Heads Up | Volume 27, Issue 21
September 28, 2020

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FASB Holds Public Roundtable to Discuss Lease Implementation Topics

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Overview

On September 18, 2020, the FASB held two public roundtables to discuss challenges with implementing ASC 842.[1] These roundtables are part of the FASB's broader effort to solicit feedback from stakeholders on difficulties with applying or interpreting the new leasing guidance. Present at the roundtables were all FASB board members, members of industry groups, preparers (from both public and private companies), users, and representatives from accounting firms (both large firms and private-company auditors). Representatives from the SEC and PCAOB staffs also observed the meeting.

Roundtable participants discussed the following five topics identified by the FASB staff (the "Staff") through its outreach efforts:

- Topic 1 — Lessee Application of Rate Implicit in the Lease.
- Topic 2 — Lessee Application of Incremental Borrowing Rate.
- Topic 3 — Embedded Leases.
- Topic 4 — Lease Modifications.
- Topic 5 — Lessee Allocation of Fixed and Variable Payments.

To facilitate the discussion, the Staff provided a roundtable handout summarizing, for each topic, the background, relevant guidance, and feedback the Staff received from outreach efforts before the roundtable. The handout also addresses potential proposed solutions as

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

applicable. The sections below give an overview of each topic and summarize the related roundtable discussion.

Generally, participants expressed hesitancy about changing the standard in a manner that would increase the complexity or effort for public business entities (PBEs) that have already adopted ASC 842 in accordance with the existing requirements. However, there appeared to be some appetite for new options that would ease certain burdens of applying ASC 842. There was some focus on considering private-company adoption of ASC 842, particularly in areas where larger public companies have observed challenges or unanticipated complexity.

Next Steps

On the basis of the feedback received during the roundtable discussion, the Staff will draft proposed action steps for each topic, which may include conducting additional outreach, issuing educational materials or interpretive guidance, proposing standard-setting activity, or taking no further action (i.e., current U.S. GAAP remains unchanged and no additional clarification is required). The Board will discuss the Staff's recommendations at a future Board meeting.

The Staff also gave roundtable participants an opportunity to raise other topics for the FASB's consideration that are not reflected in the Staff's handout. These topics included (1) related-party leases, (2) useful lives of leasehold improvements, and (3) diversity in practice related to multiple acceptable cash flow presentation methods.

Topic 1 — Lessee Application of Rate Implicit in the Lease

Background

ASC 842-20-30-3 requires a lessee to use the rate implicit in the lease as an input in its lease liability measurement if that rate is "readily determinable." If that rate is not readily determinable, the lessee will use its incremental borrowing rate (IBR). ASC 842 defines the "rate implicit in the lease" as follows:

> The rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) **the amount that a lessor expects to derive from the underlying asset following the end of the lease term** to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) **any deferred initial direct costs of the lessor**. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used. [Emphasis added]

The phrase "readily determinable" has been interpreted as a high hurdle. The boldface text in the definition refers to lessor-specific assumptions that generally will not be considered readily determinable from the lessee's perspective. That is, the lessee typically has limited visibility into the lessor's actual inputs used to calculate the precise rate. The result in practice is that most lessees use the IBR as the discount rate.

Some have observed the inconsistency that ASC 842 prioritizes the rate implicit in the lease (since a lessee is required to use that rate if it is readily determinable); however, there are limited scenarios in which lessees actually will be able to readily determine the rate implicit in a lease.

The roundtable handout presents the following three alternatives in response to this issue:

(a) Alternative A — No change to Topic 842

(b) Alternative B — Eliminate the requirement for lessees to consider the implicit rate in Topic 842

(c) Alternative C — Provide an option in Topic 842 for lessees to use the implicit rate (with a default to IBR).

Summary of Discussion

Stakeholders at the roundtable discussion generally agreed that no change to ASC 842 is required for this topic. Most large accounting firms observed that they are not frequently receiving questions on how to apply the phrase "readily determinable" in practice, and preparers mostly agreed that they have not struggled with applying this phrase. However, some expressed the view that a lack of questions on this topic does not necessarily mean that preparers would not prefer to be able to use the rate implicit in the lease. While most participants agreed that they would prefer not to change existing GAAP, some either supported or were not opposed to an *option* for lessees to determine and use the rate implicit in the lease (Alternative C), which would involve estimating lessor inputs, because such an option would provide financial reporting results that are more faithful to the economics of the underlying transaction. These individuals argued that enhanced financial reporting in these scenarios would outweigh the decrease in comparability that would result from introducing optionality. In addition, stakeholders generally agreed that the rate implicit in the lease can be readily determined when the lessee knows all material inputs in the model (e.g., initial direct costs are immaterial).

Topic 2 — Lessee Application of Incremental Borrowing Rate

Background

As discussed in Topic 1, in most cases, lessees cannot readily determine the rate implicit in the lease and therefore use the IBR as the discount rate for lease accounting purposes. In the roundtable handout, the Staff asserts that entities that have adopted ASC 842 have spent considerable time and expended significant effort in applying the guidance on determining the IBR.

The Board previously acknowledged the potential time and effort related to estimating the IBR by creating an accounting policy election under which non-PBE lessees have the option of using a risk-free rate, determined by using a period comparable to that of the lease terms. Some stakeholders have expressed concern about the use of the risk-free rate in the current economic environment, since risk-free rates are historically low (which may, in turn, cause artificially high lease liabilities and decrease the usefulness to financial statement users).

Given both (1) the costs incurred by preparers in determining the IBR and (2) the concerns regarding the use of a risk-free rate by non-PBEs, the roundtable handout proposed for discussion whether both PBEs and non-PBEs should be permitted to use some other specified rate.

In considering the appropriateness of this potential option, the Staff observed that in other areas of GAAP, discount rates have generally been interpreted to be specific rates in practice. For example, in practice, AA rates have generally been used to apply ASC 715-30 on pension accounting and A rates have typically been employed to apply ASC 944-40 on accounting for claim costs and the liability for future policy benefits associated with long-duration contracts. The use of a specific rate would reduce the cost and complexity for preparers and increase consistency, since entities would be able to identify the applicable rate through easily accessible, publicly quoted sources. The use of a specific rate would generally not affect earnings on operating lease agreements, since the lessee recognizes the single lease cost of the total undiscounted lease payments on a straight-line basis over the lease term. However, the use of a specific rate would affect earnings for a finance lease.

The Staff considered, however, that the conceptual basis for the IBR is preferable. In addition, the Staff noted that although it may be costly to initially develop the process of estimating the IBR, a significant amount of those costs may be isolated to the year of adoption as entities develop new processes and controls related to determining the IBR.

On the basis of the considerations outlined, the roundtable handout presents two alternatives in response to this issue:

(a) Alternative A — No changes to Topic 842

(b) Alternative B — Provide an option that allows all lessees (PBEs and [non-PBEs]) to use a specific rate instead of IBR.

Summary of Discussion

Roundtable participants generally expressed the view that current requirements related to the IBR should not change for public companies and that they would not prefer incremental guidance or examples from the FASB in this area. Preparers indicated that the cost of creating new processes for determining the IBR was greater than they had initially expected. However, they anticipated that the postimplementation cost would not be as significant because of the investment in the processes during adoption. Financial statement users indicated that they use the disclosure of an entity's IBR in evaluating and comparing different entities.

However, most participants were in favor of adjustments to the standard for non-PBEs. Most supported amending ASC 842 to allow non-PBEs to elect to use the risk-free rate on an asset-class basis rather than for the entity as a whole. There was discussion acknowledging that the non-PBE option to use the risk-free rate provides for the use of an arbitrary rate without any conceptual basis. Most participants therefore supported the Board's consideration of whether a different specific rate may be more appropriate for use by non-PBEs as an accounting policy election on an asset-class basis.

Topic 3 — Embedded Leases

Background

As entities have adopted ASC 842, they have reported spending significant time in identifying and accounting for leases embedded in their contracts. The requirement in ASC 842 to identify embedded leases is not new; however, because ASC 842 requires entities to recognize operating lease assets and liabilities on the balance sheet at lease commencement, the failure to appropriately identify and account for embedded leases has a greater financial statement impact.

A contract is or contains a lease under ASC 842 if it conveys the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration.[2] In a manner consistent with that definition, entities are required to determine whether service contracts that involve the use of specified plant, property, or equipment contain an embedded lease (e.g., a lease of mainframes embedded in a cloud computing services contract). Because of the large number of potential contracts and the manual nature of evaluating whether an embedded lease exists, this can be a costly exercise for preparers.

Many entities have established capitalization thresholds below which lease assets and lease liabilities are not recognized. The Board has acknowledged that this approach is acceptable and should reduce the costs of applying the guidance.[3] Therefore, an entity generally would not be required to identify and account for an immaterial embedded lease if the associated right-of-use asset and lease liability were below an entity's established capitalization threshold.

[2] See ASC 842-10-15-3 through 15-5 for the definition of a lease.

[3] See paragraph BC122 of FASB Accounting Standards Update No. 2016-02, *Leases*.

However, the Board is exploring whether further adjustments should be made to exclude some embedded leases from certain ASC 842 requirements. The roundtable handout presents the following alternatives:

- "Alternative A — No change to Topic 842."
- "Alternative B — Option to not apply Topic 842 on the basis of a *qualitative* threshold." The Board raised various potential options for a qualitative threshold (e.g., if the nonlease component is "predominant" or the nonlease component represents "substantially all" of the contract).
- "Alternative C — Option to not apply Topic 842 on the basis of a *quantitative* threshold." A quantitative threshold would function similarly to that in IFRS 16, *Leases*, which allows the lessee to elect not to apply lease accounting if the value of the underlying asset, when new, is $5,000 or less.[4]

Alternatives B and C would diverge from one of the key concepts of ASC 842, which is that most leases are analogous to financing arrangements and, therefore, that both the underlying asset and the implied debt associated with obtaining the underlying asset should be recognized on the balance sheet. In addition, any relief provided would only be relief from the recognition and measurement of the embedded leases. An entity would still be required to (1) perform an evaluation to identify potential embedded leases and (2) assess whether the embedded leases must be recognized. Thus, the roundtable handout questions whether the proposed solutions would actually reduce costs for preparers, especially since entities already consider the capitalization threshold concept.

Summary of Discussion

Large firms that participated in the roundtable were generally not in favor of amending U.S. GAAP on identifying embedded leases. Although many participants acknowledged the significant effort required to evaluate contracts and identify potential embedded leases, there was no consensus on how to best reduce the cost and complexity associated with the requirements.

There was some sympathy for implementing a quantitative threshold, with participants favorably observing that such a change would increase convergence with IFRS Standards®. However, some observed that allowing for a specific quantitative threshold similar to the IFRS exception may not be particularly helpful to preparers and that the implementation of such a threshold may be duplicative with the implementation of the capitalization thresholds already established. In addition, any threshold implemented by the FASB would potentially need to be updated over time. Some noted, however, that entities have an obligation to demonstrate and document the appropriateness of an established capitalization threshold, which would not be the case if a quantitative threshold was specifically written into the standard.

Some participants affiliated with non-PBEs supported a qualitative threshold but acknowledged that this option is likely to further increase the cost and complexity of the standard since preparers and auditors would need to apply greater judgment in assessing whether an arrangement qualifies for the qualitative exception.

Participants expressed some concern that the use of either a quantitative or a qualitative threshold may create an incentive for an entity to structure a contract to preclude an arrangement from being within the scope of ASC 842.

Finally, there was discussion regarding the definition of a lease more broadly and whether certain contracts that meet the definition currently are conceptually appropriate. Specifically, participants discussed whether an underlying asset operated by the lessor could be

[4] Paragraph 5(b) of IFRS 16 allows an entity not to apply IFRS 16 to "leases for which the *underlying asset* is of low value." See paragraphs B3–B8 of the standard for information on how to assess whether an asset is of low value.

considered under the control of the lessee and therefore result in the identification of a lease. However, most of the participants did not support amending the U.S. GAAP definition of a lease.

Topic 4 — Lease Modifications

Background

ASC 842 requires an entity to reassess whether a contract is or contains a lease in the event of a lease modification. The standard defines "lease modification," in part, as a "change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease." If the modified contract is or contains a lease, the entity analyzes whether the modification should be accounted for as a separate contract or a continuation of the existing contract.[5]

When the modification is not accounted for as a separate contract, a lessee is required to reassess lease classification, remeasure its lease liability (which includes updating the discount rate as of the effective date of the modification), and reallocate consideration in the contract by using updated stand-alone prices as of the effective date of the modification. Similarly, if a modification is not accounted for as a separate contract for a lessor, a lessee will also need to reassess lease classification and reallocate consideration in the contract.

The roundtable handout notes that the Staff has received feedback from stakeholders indicating that it is complex to apply the modification framework because of the requirement to reassess lease classification and update the assumptions used in measuring the lease liability. In addition, preparers have highlighted that the modification framework sometimes results in an outcome that does not faithfully represent the nature of the underlying transaction, such as (1) situations in which a minor modification results in a change to a lease's classification solely as a result of the passage of time or (2) when there is a partial reduction of a lease component (or multiple lease components) in a contract and the remaining lease components are economically unaffected by that termination. Further, some have observed that the requirement to reassess the discount rate assumption in a modification can be burdensome for lessees.

Unlike the other topics on the roundtable agenda, this topic did not offer any specific potential alternatives to current U.S. GAAP. Rather, the Staff sought feedback from roundtable participants on matters identified within the modification framework. These matters included the following:

- Certain reductions within the scope of a lease contract (e.g., a master lease agreement). (Note that the Board is currently considering this topic separately.[6])
- Requiring entities to reassess lease classification and update assumptions upon a modification that does not create a separate contract (e.g., reductions in lease term).
- Accounting for termination penalties.
- Whether modification accounting should be required for "minor" modifications.

[5] ASC 842-10-25-8 stipulates that an entity should account for a modification as a separate contract when both (1) the modification grants an additional right of use and (2) the lease payments associated with the additional right of use are commensurate with the stand-alone selling price.

[6] For more information on this project, see Deloitte's summary of the July 29, 2020, Board meeting and the Tentative Board Decisions on the FASB's Web site.

Summary of Discussion

A few general themes emerged during the discussion of this topic:

- All stakeholders supported the FASB's exploration of potential ways to simplify the existing modification guidance to reduce the cost and complexity of applying the standard.
- Stakeholders generally agreed that the modification framework under ASC 842 represents an improvement over the guidance under ASC 840 and did not recommend that the Board revert to the legacy guidance.
- Certain large firms acknowledged that the issues identified by the Staff in this topic and the forthcoming exposure draft are interrelated and cautioned the FASB against making piecemeal updates to the standard without first evaluating the impact of any change on the modification framework more broadly.
- Certain large firms also noted that a change to the standard may be appropriate but advised the Board to consider the impact of such a change on convergence with IFRS 16 and consistency with other U.S. GAAP standards (such as ASC 606 for lessors).
- Preparers with large lease portfolios indicated that they have generally found it difficult and costly to apply the modification framework at scale, including the requirement to revisit the stand-alone prices (or stand-alone selling prices) for lease and nonlease components upon modification.
- Preparers also specifically highlighted concerns over the requirement to reassess lease classification and scenarios in which a lease's classification changes in a modification solely as a result of the passage of time. Preparers argued that this phenomenon creates operational complexities and financial reporting results that are difficult for users to interpret, given that the change in classification is divorced from the economics of the transaction itself (i.e., it is solely due to the impact of the passage of time on the lease classification test and is not a fundamental change in the arrangement). Board members acknowledged that this consequence was unintended.

As discussed above, all stakeholders agreed that they would support the Board's moving forward with exploring how to reduce the cost and complexity for preparers in applying the modification framework. However, the discussion did not focus on *how* the framework should change to accomplish that objective. Representatives of the large firms discussed and generally supported a simplified model for "minor" modifications. Preparers were also receptive to this idea but questioned how a simplified model could be employed within their systems and processes and whether "minor" should be a quantitative or event-based threshold.

Topic 5 — Lessee Allocation of Fixed and Variable Payments

Background

ASC 842 requires a lessee to identify the separate lease and nonlease components of a contract and allocate the total consideration provided in that contract to each of those components on the basis of their respective stand-alone prices. In situations in which a lease contract has lease and nonlease components along with variable and fixed payments, the application of the guidance can be difficult and, some have argued, can result in accounting that potentially does not reflect the economics of lease transactions.

For example, an agreement may allow the lessee to lease multiple floors of an office building and receive common-area maintenance (CAM) services from the lessor. The agreement may specify a fixed payment amount for the use of the office building, whereas the payment for CAM services may be variable on the basis of the lessor's incurred costs. In this example, the lessee would generally be required to (1) identify the relative stand-alone price for the floors of the building and the CAM services and (2) allocate both the fixed and variable payments to each of the lease and nonlease components on the basis of their respective stand-alone prices.[7] Entities have reported system challenges in appropriately coding a split for variable payments because they are generally processed within a lessee's procurement system (rather than its lease accounting system), and the requirement to split the payments between multiple general ledger accounts is often manual and not intuitive. Stakeholders have also questioned whether allocating the variable payments to both the lease and nonlease components reflects the economics of the arrangement if the variable payment is economically aligned only with a single component (e.g., the CAM services).

Therefore, the Staff questioned whether ASC 842 should be amended to require the allocation of fixed and variable payments solely to a lease or nonlease component if certain conditions are met. For example, if, in accordance with the contractual terms, a payment is related solely to a particular component and the amount of allocation represents the stand-alone price of that component, an entity would be required to allocate the payment to the associated component on the basis of the contractual terms (rather than allocating it to all of the lease and nonlease components in the contract).

Stakeholders have pointed out that the lessor guidance in ASC 842 is aligned with ASC 606 and allows for variable payments to be allocated entirely to the nonlease component(s) to which the variable payment is specifically related in certain circumstances.[8] The Board previously addressed this divergence, indicating that it is not appropriate for lessees to apply the revenue guidance in ASC 606 because they are customers rather than suppliers. Moreover, at the time, the Board indicated that the allocation guidance in ASC 842 for lessees was less complex and more intuitive than the allocation guidance under ASC 606.[9]

ASC 842 already provides lessees with a practical expedient to combine lease and nonlease components and account for the entire contract as a lease, which eliminates the operational burden of allocating payments between lease and nonlease components. On the basis of outreach to stakeholders, a significant majority of PBE lessees have elected that expedient. Accordingly, it is unclear whether an amendment to ASC 842 is necessary.

The roundtable handout presents the following alternatives in response to this issue:

(a) Alternative A — Amend lessee allocation guidance

(b) Alternative B — No changes to Topic 842.

Summary of Discussion

Preparers that participated in the roundtable and have already adopted ASC 842 were not in favor of U.S. GAAP changes in this area. They noted that most had adopted the practical expedient to combine lease and nonlease components for asset classes for which the lease components were expected to be greater than their capitalization thresholds. These preparers expressed concern that changes to existing guidance would be difficult and costly to implement retrospectively and that prospective adoption would cause comparability concerns for a significant period given the length of many lease contracts. Public-company preparers indicated that if the amended guidance continued to allow for the combination of lease and nonlease components, they would continue to make that election and would not change their current accounting methods.

Private-company preparers asserted that the allocation framework is not intuitive and is difficult to implement. These preparers expressed their belief that one of the reasons entities have elected to combine lease and nonlease components is that the allocation guidance is

7 Note that the requirement to allocate consideration to lease and nonlease components is only applicable if an entity has **not** elected the practical expedient to combine components under ASC 842-10-15-37.

8 See ASC 842-10-15-39.

9 See paragraph BC156 of ASU 2016-02.

very difficult to understand and implement. They argued that if the allocation guidance for lessees is aligned with the allocation objective in ASC 606, more entities would be able to separate lease and nonlease components and financial reporting would improve as a result.

Large firms generally seemed to believe that a change to align the allocation guidance for lessees with ASC 606 was conceptually supportable but that such a change may not be necessary because they expected most entities to adopt the practical expedient to combine lease and nonlease components.

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