	LEGACY	NEW
Right to Economic Benefits	X	X
Right to Direct the Use		X

Certain arrangements are outside the scope of the leasing standard, including:

- Leases of inventory or of construction in progress
- Leases of intangible assets, including licenses of internal-use software
- Leases to explore for or use natural resources
- Leases of biological assets
- Service concession arrangements within the scope of ASC 853, *Service Concession Arrangements*

The right to direct the use of the asset focuses on the right to direct how and for what purpose the asset is used, which directly affects the economic benefits to be derived from the identified asset.

> **Example:** A manufacturing arrangement whereby a supplier providing equipment to be used on the customer's property also makes all the operating decisions regarding that equipment during the period of use. While the customer acts as custodian and ultimately receives the economic benefits of the asset, it does not *control* the identified asset because it does not *direct its use*. Under legacy GAAP, this is a lease because the customer controls the economic benefits and physically has access to the equipment. Under the new guidance, this is no longer a lease because the supplier directs its use.

In assessing a contract to determine if it is a lease, the customer must determine which party – supplier or customer – has the right to make operating decisions most relevant to the economic benefits to be derived from use of the asset, and receives the economic benefits from using the identified asset.

Finance Versus Operating Lease Classification

While the new guidance puts both finance and operating leases onto the balance sheet, classification remains important, as it continues to determine how the amounts are presented on financial statements. Legacy GAAP stipulated a bright-line test to differentiate between capital (now termed "finance") and operating leases. Topic 842 allows for more judgment by financial statement preparers. The criteria under legacy and new GAAP are detailed below. If any of these criteria are met, the lease will be classified as a finance lease.

FINANCE LEASE DETERMINATION

LEGACY GAAP	NEW GAAP
Transfer of ownership occurs at lease termination.	Transfer of ownership occurs by the end of the lease term.
A bargain purchase option exists, whereby the customer may purchase the asset at a price significantly lower than fair market value at lease termination.	The lease provides the lessee an option to purchase the underlying asset, and that option is reasonably certain to be exercised.
The term of the lease is greater than or equal to 75 percent of the useful life of the underlying asset.	The lease term is for the major part of the remaining economic life of the underlying asset, even if title is not transferred.
The present value of minimum lease payments is greater than or equal to 90 percent of the underlying asset's fair value at lease inception.	The present value of the lease payments (plus any residual value guarantee by the lessee) equals or exceeds substantially all the fair value of the underlying asset.
	The underlying asset is of a specialized nature that only the lessee can use, absent major modifications.

While the new guidance does not significantly change the criteria used, it certainly requires financial statement preparers to take a substantive look at each arrangement. A preparer should ask: **Does the lease essentially represent an installment sale, whereby substantially all the economic benefits of the asset are consumed?** If so, and if the underlying fact pattern does not conflict with the above criteria, the lease should be classified as a finance lease.

Initial Lease Measurement

In another significant change, the classification determination is no longer made when the terms are agreed upon (date of inception). Rather, lease classification should be determined when the lessor makes the underlying asset available to the lessee (commencement date).

Only the components integral to the right to use an identified asset are considered lease components. Any nonlease components should be accounted for using other accounting models, unless a special exception is elected, as described later in this paper (see p. 10).

What should be included in total lease payments at commencement?

- Fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to the lessee
- Variable lease payments that depend on an index or rate (such as CPI), initially measured using the index or rate at the commencement date
- The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option
- Payments for penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease
- Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction
- Amounts probable to be owed by the lessee under residual value guarantees

What should be excluded at commencement?

- Variable lease payments, unless otherwise included above
- Any guarantee by the lessee of the lessor's debt
- Amounts allocated to nonlease components (barring lessee election to aggregate, as discussed below)

The FASB provides lessees with a practical expedient for separating lease and nonlease components, allowing the components to be treated instead as a single lease component. While this election results in a larger lease liability on the balance sheet, it relieves lessees of the need to perform a pricing allocation. The lessee must make this election by asset class. Nonlease components are discussed further in the Nonlease Component Considerations section of this paper (see p. 10).

In 2018, the FASB introduced a practical expedient for lessors allowing for similar aggregation of lease and nonlease components; however, the practical expedient is more limited in nature.

Practical Expedient

The new leasing standard does not require lessees to apply the guidance to arrangements with a lease term of 12 months or less. This practical expedient should be disclosed in the footnotes to the financial statements.

Nonlease Component Considerations

Leases are often identified as either net or gross leases. Under a net lease, the required payment covers only the actual lease payment for the use of the asset. Additional costs (such as maintenance or insurance) are paid directly by the lessee.

Under a gross lease, the lessee's required payment includes the actual lease payment plus additional costs for goods and services provided to the lessee separate from the right to use the leased asset. Because these costs are not related to the actual leasing of the asset, they are considered nonlease components.

An example of a nonlease component would be one year of scheduled maintenance appointments on a leased vehicle at no additional charge. It is important to note that payments to compensate a lessor for administrative tasks in setting up the lease contract or to reimburse the lessor for the costs of owning an asset (such as property taxes) are not classified as nonlease components.

Topic 842 requires a lessee to account for nonlease components separately from lease components, unless an accounting policy is elected to treat the nonlease components as being related to lease components. Under Topic 842, the allocation of the lease payment is calculated using the cost of purchasing the item on its own, otherwise known as the relative standalone price basis. When observable, standalone prices are not available (i.e., the item does not have a readily identifiable market price), lessees should estimate the standalone price for lease and nonlease components based on the best information available.

As an example, say KSM Enterprises leases equipment for two years and determines the arrangement should be classified as a finance lease. The monthly payment is fixed at $5,000 per month, payable in advance, for the entire term of the lease. Under the lease contract, the lessor agrees to remain on-call 24 hours a day, seven days a week, in the event the equipment unexpectedly stops working. The lessor also agrees to repair or replace the nonfunctioning equipment within one business day.

The maintenance agreement built into the lease represents a nonlease component, since these are services that KSM Enterprises would otherwise pay a third party. Therefore, KSM Enterprises must separate its monthly payment into the leasing component and the nonleasing component. KSM Enterprises will calculate this based on the standalone pricing of leasing the equipment and the standalone pricing of a maintenance agreement.

Now, say that KSM Enterprises determines it could enter into a maintenance contract with a third party that provides similar services for a cost of $10,000 per year. KSM Enterprises can't find observable standalone prices for the lease component of the arrangement from the same supplier, but it can estimate – based on observable data from competing leasing companies – that net leases for comparable equipment cost $3,500 per month. Accordingly, the standalone prices of the contract's components are:

- A two-year service contract at $20,000 ($10,000 per year for two years)
- The lease of equipment at $84,000 ($3,500 per month for 24 months)

On a relative standalone price basis, 19 percent of the contract amount should be allocated to the maintenance contract or the nonlease component, and 81 percent to the lease component. KSM

Enterprises would apply these percentages to allocate the monthly payment of $5,000. That is, approximately $950 of the monthly payment would relate to the nonlease component of the agreement and $4,050 would relate to the lease component of the agreement.

As discussed above, Topic 842 requires lessees to initially recognize an ROU asset and lease liability at lease commencement. The ROU asset and lease liability are based only on the payment allocated to the lease component of the agreement. Under a finance lease, KSM Enterprises will recognize amortization expense related to the ROU asset and interest expense related to the lease liability. Of the $5,000 monthly payment, $4,050 will be allocated between interest expense and a reduction in the lease liability, and $950 will be recorded either as a prepaid asset or maintenance expense, depending on the timing of the payment in relation to when the services are performed.

FINANCE LEASE EXAMPLE:

In Year 1, the lessee will record the following journal entry for the lease liability and the ROU asset ($4,050 × 24 months discounted at five percent):

Right of Use (ROU) Asset	$ 90,367	
Lease Liability		$ 90,367

The entry for Year 1 would be:

Interest Expense	$ 4,518	
Lease Liability		$ 4,518
Amortization Expense	45,184	
ROU Asset		45,184
Lease Liability	48,600	
Cash		48,600
Maintenance Expense	11,400	
Cash		11,400

Following this pattern, the final year of the lease requires the following entry:

Interest Expense	$ 2,314	
Lease Liability		$ 2,314
Amortization Expense	45,184	
ROU Asset		45,184
Lease Liability	48,600	
Cash		48,600
Maintenance Expense	11,400	
Cash		11,400

> "Administrative costs for setting up a lease contract, property taxes, and other payments to reimburse the lessor for costs of owning the asset are not classified as nonlease components."

As the accounting for nonlease components can become complex, Topic 842 does allow for a practical expedient. The lessee may elect to combine lease and nonlease components. That is, the lessee can elect to account for lease and nonlease components together, as a single combined lease component. Using the figures from our example above, if KSM Enterprises had elected to account for the lease and nonlease components together, the initial ROU asset and lease liability would be calculated based on the full payment of $5,000 per month, and the full payment would be allocated between interest expense and a reduction of the lease liability each month. This election must be disclosed in the notes to the financial statements. The election is done by class of underlying asset, not by lease. This prevents an entity from electing a different treatment on each of two leases that are part of the same class of asset.

Other Lease Measurement Considerations

Topic 842 requires an entity to thoughtfully examine the substance of a lease and the related terms to determine what should be recognized.

Renewal Options: The lease term must cover any noncancelable period during which the lessee has a right to use the underlying asset, plus any periods covered by a renewal option if the lessee is reasonably certain to exercise the option.

Short-Term Leases: Leases of less than 12 months are not required to be recorded on the balance sheet as long as they do not contain renewal options whose exercise is reasonably certain. Should the entity choose not to recognize an asset and liability for these short-term leases, it must make an accounting policy election by asset class.

Related-Party Leases: It is common to see related-party leasing arrangements that operate month-to-month. An entity must consider whether these leases are reasonably certain to operate in a long-term manner. For instance, would it be economically burdensome in a real estate arrangement to move facilities quickly? In many cases, such situations should be considered long-term lease arrangements, even if the terms (whether formal or informal) only require a monthly commitment.

Modifications: Defined by the FASB as a c*hange to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease*, a modification to a lease requires both the lessor and the lessee to revisit the accounting for a lease. The modification should be treated as a completely new lease if it introduces a new right of use and the lease payments increase commensurate with the standalone price for that new right of use. However, if the modification simply extends (or reduces) the lease period, a new lease is not created from an accounting standpoint. In this case, a lessee should reconsider the lease classification, re-measure the lease liability at the discount rate applicable at the modification date, and adjust the ROU asset.

Subleases: Throughout the life of a leasing arrangement, a lessee may choose to sublease a portion (or all) of the asset that is under lease. Under Topic 842, the original lease (referred to as a *head lease*) and each sublease are almost always treated as separate contracts. As such, the head lease and the sublease(s) should be separately analyzed to determine their classification under Topic 842. It is possible for the head lease to be classified as a finance lease while the sublease is classified as an operating lease. Generally, an entity should not offset the lease expense of a head lease with the income generated from a sublease. In addition, the assets and liabilities from the head lease and sublease should not be combined on the entity's balance sheet.

Lessee Accounting and Discount Rate

We will now consider how a lessee applies the new guidance to operating and finance leases. For both examples, assume a three-year lease requiring annual payments of $60,000, with a discount rate of five percent.

Regardless of lease classification, this entry is recorded at the present value of the three-year cash outlay ($180,000), assuming a prevailing discount rate of five percent:

Right of Use (ROU) Asset Lease Liability	$ 163,395	 $ 163,395

While the initial balance sheet entry is the same for operating and finance leases, subsequent measurement deviates.

OPERATING LEASES

In Year 1, the lessee will record the following journal entry:

Lease Expense Lease Liability	$ 60,000 (1) 51,830 (2)	
ROU Asset Cash		$ 51,830 60,000

(1) The entry in Year 1 to the statement of activities has not changed from legacy GAAP. The FASB still requires a straight-line lease expense entry equal to the cash outlay: Total future payments ($180,000) ÷ Term of the lease (three years).

(2) However, underlying the lease expense calculation are an interest component and an amortization component that determine the entry to the balance sheet: Cash outlay ($60,000) – [ROU asset ($163,395) × Discount rate (five percent)].

Following this pattern, the final two years of the lease require the following entries.

Year 2:		
Lease Expense Lease Liability	$ 60,000 54,422	
ROU Asset Cash		$ 54,422 60,000

Year 3:		
Lease Expense Lease Liability	$ 60,000 57,143	
ROU Asset Cash		$ 57,143 60,000

Analysis: The new lease standard requires operating leases to be recognized on the balance sheet at the present value of future lease payments, using the established discount rate. On the statement of cash flows, the annual impact will be categorized as a component of operating cash flows. It is important to note that any lease incentive received or receivable from the lessor (including up-front payments made from the lessor to the lessee, lessor reimbursement of lessee cost, etc.) should be deducted from the lease payments when calculating the ROU asset.

FINANCE LEASES

In Year 1, the lessee will record the following journal entry:

Interest Expense	$ 8,170 (3)	
Lease Liability		$ 8,170
Amortization Expense	54,465 (4)	
ROU Asset		54,465
Lease Liability	60,000	
Cash		60,000

(3) The new guidance requires finance lessees to split out the interest and amortization components on the statement of activities. Interest is calculated consistent with (2) above, $163,395 × five percent, and the liability is adjusted to reflect an increase for the interest expense reduced by the lease payment.

(4) Amortization expense is measured on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee will consume the asset. This is consistent with the amortization approach of other nonfinancial assets.

Following this pattern, the final two years of the lease require the following entries.

Year 2:		
Interest Expense	$ 5,578	
Lease Liability		$ 5,578
Amortization Expense	54,465	
ROU Asset		54,465
Lease Liability	60,000	
Cash		60,000

Year 3:		
Interest Expense	$ 2,857	
Lease Liability		$ 2,857
Amortization Expense	54,465	
ROU Asset		54,465
Lease Liability	60,000	
Cash		60,000

Analysis: Finance lease recognition under the new standard hasn't significantly changed from the legacy standard. The ROU asset is still amortized on a straight-line basis, while the lease liability is settled via principal reduction only (using the effective interest method). However, the new lease standard requires the cash flow impact of the interest expense component to be carved out and placed in cash outflows from operating activities, as opposed to financing activities ($2,857 in Year three, for example).

Determining a Discount Rate

Determining a suitable discount rate to use in calculating the present value of future minimum lease payments is important. Some lease contracts will contain a stated interest rate or provide enough quantitative information to calculate the rate (such as the fair market value of the asset, the periodic payment, and the residual value of the asset at lease termination). In these cases, the discount rate is simply the implied rate in the contract.

However, many leases do not contain a known or calculable rate. In these circumstances, the lessee should apply the incremental borrowing rate, which is defined in the new guidance as *the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.* Since researching and documenting a supportable conclusion takes some time and effort, the FASB provides an election to private companies to bypass the incremental borrowing rate determination and select the current market risk-free rate for all leases.

Lessor Impact

A primary objective of Topic 842 is to improve comparability and transparency in lessee financial statements by recognizing assets and liabilities for lease arrangements that historically were only disclosed in the notes to the financial statements. The FASB concluded that existing accounting guidance for lessors was generally appropriate, and therefore Topic 842 makes few changes to existing lessor accounting rules. However, a few targeted changes focus on aligning lessor accounting with concepts in Topic 606, *Revenue from Contracts with Customers*.

CLASSIFICATION

Lessors will continue to evaluate and classify leases as operating, direct financing, or sales-type leases. Leveraged leases are no longer an appropriate classification. However, the FASB did provide some relief by allowing the previous accounting model to be used for leveraged leases existing as of the effective date.

SALES-TYPE LEASES

The most significant changes for lessors relate to leases classified as sales-type leases. Under existing GAAP, a sales-type lease occurs when (among other conditions) the fair value of the leased property at lease inception differs from its carrying amount. Topic 842 no longer requires this condition to classify a lease as sales-type. Under Topic 842, a sales-type lease results when a lease meets one of the five criteria for finance lease classification (see p. 8).

Please note that for a sales-type lease, the lessor must transfer control (as defined in Topic 606) of the underlying asset to the lessee. Therefore, a lessor cannot recognize revenue unless the lease arrangement meets the revenue recognition conditions in Topic 606.

INTERNAL COSTS

One final impact to lessors from Topic 842 relates to what qualifies as an initial direct cost of entering into a lease arrangement. Topic 842 only allows incremental costs to be eligible for deferral. Thus, internal costs – even if associated with specified lease-origination activities – cannot be deferred as initial direct costs under Topic 842.

NARROW-SCOPE IMPROVEMENTS FOR LESSORS

The FASB did give additional guidance to lessors in ASU No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, which is expected to reduce a lessor's implementation cost and ongoing costs associated with applying Topic 842. Specifically, ASU No. 2018-20 addresses the following challenges lessors face when applying Topic 842:

- **Sales taxes and other similar taxes collected from lessees.** Lessors can elect not to evaluate whether certain sales taxes and other similar taxes are lessor costs or lessee costs. Instead, lessors who make this election will account for those costs as if they are lessee costs and exclude the costs from lease revenue and expenses. Lessors must disclose this election.

- **Certain lessor costs paid directly by lessees.** Lessors may exclude from variable payments – and thus exclude from lease revenue – lessor costs paid by lessees directly to third parties. However, the lessor is required to account for costs excluded from the consideration of a contract that are paid by the lessor and reimbursed by the lessee as variable payments. A lessor will record those reimbursed costs as revenue.

- **Recognition of variable payments for contracts with lease and nonlease components.** Lessors must allocate certain variable payments to the lease and nonlease components upon a change in the facts and circumstances that determine the variable payment. After the allocation, the amount of variable payments allocated to the *lease* components will be recognized as income in profit or loss in accordance with the new leasing guidance. The amount of variable payments allocated to *nonlease* components will be recognized in accordance with other accounting guidance, such as revenue from contracts with customers (Topic 606).

CLARIFICATION

- The FASB has issued ASU 2019-01, *Leases (Topic 842): Codification Improvements*, to clarify that lessors should classify all principal and interest payments received under a lease within the investing section of the statement of cash flows.

- ASU 2019-01 also clarifies that determining fair value of the underlying asset by a lessor (that is not a manufacturer or dealer) at lease commencement is its cost, reflecting any volume or trade discounts that may apply. However, if there has been a significant lapse of time between when the underlying asset is acquired and when the lease commences, the definition of fair value (found in Topic 820, *Fair Value Measurement*) should be applied within the scope of Topic 842.

Donated Rent and Below-Market Leases

Certain situations are similar to a lease but do not meet the new definition of a lease. For example, unconditional promises to give the use of a building or other long-lived asset, in which the donor retains legal title, may be similar to a lease but have no lease payment required. Under the new leasing standards, a lease is defined as a contract, or part of a contract, that conveys the right to control the use of identified property and equipment for a period of time in exchange for consideration. Thus, such promises are not within the scope of the leasing standard, since no consideration has been exchanged.

The entity receiving the donated use of the long-lived property would have to look at the applicable section of the codification when recording contributions:

- A not-for-profit entity that receives a contribution of the use of property or facilities, in which the donor retains legal title to the assets, should record the fair value of the use of the property as contribution revenue in the period in which the contribution is received, and as expense in the period when the property or facilities are used (FASB ASC 958-605-55-23 and ASC 958-605-25-2).

However, many leases do not contain a known or calculable rate. In these circumstances, the lessee should apply the incremental borrowing rate, which is defined in the new guidance as *the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.* Since researching and documenting a supportable conclusion takes some time and effort, the FASB provides an election to private companies to bypass the incremental borrowing rate determination and select the current market risk-free rate for all leases.

In other instances, a lessee may receive below-market leases (i.e., required lease payments are below the market rate for similar leases). When calculating ROU assets and lease liabilities, organizations should not include the fair rental value of donated use of facilities that exceeds the stated lease payments. Again, a contract is considered a lease only if the right to control the asset is exchanged for consideration. Consideration, as defined in the leasing standard, should only include cash or other assets exchanged in the transaction as well as noncash consideration (subject to certain exceptions). The below-market portion (donated rent) would be recorded as a contribution and recognized in accordance with FASB ASC 958-605.

Appendix A: Effective Dates

The effective dates of Topic 842 are:

ENTITY TYPE	EFFECTIVE DATE
Public business entities	Fiscal years, and interim periods within those fiscal years, beginning after Dec. 15, 2018
Not-for-profit entities that have issued, or are conduit bond obligators for, securities that are traded, listed, or quoted on an exchange or over-the-counter market	
Employee benefit plans that file or furnish financial statements to the SEC	
Private companies and other nonpublic entities	Fiscal years beginning after Dec. 15, 2020, and interim periods within fiscal years beginning after Dec. 15, 2020. Early adoption is permitted.

TRANSITION METHOD

When the FASB first issued the new lease standard in February 2016, it required a modified retrospective adoption that would require all periods presented in the financial statements to be restated. After listening to feedback, the FASB provided an amendment in 2018 adding an additional transition method. Entities may now elect to apply the guidance as of the effective date, instead of the beginning of the earliest comparative period presented. Using this method, entities will recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption.

Example: If an entity is adopting Topic 842 as of Jan. 1, 2020, the standard will be applied to leases existing as of Jan. 1, 2020, as well as any leases commencing thereafter.

- The entity would recognize ROU assets and lease liabilities for the present value of minimum lease payments as of Jan. 1, 2020, with no adjustments to the 2019 financial statements.
- The entity would recognize a cumulative-effect adjustment to the opening balance of retained earnings on Jan. 1, 2020.
- Disclosures would be presented based on the previous guidance for 2019 and based on Topic 842 for 2020.

PRACTICAL EXPEDIENTS

The FASB has offered some relief in implementing the transition guidance. Entities, whether lessor or lessee, can elect not to reassess:

- Whether any expired or existing contract is (or contains) a lease
- The lease classification of any expired or existing leases
- Initial direct costs for any existing leases

If an entity elects the above practical expedients, it must elect them as a package, and the election must be applied consistently to all leases. These practical expedients may not be individually elected.

Appendix B: Disclosures

The FASB has introduced new note disclosure requirements related to leases (in **bold**), while also retaining some of the existing disclosures.

All entities are required to disclose information about the following:

- The nature of the entity's leases, including:
  - General description of the entity's leases
  - Basis and terms and conditions on which any variable lease payments are determined
  - Existence and terms and conditions of any options to extend or terminate the lease
  - Residual value guarantees
  - Restrictions or covenants imposed by leases
- **Leases that have not yet commenced**
- **Significant assumptions and judgments made in applying Topic 842, including:**
  - **Determination of whether a contract contains a lease**
  - **Allocation of the consideration in a contract between lease and nonlease components**
  - **Discount rate assigned**
- Amounts recognized in the financial statements, including:
  - Finance lease cost
  - Operating lease cost
  - Short-term lease cost
  - Variable lease cost
  - Sublease income
  - Net gain or loss from sale-and-leaseback transactions
  - **Cash paid for amounts included in measurement of lease liabilities**
  - **Supplemental noncash**
  - **Weighted-average remaining lease term**
  - **Weighted-average discount rate**
- Related-party lease arrangements
- **Practical expedients applied to:**
  - **Short-term leases**
  - **Separating lease components**
- Maturity analysis for lease obligations

In addition, lessors are required to disclose the following:

- The nature of the entity's leases, including:
  - General description of the entity's leases
  - Basis and terms and conditions on which any variable lease payments are determined
  - Existence and terms and conditions of any options to extend or terminate the lease
  - Existence and terms and conditions of any options for a lessee to purchase the underlying asset
- **Significant assumptions and judgments made in applying Topic 842, including:**
  - **Determination of whether a contract contains a lease**
  - **Allocation of the consideration in a contract between lease and nonlease components**
  - **Determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term**

- How the lessor manages its risk associated with the residual value of the entity's leased assets, including:
  - Risk management strategy for residual assets
  - Carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor)
  - Any other means by which the lessor reduces its residual asset risk (for example, buyback agreements or variable lease payments for use in excess of specified limits)
- Additional quantitative and qualitative disclosures depending the type of lease (sales-type, direct financing or operating)

INDIANAPOLIS
800 East 96th Street, Suite 500
Indianapolis, IN 46240
TEL 317.580.2000

FORT WAYNE
202 East Berry Street, Suite 600
Fort Wayne, IN 46802
TEL 260.496.8297

LOUISVILLE
9850 Von Allmen Court, Suite 201
Louisville, KY 40241
TEL 502.909.7848

NEW YORK
7 Penn Plaza, Suite 1500
New York, NY 10001
TEL 212.557.9800

OKLAHOMA CITY
12316 St. Andrews Drive, Suite B
Oklahoma City, OK 73120
TEL 317.580.2400

KSM KATZ SAPPER & MILLER

ksmcpa.com