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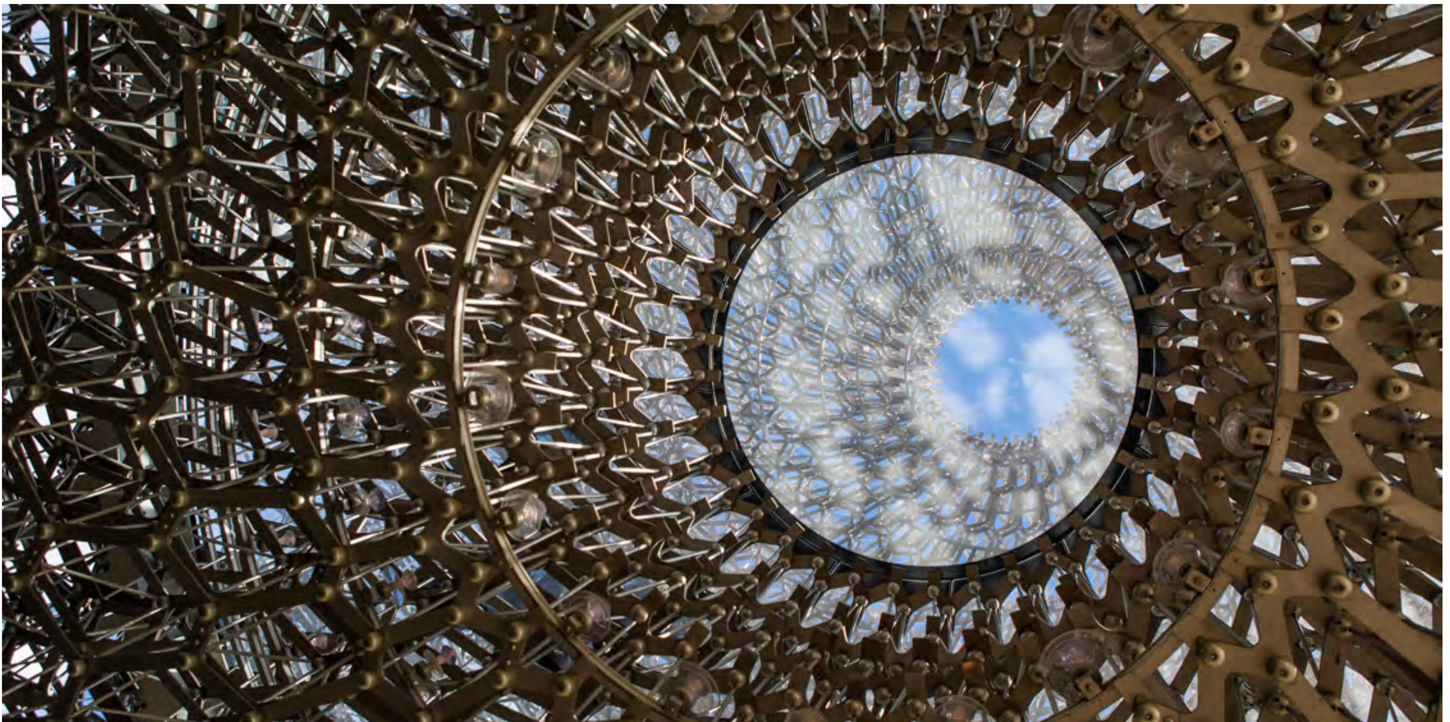

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At "Lease" There Are Answers to Transition Questions

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Introduction

With less than three months to go before the leasing guidance in ASC 842[1] becomes effective for public companies,[2] entities are increasing their focus on transition accounting. The purpose of this *Heads Up* is to provide our views on certain transition issues on which we regularly receive questions and that will have a direct impact on the transition entries recorded by affected companies. Two of the issues have been discussed with the FASB and SEC staffs and may increase flexibility for preparers depending on their historical accounting and materiality. Topics addressed in this *Heads Up* include the interim reporting requirements associated with early adoption (including adoption in the fourth quarter of 2018); the determination of the lease obligation for existing operating leases; and the nuances of historical build-to-suit accounting, including the implications of historical impairments. This publication also addresses implications of historical cease-use events as well as a common scenario in the retail industry, in which a company has an ASC 420 liability as of the adoption date that exceeds the amount of the right-of-use (ROU) asset that would otherwise be recognized in transition.

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

2 Public companies include public business entities (PBEs) and certain not-for-profit entities and employee benefit plans, as further defined in ASC 842-10-65-1(a).

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This *Heads Up* is divided into two parts. The body of this publication provides a high-level summary of each of the transition issues. The appendix contains Q&As that comprehensively address each of these issues as well as our views on them.[3]

For more information about transition issues related to the adoption of ASC 842, see Chapter 16 of Deloitte's *A Roadmap to Applying the New Leasing Standard*. Readers with any other questions about ASC 842 should also consult this Roadmap, which serves as a comprehensive guide to the new leasing guidance.

Q&A 1 Early Adoption of ASC 842 in an Interim Period Other Than the First Interim Period in a Fiscal Year

For PBEs, as well as certain not-for-profit entities and employee benefit plans, the guidance in ASC 842 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018 (e.g., for calendar-year-end entities, annual periods beginning on January 1, 2019). The guidance allows for early adoption in an interim period. ASC 842 does not address whether an entity is permitted to early adopt the guidance in an interim period other than the first interim period in a fiscal year, nor does it specifically prohibit early adoption in any interim period in a fiscal year. We believe that an entity may elect to early adopt the guidance in an interim period other than the first interim period in a fiscal year and that, if elected, the early adoption should be reflected as of the beginning of the annual period.

Q&A 2 Identifying Minimum Rental Payments

In the transition to ASC 842, the lease obligation for an operating lease is typically measured by using the remaining minimum rental payments, as described in ASC 840. ASC 840 does not define the term "minimum rental payments," but the Background Information and Basis for Conclusions (BC) in ASU 2016-02[4] indicates that the application of this term should be similar to that under prior guidance. However, under ASC 840, there is diversity in practice related to how an entity quantifies minimum rental payments when preparing the disclosure of future commitments under operating leases (i.e., how to quantify lease payments that depend on an index or rate and whether to include or exclude executory costs), as described in Q&As 3 and 4, respectively.

Q&A 3 Operating Lease Payments That Fluctuate on the Basis of a Variable Rate or Index — Transition Considerations

In transitioning its operating leases under ASC 840 to the new leasing guidance under ASC 842, a lessee must measure its lease liabilities as of the date of initial application by using the remaining minimum rental payments under ASC 840. Diversity in practice exists with respect to the variable index or rate used in the disclosure of future operating lease payments (i.e., the "lease commitments table") under ASC 840, since some entities have historically used an updated index or rate (i.e., a new/current rate each time the disclosure is prepared), while others have used the index or rate that existed at lease inception without updating it.

On the basis of formal discussions with the SEC staff, either historical approach is acceptable and it would be appropriate for a lessee to use the same approach for initial application of ASC 842 as it has historically used for disclosure purposes under ASC 840. An entity that wishes to change from its historical approach may be able to do so on the basis of various

[3] As with many other interpretive questions associated with ASC 842, there may be other facts and circumstances related to these issues that were not contemplated. An entity should carefully interpret the views in this publication, and we encourage affected companies to discuss these views with their accounting advisers and auditors.

[4] FASB Accounting Standards Update No. 2016-02, *Leases*.

factors (e.g., materiality of the historical policy to the overall financial statements, the direction of the change, and the basis for the change). The following are some related considerations:

- If an entity changes its historical approach from using the inception rate to using an updated rate, and the historical approach represents a material accounting policy, preferability is required and the entity must retrospectively apply the change in accordance with ASC 250. A change in this direction would generally be viewed as preferable.
- If an entity historically updated the rate for disclosure purposes, the entity may change to using the inception rate without needing to perform a preferability assessment. A change in this direction is consistent with formal feedback received from the FASB staff.
- If, on the basis of materiality, the historical disclosure approach is not considered an elected accounting policy, an entity could change the approach without establishing preferability and is not required to reflect the change in prior periods.

Join us on October 23 at 2:00 p.m. ET for a ***Dbriefs* webcast**, "Public company lease accounting: Time for the final sprint."

Q&A 4 Approaches to Accounting for Executory Costs for Operating Leases in Transition

Under ASC 840, it was acceptable for an entity to include executory costs in, or exclude them from, the disclosure of minimum rental payments for operating leases. The FASB staff has generally indicated that a lessee would use its ASC 840 disclosure approach to determine the lease payments when establishing its lease liability upon adopting ASC 842 and would "run off" the balance. On the basis of discussions with the SEC staff, it would be appropriate for a lessee to use the same approach for initial application of ASC 842 as it has historically used for disclosure purposes under ASC 840. An entity that wishes to change its historical approach may be able to do so when making the transition to ASC 842. Some key considerations related to this issue are as follows:

- If the inclusion (exclusion) of executory costs does not have a material impact on the financial statements, a lessee may change its treatment of executory costs before or upon adopting ASC 842 without assessing preferability.
- If an entity's historical approach related to executory costs has a material impact on its financial statements, it will generally represent the election of an accounting policy. Such a change must be applied retrospectively to all periods presented under ASC 840.
- We do not believe that it would be appropriate (depending on the materiality of the impact on the financial statements) for a lessee to change its ASC 840 disclosure approach for executory costs in a manner that reduces comparability to its ASC 842 accounting, including the impact of the lessee's election to include nonlease components in, or exclude them from, the lease liability under ASC 842.[5]

Q&A 5 Derecognition of Existing Build-to-Suit Assets and Liabilities in Transition

The build-to-suit transition guidance specifies that any build-to-suit assets and liabilities recognized under ASC 840 should be derecognized in transition. An entity is not required to assess ASC 842's principles of control during the comparative periods (regardless of whether the lessee was the deemed owner under ASC 840) as long as construction is complete and the lease commenced before ASC 842's effective date. This is true regardless of whether an entity

[5] A lessee may elect, as an accounting policy for each underlying asset class, not to separate lease and nonlease components (which include costs characterized as executory costs under ASC 840) on the effective date. We believe that an entity may elect this policy for either (1) both the existing lease population and new or modified leases or (2) only new leases or modified leases. An entity electing the practical expedient can apply it to all existing leases, regardless of the entity's prior treatment of executory costs under ASC 840, without being subject to the preferability requirement in ASC 250. See Q&A 4 in the appendix for further discussion.

elects the Comparatives Under 840 Option.[6] Therefore, the lessee should (1) derecognize any build-to-suit assets and liabilities that were capitalized *solely as a result* of the lessee's being the deemed accounting owner and (2) recognize the difference, if any, in equity. Note that lessee-paid costs that were included in the build-to-suit asset may not have been capitalized *solely as a result* of the build-to-suit designation and therefore should be retained (and perhaps recharacterized) in transition. For example, costs considered prepaid lease payments or payments for lessee-owned improvements would not be derecognized through equity upon transition. This Q&A discusses the derecognition requirements and contains examples illustrating the application of these requirements.

Q&A 6 Accounting for a Previously Impaired Build-to-Suit Asset

Under ASC 840, a build-to-suit asset and financing obligation may be recognized on a lessee's balance sheet as a result of a transaction's build-to-suit designation. Under this deemed ownership model, entities looked to the impairment guidance in ASC 360, which may have resulted in the recognition of historical impairment charges related to a build-to-suit asset. As discussed in Q&A 5, the build-to-suit transition guidance specifies that any build-to-suit assets and liabilities recognized under ASC 840 should be derecognized in transition unless the lease has yet to commence as of the effective date and the lessee controls the construction effort in accordance with ASC 842. ASC 842 addresses lease measurement related to situations in which an ASC 420 liability has been previously recorded for an operating lease but does not discuss historical ASC 360 impairments for build-to-suit arrangements that will be accounted for as leases under the new guidance. As a result, entities have questioned how previous impairment charges recognized on a build-to-suit asset should be treated in transition given that the asset to which the impairment is related will be derecognized upon adoption of ASC 842 and replaced by an ROU asset. Specifically, entities have asked whether the prior impairment should affect the measurement of the new ROU asset and, if so, how.

To the extent that a historical impairment was recognized and the impairment indicator or indicators continue to exist as of the transition date, we believe that a lessee should subject a newly recognized ROU asset to a full impairment test in accordance with ASC 360 as of the effective date of ASC 842. Accordingly, a lessee would determine a "new" impairment amount on the basis of the impairment test conducted as of the effective date.

Q&A 7 Transition Considerations Related to Lease Measurement When an Entity Ceases Use of a Leased Asset Before the Adoption of ASC 842

Under ASC 840, when an entity ceases use of an asset subject to an operating lease, the entity applies the guidance in ASC 420 to determine whether to recognize a liability for its costs related to terminating the operating lease and costs that will continue to be incurred without economically benefiting the entity, offset by assumed sublease income. In accordance with ASC 420, an entity would record the liability in this manner regardless of whether the lessee has the intent to sublease the asset.

Under ASC 420 and ASC 840, an entity is considered to have ceased use of an asset even if the entity has the intent and ability to sublease the asset. However, under ASC 842, the cease-use determination is no longer relevant; rather, an entity must determine whether the leased asset is abandoned in accordance with ASC 360.

Under ASC 842, we do not consider an ROU asset to be abandoned if an entity has ceased use of the underlying asset but is currently subleasing (or plans to sublease) the asset. An entity's receipt of sublease payments is considered as obtaining economic benefits from use

[6] FASB Accounting Standards Update (ASU) No. 2018-11, *Leases (Topic 842): Targeted Improvements*, amended ASC 842 so that entities may elect not to recast their comparative periods in transition (the "Comparatives Under 840 Option"). The ASU allows entities to change their date of initial application to the beginning of the period of adoption. See Deloitte's August 7, 2018, *Heads Up* for a detailed discussion of the Comparatives Under 840 Option.

of the underlying asset under ASC 842. However, if an entity ceases use of a leased asset before adopting ASC 842 and does not have the intent and ability to sublease the asset, the entity should not recognize an ROU asset upon adopting ASC 842. In that situation, to the extent that any associated ASC 420 liability is less than the carrying amount of the ROU asset that would otherwise be recognized to offset the corresponding lease liability, any remaining portion of the ROU asset not offset by the ASC 420 liability should be written off as an adjustment to equity.

Q&A 8 Initial Measurement of an ROU Asset When a Previously Recognized ASC 420 Liability Exceeds the Lease Liability Recognized in Transition

Before adopting ASC 842, a lessee may have recognized, in accordance with ASC 420, a liability for costs such as maintenance (including common-area maintenance (CAM)), insurance, and property taxes associated with an exit or disposal activity related to an operating lease. Upon adoption of ASC 842, after the lease liability and corresponding ROU asset are established, ASC 420 liabilities reduce the carrying amount of the ROU asset.[7] In certain circumstances, the carrying amount of a lessee's ASC 420 liability immediately before ASC 842's effective date for an existing operating lease may exceed the amount that would otherwise be recognized as the ROU asset as of the effective date (e.g., if the lessee's ASC 420 liability included CAM, insurance, and property taxes). We do not believe it would be appropriate for a lessee to recognize a negative ROU asset in transition. See Q&A 8 in the appendix for approaches that we believe are acceptable in this scenario.

[7] As discussed in Q&A 7, if an entity (1) has ceased using an asset before the adoption date of ASC 842 and that designation has not changed as of the adoption date and (2) does not have the intent and ability to sublease the asset as of the adoption date, we do not believe that it is appropriate for an entity to recognize an ROU asset upon adoption.

Appendix — Q&As on Transition Issues

Q&A 1 Early Adoption of ASC 842 in an Interim Period Other Than the First Interim Period in a Fiscal Year

For public companies,[8] the guidance in ASU 2016-02 (i.e., ASC 842) is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018 (e.g., for calendar-year-end entities, annual periods beginning on January 1, 2019). For entities other than public companies, the guidance is effective for annual periods beginning after December 15, 2019 (e.g., for calendar-year-end entities, annual periods beginning on January 1, 2020), and interim periods beginning after December 15, 2020. Early adoption is permitted for all entities.

Public companies are allowed to early adopt the guidance in an interim period. ASC 842 does not address whether an entity is permitted to early adopt the guidance in an interim period other than the first interim period in a fiscal year, nor does it specifically prohibit early adoption in any interim period in a fiscal year.

Question

Can a public company early adopt ASC 842 in an interim period other than the first interim period in a fiscal year and, if so, what are the reporting implications?

Answer

We believe that an entity may elect to early adopt ASC 842 in an interim period other than the first interim period in a fiscal year (e.g., as of October 1, 2018, the start of a calendar-year-end entity's fourth quarter). If elected, the early adoption should be reflected as of the beginning of the annual period in accordance with ASC 842-10-65-1(a), which indicates that ASC 842 is effective for public companies in interim periods within the annual period of adoption.

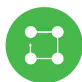
Further, we believe that, in the absence of any specific reference in an ASU's transition requirements to prospective adoption in an interim period, preparers should apply the guidance in ASC 250-10-45-14, which states:

> A change in accounting principle made in an interim period shall be reported by retrospective application in accordance with paragraphs 250-10-45-5 through 45-8. However, the impracticability exception in paragraph 250-10-45-9 may not be applied to prechange interim periods of the fiscal year in which the change is made. When retrospective application to prechange interim periods is impracticable, the desired change may only be made as of the beginning of a subsequent fiscal year.

Therefore, a calendar-year-end entity's early adoption of ASC 842 in the second, third, or fourth quarter of 2018 should be reflected as if the entity had adopted ASC 842 on January 1, 2018. Accordingly, **application of ASC 842 for the entire fiscal year** is required in such circumstances. As a result, in accordance with SEC Regulation S-K, Item 302(a), the selected quarterly financial data presented in the year-end 2018 Form 10-K must reflect the adoption of ASC 842. Further, when the entity subsequently presents 2018 comparative periods in the interim financial statements for the first, second, or third quarter of 2019, the 2018 comparative financial statements should reflect the application of ASC 842.

This answer is further supported by a recent discussion at the September 2018 Center for Audit Quality meeting, at which the SEC staff also discussed issues related to emerging growth companies (EGCs) that have elected to adopt ASC 606 (the "new revenue standard") by using non-PBE effective dates. The SEC staff confirmed that a calendar-year-end entity that loses its EGC status during 2018 would be required to report in its Form 10-K for 2018 the adoption of the new revenue standard as of January 1, 2018, by using the adoption date for public companies. In addition, such an entity will reflect the adoption of the new revenue standard in all quarterly periods for the year of adoption (and for the prior year if the retrospective method of adoption was selected) in its selected quarterly financial data, in accordance with SEC Regulation S-K, Item 302(a).

[8] See footnote 2.



Connecting the Dots

After the issuance of ASC 606, the SEC provided EGCs with an accommodation related to the adoption of the new revenue standard. Specifically, EGCs could elect to use the transition approach available to nonissuers (e.g., adoption as of January 1, 2019, for entities with a calendar year-end). In addition, like nonissuers, EGCs could choose **not to apply** the new revenue standard to interim periods within their elected annual periods of adoption. As indicated above, under the current guidance in ASC 842 and ASC 250, PBEs (which may include EGCs) are required to apply ASC 842 to interim periods in the year of adoption.

Paragraph 11110.2 of the SEC's Financial Reporting Manual (FRM) provides the following Q&A applicable to an EGC that uses the non-PBE adoption date for ASC 606 by adopting the standard for annual periods beginning on January 1, 2019, and interim periods beginning on January 1, 2020 (for calendar-year-end entities).

> ***Question***
>
> A calendar year-end EGC that has elected to follow accounting transition applicable to non-issuers elects to adopt ASU 2014-09 for annual periods beginning on January 1, 2019 and for interim periods within annual [periods] beginning on January 1, 2020. Must the company reflect adoption of the new revenue standard in the supplementary quarterly financial data (S-K Item 302(a)) contained in its 2019 annual report?
>
> ***Answer***
>
> No. The EGC need not accelerate application of the standard to interim periods for the sole purpose of reporting supplementary quarterly financial data.

While the relief that the SEC provided in paragraph 11110.2 of the FRM specifically applies to the adoption of ASC 606, the SEC may allow for relief for EGCs adopting ASC 842. However, in the absence of additional guidance from the SEC, we believe that an EGC should reflect the adoption of ASC 842 as of the beginning of the annual period in which the entity adopts ASC 842, including application to interim periods therein.

We encourage affected entities to monitor future developments related to this topic and to consult with their auditors and accounting advisers.

Q&A 2 Identifying Minimum Rental Payments

In the transition to ASC 842, the lease obligation for an operating lease is typically measured by using the remaining minimum rental payments, as described in ASC 840.

Question

What is included in minimum rental payments?

Answer

Although ASC 840 does not define the term "minimum rental payments," ASC 840-20-50-2 indicates that lessees must disclose future minimum rental payments as of the balance sheet date for operating leases that meet certain conditions:

> For operating leases having initial or remaining noncancelable lease terms in excess of one year, the lessee shall disclose both of the following:
>
> a. Future **minimum rental payments** required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years
>
> b. The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented. [Emphasis added]

The FASB has confirmed that the intent of requiring, in transition, lessees to measure operating leases by using the ASC 840 minimum rental payments is to ease the burden of determining the lease liability in transition. That is, in providing the above disclosure under ASC 840, a lessee should be able to determine the gross amounts due under the lease and discount those required payments to determine the initial lease liability under ASC 842. This is consistent with paragraph BC390 of ASU 2016-02, which states that the application of the term "minimum rental payments" should be similar to that under prior guidance.

We have noted diversity in practice related to two aspects of the disclosure of future minimum rental payments under ASC 840:

1. *Lease payments that depend on an index or rate* — Some entities have included the most current rate as of the balance sheet date when disclosing future minimum rental payments, whereas other entities have included the rate in effect at the inception of the lease. ASC 840-10-25-4 and 25-5 define what does or does not constitute a minimum lease payment (as opposed to a minimum "rental" payment). Those paragraphs state (emphasis added):

   > **25-4** This guidance addresses what constitutes minimum lease payments under the minimum-lease-payments criterion in paragraph 840-10-25-1(d) from the perspective of the lessee and the lessor. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. . . . However, **lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at lease inception; any increases or decreases** in lease payments that result from subsequent changes in the index or rate **are contingent rentals** and thus affect the determination of income as accruable.
   >
   > **25-5** For a lessee, minimum lease payments comprise the payments that the lessee is obligated to make or can be required to make in connection with the leased property, **excluding** both of the following:
   >
   > a. **Contingent rentals**
   >
   > b. Any guarantee by the lessee of the lessor's debt and the lessee's obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property.

   In a recent formal discussion, the SEC staff indicated that either historical approach is acceptable and that an entity may, depending on the facts and circumstances, deviate from its historical policy when measuring its leases as of the date of initial application. See Q&A 3 for further discussion of lease payments that fluctuate on the basis of a variable index or rate in the context of transition of a company's operating leases under ASC 840 to the new leasing guidance under ASC 842.

2. *Executory costs (i.e., insurance, property taxes, and CAM)* — Some entities have concluded that executory costs are part of minimum rental payments under ASC 840 and other entities have not. A technical inquiry with the FASB staff has confirmed that either interpretation is acceptable under ASC 840. See Q&A 4 for additional information regarding the inclusion or exclusion of executory costs in the determination of a lessee's lease liability for existing operating leases in transition, including considerations for entities that wish to change their historical approach under ASC 840.

Q&A 3 Operating Lease Payments That Fluctuate on the Basis of a Variable Rate or Index — Transition Considerations

In transitioning its operating leases under ASC 840 to the new leasing guidance under ASC 842, a lessee must measure its lease liabilities as of the date of initial application by using the remaining minimum rental payments, as defined in ASC 840. Like ASC 842, ASC 840 contains guidance designed to address variable payments that depend on an index or rate, including how an entity should view these payment mechanisms when determining minimum rental payments for classification and measurement purposes. While ASC 842 is clear on the treatment of variable lease payments that depend on an index or rate, we are aware of diversity in practice related to how such payments have been treated under ASC 840, particularly with respect to the disclosure of future operating lease payments required by ASC 840-20-50-2(a) (commonly referred to as the "lease commitments table"). While ASC 840 appears clear on the treatment of such payments for classification and initial measurement purposes (if applicable), it is less clear on how the lease commitments table should be constructed in the required footnote disclosures. For classification and initial measurement purposes, ASC 840 requires lessees to compute the minimum rental payments on the basis of the index or rate existing at *lease inception*. However, ASC 840 does not discuss how to determine future lease payments for disclosure purposes, and some entities have used updated index/rate information for this purpose under the belief that the disclosure is primarily a liquidity disclosure and therefore should reflect updated information about an entity's obligations as of each balance sheet date. Other entities have continued to present future lease payments for disclosure purposes by using the index or rate existing at lease inception.

Question 3a

In making the transition to ASC 842, what date should a lessee in an operating lease use to determine the rate or index that it should employ to determine the lease payments that are included in the calculation of the lessee's lease liability under ASC 842?

Answer

It depends. ASC 842-10-65-1(l) addresses the transition for operating leases and states:

> A lessee shall measure the lease liability at the present value of the sum of the following, using a discount rate for the lease . . . established at the application date . . .
>
> 1. The remaining minimum rental payments (as defined under [ASC] 840).
> 2. Any amounts probable of being owed by the lessee under a residual value guarantee.

As discussed in paragraph BC390 of ASU 2016-02, the FASB intended for a lessee to effectively "run off" leases existing under ASC 840 upon adopting ASC 842 (i.e., the lessee should use its minimum rental payment table disclosed under ASC 840 as the basis for initially measuring its operating lease liabilities under ASC 842). However, the transition guidance in ASC 842-10-65 is silent on the index or rate that should be used to determine lease payments in transition, other than via the reference to minimum rental payments under ASC 840, which, as described above, has been interpreted differently in practice for purposes other than classification and initial measurement. For this reason, stakeholders have expressed two potential alternatives:

- *Alternative 1* — Use the index or rate that was employed to calculate the lessee's minimum lease payments as of lease inception.
- *Alternative 2* — Use the index or rate existing as of the date of initial application of ASC 842.

On the basis of formal discussions with the SEC staff, we understand that it would be acceptable for a lessee to use the same approach for initial application as it has historically used for disclosure purposes under ASC 840. In other words, if a lessee used the inception rate for its ASC 840 disclosure, it would be acceptable for the lessee to use the inception rate when determining its lease liabilities upon adopting ASC 842. Likewise, if a lessee has historically updated the index or rate for its ASC 840 disclosure, it would be acceptable for the lessee to use the rate as of the date of initial application when determining its lease liabilities upon adopting ASC 842. The SEC staff has indicated that it considers the definition of minimum rental payments in ASC 840 — for purposes other than classification and initial measurement — to be ambiguous and that it is therefore acceptable either to use the original index/rate or to update the index/rate for ASC 840 disclosure purposes. The SEC staff views the historical approach related to developing the ASC 840 disclosure as a policy election and therefore would generally expect an entity to apply its chosen approach consistently when making the transition to ASC 842. However, an entity may be able to change its historical approach on the basis of various factors, including the materiality of the historical policy to the overall financial statements, the direction of the change (e.g., changing from inception rate to initial application rate or vice versa), and the basis for making the change. The following are considerations related to each of these factors:

- *Materiality*[9] — An entity should first assess the significance of its policy (the use of the inception rate as opposed to an updated rate) in the context of the overall financial statements. We generally believe that an entity can change its historical approach to the extent that the policy is immaterial to the overall financial statements.
- *Direction of the change* — We believe that an entity can change from using an updated rate to using the inception rate when determining its lease liabilities upon adopting ASC 842. A change in this direction is consistent with formal feedback received from the FASB staff regarding the requirements of ASC 840, and many entities have relied on such feedback as part of their implementation processes. Such a change is also more consistent with a literal read of the definition of minimum lease payments in ASC 840. Therefore, we do not believe that an entity would be required to apply the accounting guidance in ASC 250-10 when making such a change. However, we also believe that, under certain circumstances, a company can change from using the inception rate to using an updated rate when determining its lease liabilities upon adopting ASC 842. An entity wishing to do so may be subject to the preferability requirements in ASC 250-10, as discussed in the next bullet.

[9] An entity is not required to apply U.S. GAAP to immaterial items; therefore, materiality is always a consideration in the preparation of financial statements. The assessment of materiality is company-specific and involves qualitative and quantitative considerations. A company's explicit financial statement disclosure of its historical treatment under ASC 840 may serve as qualitative evidence that the policy is material.

- *Basis for the change* — If an entity that has historically used the inception rate for its ASC 840 disclosure wishes to change the rate (i.e., wishes to use the rate as of the date of initial application) to determine its lease liabilities upon adopting ASC 842, it may be able to do so if the change is appropriate on the basis of the guidance in ASC 250-10 on accounting changes. In other words, if the historical approach represents a material policy and the entity wants to change its historical treatment, it would be subject to the preferability requirements in ASC 250-10-45-2(b). In this regard, the SEC staff indicated that it generally believes that the use of an updated rate or index would result in a more accurate depiction of the lessee's ROU assets and lease liabilities as of the transition date; we therefore believe that the SEC staff would view the use of an updated index/rate as preferable.

The following table summarizes the SEC staff's and FASB staff's views on whether it is acceptable for an entity to change its historical disclosure approach upon transition to ASC 842 when calculating its initial lease liability under ASC 842:

Historical ASC 840 Disclosure Approach	ASC 842 Transition Approach	Views on Acceptability
Inception rate	Inception rate	SEC staff views as acceptable
Updated rate	Updated rate	SEC staff views as acceptable
Inception rate	Updated rate	Assess preferability[10] — SEC staff
Updated rate	Inception rate	FASB staff views as acceptable

Question 3b

If an entity changes its accounting policy from using the rate at lease inception to using an updated rate when calculating its lease liability upon adopting ASC 842, must that change be reflected retrospectively in accordance with ASC 250?

Answer

It depends. If the use of an inception rate (as opposed to an updated rate) represents a material accounting policy, the change to an updated rate would need to be preferable and retrospective application would be required in accordance with ASC 250. However, if the policy is not deemed material to the overall financial statements, an entity could make the change without establishing preferability and would likewise not be required[11] to reflect the change in prior periods.

As discussed in Question 3a above, the SEC staff has indicated that it would generally be preferable to use an updated rate since the use of such a rate results in better information regarding a lessee's future commitments upon adoption of the new guidance.

Question 3c

The discussion above refers to the appropriate rate for an entity to use in making the transition from ASC 840 to ASC 842 for **operating** lease liabilities. Does an entity's decision to change its approach (i.e., use a different rate for adoption) affect its recognition of lease liabilities in transition for capital/finance leases?

Answer

It depends. We generally believe that the analysis in Questions 3a and 3b above is limited to an entity's operating lease portfolio and would not affect the measurement of capital/finance lease liabilities in transition. An exception to this rule could arise for entities that do **not** elect the "practical expedient package" and that have capital leases under ASC 840 that become operating leases under ASC 842.

When the practical expedient package is elected or when classification of a capital lease otherwise remains unchanged upon adoption of ASC 842, we would not expect a change related to the measurement of operating leases to affect the measurement of capital/finance leases. We do not believe that a policy choice (inception rate vs. updated rate) existed for capital leases under ASC 840. ASC 840 is clear on the initial measurement of capital lease liabilities and does not

[10] A preferability determination is required under ASC 250 if an entity that is making the transition from ASC 840 to ASC 842 wishes to change from using an inception rate to using an updated rate to calculate its lease liability, provided that the historical policy has a material impact on the financial statements.

[11] While an entity is not required to reflect the change in historical periods in this circumstance, we believe that an entity is permitted to do so since the change would increase comparability.

require (or allow) remeasurement for changes in an index/rate. Since the initial measurement of capital lease liabilities is clear and footnote disclosures of total outstanding capital lease liabilities under ASC 840 are tied directly to the balance sheet, there is no ambiguity in the index/rate used to meet the disclosure requirements for capital leases under ASC 840. Furthermore, the transition guidance in ASC 842 for capital/finance leases indicates that they should be recognized at the carrying amount of the lease asset and capital lease liability immediately before adoption (i.e., the balances are simply carried forward).

When the practical expedient package is not elected and the classification of a lease changes from capital to operating, the lessee is required to derecognize the previous capital lease recorded under ASC 840 and record the new operating lease under ASC 842 by measuring an operating lease liability and ROU asset. We believe that, in such circumstances, an entity should measure its lease liability in a manner consistent with its other operating lease liabilities recognized upon transition. In doing so, the entity should consider a change in the index/rate used to measure these liabilities in transition, if applicable.

Q&A 4 Approaches to Accounting for Executory Costs for Operating Leases in Transition

Under ASC 840, executory costs include three primary components: (1) property taxes, (2) insurance, and (3) maintenance (e.g., CAM). Since ASC 840 does not distinguish between these three components, a historically acceptable approach has been to fully include executory costs in (or fully exclude them from) disclosures about remaining rental payments provided under ASC 840. However, under ASC 842, maintenance is considered a nonlease component while property taxes and insurance are considered neither a lease component nor a nonlease component; instead, the consideration attributable to property taxes and insurance is allocated to the components in the arrangement.

As described above and further discussed in Q&A 2, it was acceptable under ASC 840 for executory costs to be included in or excluded from the disclosure of minimum rental payments for operating leases. Further, the FASB staff has generally indicated that a lessee (1) would use its ASC 840 disclosure to determine the lease payments when calculating the lease liability upon adopting ASC 842 and (2) would "run off" the balance.[12] In addition, at the 2017 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff stated that it "did not object to registrants consistently applying their historical accounting policy conclusions regarding the composition of minimum lease payments when concluding whether executory costs should be included in remaining minimum rental payments for purposes of establishing the lease liability in transition."

However, given the differences in how these costs are treated under ASC 842, questions have arisen about whether it would be acceptable for an entity, upon adopting ASC 842, to treat executory costs differently when calculating the lease liability in transition than it has historically treated the costs for disclosure purposes (e.g., changing from including executory costs in, to excluding them from, the determination of lease payments).

Question 4a

Is it acceptable for an entity's treatment of executory costs to differ from historical practice when the entity is initially measuring the lease liability as part of its transition from ASC 840 to ASC 842?

Answer

It depends. On the basis of discussions with the SEC staff, if an entity's policy on executory costs has a material impact[13] on the entity's financial statements, a change in whether executory costs are included in minimum rental payments meets the definition of an "accounting change" and would be subject to the preferability requirements in ASC 250-10-45-2(b). ASC 250-10-20 (and the ASC master glossary) defines a "change in accounting principle," in part, as "a change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply." Thus, a lessee's change in the treatment of executory costs as of the effective date of ASC 842 represents a change from its historical policy under ASC 840.

[12] Paragraph BC390 of ASU 2016-02 states that the "practical effect of the modified retrospective transition method, particularly when combined with the practical expedients that are offered, is that an entity will **'run off' those leases existing at the beginning of the earliest comparative period presented** in accordance with previous GAAP" (emphasis added).

[13] See footnote 9.

Discussions with the SEC staff have further addressed how an entity should assess the preferability of changing whether executory costs are included in "minimum rental payments." In assessing preferability, an entity must conduct a well-reasoned analysis and should consider, among other factors, the prospective accounting policy of the lessee under ASC 842, including an entity's election to combine lease and nonlease components. We believe that an entity may elect the practical expedient for either (1) both the existing lease population and new or modified leases or (2) only new or modified leases. For example, if a lessee plans to elect the practical expedient to account for the nonlease components in a contract as part of the single lease component to which they are related under ASC 842 for **new or modified leases only** (i.e., the entity is not choosing to elect the practical expedient to combine lease and nonlease components for existing leases), this election would generally be a factor supporting the preferability of changing from excluding executory costs from minimum rental payments under ASC 840 to including them under ASC 842 for the **existing lease** population (see Question 4c below). We also understand that a change from including executory costs to excluding such costs would be viewed negatively by the SEC staff, and would generally not be preferable, if the change is made solely to reduce the lease liability at transition.

Further, we believe that when an entity makes the transition from ASC 840 to ASC 842 and elects both (1) to change its historical practice related to accounting for executory costs on the basis of the preferability requirement in ASC 250 and (2) the Comparatives Under 840 Option, the change must be applied retrospectively. The change in this historical practice is an elective accounting policy change made on the basis of ASC 250 and is not required by ASC 842. Therefore, the historical financial statement disclosures (i.e., the future minimum rental payments required by ASC 840-20-50-2(a), commonly referred to as the "lease commitments table") that will be presented when an entity adopts ASC 842 by using the Comparatives Under 840 Option should take into account the accounting change made in accordance with ASC 250.

In summary, when making the transition to ASC 842, a lessee may be allowed to change the approach it has historically used under ASC 840 to include or exclude executory costs. If the existing approach under ASC 840 has a material impact on the financial statements, a change would need to be made on the basis that it is preferable. On the other hand, if an entity's historical approach related to executory costs does not have a material impact on the financial statements, the entity may change its historical approach under ASC 840 and would not be required to assess preferability. In developing the transition requirements, the FASB expected that a lessee could "run off" its existing minimum rental payments. Therefore, in making the transition to ASC 842, a lessee should consider the following principles in determining its approach related to executory costs:

- It was acceptable for an entity to either include executory costs in, or exclude them from, a disclosure of minimum rental payments; therefore, diversity in practice has arisen. Either historical approach would have never affected measurement of operating leases (because of off-balance-sheet treatment under ASC 840), and the historical policy may have never been material to the financial statement disclosures.
- If the inclusion (exclusion) of executory costs *does not have a material impact* on the financial statements, a lessee may change its treatment of executory costs before or upon adopting ASC 842 without assessing preferability and would likewise not be required[14] to reflect the ASC 840 policy change in prior periods, since those periods would continue to be presented under ASC 840 if the entity is electing the Comparatives Under 840 Option. If a lessee has explicitly disclosed in its financial statements its approach for including (excluding) executory costs under ASC 840, such disclosure may be an indication that the policy is material.
- As discussed above, a choice between two acceptable methods of presenting disclosure information is an accounting principle for which a change in method must be preferable under ASC 250-10-45-11 through 45-13 if an entity's policy on executory costs has a material impact on its financial statements. This change must be retrospectively applied to all periods presented under ASC 840. Practically, the only impact of retrospective application should be a revision of the lease commitments table disclosure for the year ended immediately before the date of initial application. This historical table must be included again in the financial statements (quarterly and annual) in the year of adoption if the Comparatives Under 840 Option is elected.

[14] While not required to reflect the change in the historical periods in this circumstance, we believe that an entity is permitted to do so since the change would increase comparability.

Question 4b

When making the transition from ASC 840 to ASC 842, how should an entity treat executory costs if the entity elects, as a practical expedient, to combine lease and nonlease components for existing leases at transition?

Answer

A lessee may elect, as an accounting policy for each underlying asset class,[15] not to separate lease and nonlease components (including executory costs) on the effective date. We believe that a lessee may elect such a policy for both the existing lease population and new or modified leases, since the lessee may prefer comparability and consistent application for all leases regardless of whether they commenced before the effective date.

The guidance on the practical expedient under which a lessee may elect not to separate lease and nonlease components is silent on the treatment of noncomponents in a contract (e.g., executory costs such as property taxes and insurance). Specifically, ASC 842-10-15-37 only discusses lease and nonlease components, stating the following:

> As a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose not to separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component.

When the practical expedient is elected, any portion of the consideration in the contract that would otherwise be allocated to the nonlease components is instead accounted for as part of the related lease component for classification, recognition, and measurement purposes. In addition, any payments related to noncomponents would be accounted for as part of the related lease component (i.e., the associated payments would not be allocated between the lease and nonlease components since they are all treated as a single lease component). Therefore, an entity electing the practical expedient would do so for both the nonlease components and noncomponents of the contract (e.g., executory costs). An entity that elects this accounting policy for existing leases would therefore account for all executory costs as part of its lease payments, regardless of whether the entity had included or excluded executory costs when determining the minimum rental payments (i.e., the "lease commitments table") under ASC 840.

As discussed in Question 4a, the SEC staff has indicated that a change in whether executory costs are included in minimum rental payments meets the definition of a "change in accounting principle" and would be subject to the preferability requirements in ASC 250-10-45-2(b), if an entity's policy on executory costs has a material impact on its financial statements. However, we do not believe that the same requirement would apply when an entity elects the practical expedient to combine lease and nonlease components, including noncomponents of a contract (e.g., executory costs), for existing leases at transition. The question raised to the SEC staff involved a registrant's ability to change its treatment of executory costs but was not premised on the election of the practical expedient. We believe that an entity can elect to apply the practical expedient in transition to all existing leases, regardless of the entity's prior treatment of executory costs, without being subject to the preferability requirement in ASC 250-10-45-2(b).

Question 4c

When making the transition from ASC 840 to ASC 842, how should an entity treat executory costs if the entity elects, as a practical expedient, to combine lease and nonlease components for new or modified leases only?

Answer

As discussed in Question 4b above, a lessee may elect, as an accounting policy for each underlying asset class, not to separate lease and nonlease components (including executory costs) on the effective date. We believe that the lessee may elect such a policy for either (1) both the existing lease population and new or modified leases or (2) only new or modified leases. With respect to new or modified leases, this election only applies to those that commence or are modified on or after the effective date of ASC 842. When this election is made for new or modified leases only, a lessee that has historically excluded executory costs from its minimum rental payment disclosures under ASC 840 may be able to change to including executory costs under ASC 842 for the existing lease population, as described below.

[15] Depending on an entity's election (made by underlying asset class) to combine lease and nonlease components, all or a portion of an entity's leases may be affected by this election. In contrast, an entity's ASC 840 policy choice for including or excluding executory costs is an entity-wide election. Accordingly, inconsistencies between ASC 840 and ASC 842 may arise in such circumstances.

As discussed in Question 4a, the SEC staff has indicated that a change in whether executory costs are included in "minimum rental payments" meets the definition of a "change in accounting principle," and would be subject to the preferability requirements in ASC 250-10-45-2(b), if an entity's policy on executory costs has a material impact on its financial statements. We believe that this requirement would apply when an entity **does not elect** the practical expedient to combine lease and nonlease components, including noncomponents of a contract (e.g., executory costs), for the **existing lease population** at transition (i.e., the entity elects the practical expedient for new or modified leases only) but wishes to change from excluding executory costs under ASC 840 to including executory costs when determining the opening lease liability under ASC 842. See Question 4d below for considerations that may be relevant to the evaluation of preferability. As discussed in Question 4b above, if the entity had elected to apply the practical expedient in transition to all existing leases, a change regarding the entity's prior treatment of executory costs would not be subject to the preferability requirement in ASC 250-10-45-2(b).

Question 4d

In what situations is it appropriate for an entity to change its ASC 840 disclosure approach for executory costs for existing leases at transition?

Answer

We do not believe that it would be appropriate (depending on the materiality of the impact under ASC 840) for a lessee to change its ASC 840 disclosure approach for executory costs, as discussed in Question 4a, in a manner that reduces comparability to its ASC 842 accounting, including the impact of the lessee's election to include or exclude nonlease components.

We expect that one of the scenarios below will apply to an entity that wishes to change its disclosure approach for executory costs in transition. We further expand on whether we believe it may be appropriate for an entity to change its ASC 840 disclosure approach for existing leases at transition, depending on the scenario.

- *Scenario 1* — An entity historically excluded executory costs from its minimum rental payment disclosures under ASC 840 but intends to elect the practical expedient related to combining lease and nonlease components for **new or modified leases only** (see Question 4c above). The entity may prefer to change from excluding executory costs under ASC 840 to including them under ASC 842 for the **existing lease population**. Such an entity will be subject to the preferability determination discussed in Question 4a if the inclusion/exclusion of executory costs under ASC 840 has a material impact on the financial statements.
- *Scenario 2* — An entity historically excluded executory costs from its minimum rental payment disclosures under ASC 840 and intends to elect the practical expedient to combine lease and nonlease components for **both existing and new or modified leases**. The entity will then include nonlease components under ASC 842 in the calculation of the lease liability for the existing lease population at transition. Such an entity will not be subject to the preferability determination as discussed in Question 4b when the entity elects the practical expedient to combine lease and nonlease components, including noncomponents of a contract (e.g., executory costs), for existing leases at transition.
- *Scenario 3* — An entity historically included executory costs in its minimum rental payment disclosures under ASC 840 and does not intend to elect the practical expedient to combine lease and nonlease components for new or existing leases. The entity wishes to exclude executory costs for existing leases when initially calculating its lease liability upon adopting ASC 842. Such an entity will be subject to the preferability determination discussed in Question 4a if the inclusion/exclusion of executory costs under ASC 840 has a material impact on the financial statements. An entity in this scenario should also contemplate the makeup of the executory costs under ASC 840 as follows:
  - *Scenario 3A* — The entity's executory costs under ASC 840 predominantly consist of maintenance costs, which are considered a nonlease component under ASC 842. In this situation, changing from including executory costs under ASC 840 to excluding executory costs in the transition to ASC 842 generally **enhances comparability** between existing and new or modified leases.

- *Scenario 3B* — The entity's executory costs under ASC 840 predominantly consist of property taxes and insurance (i.e., noncomponents under ASC 842). In this situation, changing from including executory costs under ASC 840 to excluding executory costs in the transition to ASC 842 generally **does not enhance comparability** between existing and new or modified leases.

Achieving perfect comparability between ASC 840 and ASC 842 may be difficult (unless all lease and nonlease components are combined for new and existing leases) because "executory costs" is an ASC 840 concept and the components of executory costs are characterized differently under ASC 842, as described in the background above. In the above scenarios, the entity's treatment of costs for property taxes, insurance, and maintenance upon adoption of ASC 842 changes from the historical treatment under ASC 840. We believe that such a change should enhance comparability between ASC 840 and ASC 842, as illustrated in Scenarios 1, 2, and 3A above. Scenario 3B **will not enhance comparability** since property taxes and insurance (i.e., noncomponents) **are greater than** maintenance. Therefore, when assessing preferability, lessees should carefully consider the significance of property taxes and insurance compared with that of maintenance.

As indicated above, we do not believe that it would be appropriate for an entity to change its ASC 840 disclosure approach in a manner that reduces comparability to its ASC 842 election to include or exclude nonlease components. Consider the following additional scenario in which **comparability is not enhanced:**

- *Scenario 4* — An entity historically included executory costs in its minimum rental payment disclosures under ASC 840 and intends to elect the practical expedient to combine lease and nonlease components for new or modified leases. The entity wishes to change its treatment to exclude executory costs when initially calculating its lease liability upon adopting ASC 842 for the existing lease population. An entity electing to do so would be subject to the preferability determination, as discussed in Question 4a, if the inclusion/exclusion of executory costs under ASC 840 has a material impact on the financial statements. However, we believe that it would be inappropriate for such an entity to change its treatment of executory costs for existing leases upon adoption of ASC 842, since doing so would reduce comparability between ASC 840 and ASC 842.

The table below summarizes whether (1) the scenarios above enhance comparability between the disclosure approach under ASC 840 and the measurement approach under ASC 842; (2) an entity in these scenarios is required to determine preferability under ASC 250 to change its historical approach of accounting for costs related to property taxes, insurance, and maintenance; and (3) the change in treatment of such costs is appropriate.

	Enhances Comparability?	Preferability Determination Required Under ASC 250?[16]	Change in Treatment of Executory Costs Appropriate?[17]
Scenario 1	Yes	Yes	Generally yes, subject to a well-reasoned preferability analysis
Scenario 2	Yes	No	Yes
Scenario 3A	Yes	Yes	Generally yes, subject to a well-reasoned preferability analysis
Scenario 3B	No	Yes	Generally no
Scenario 4	No	Yes	Generally no

Because executory costs are characterized differently under ASC 840 than they are under ASC 842, the following are generally true:

- The lease liability in a gross lease of real estate that excludes executory costs under ASC 840, and for which the lessee elects to separate nonlease components, will be **lower** if the lease commences before the effective date of ASC 842 than it will if the lease commences on or after the effective date of ASC 842. The reason for the

[16] The preferability determination is required under ASC 250 if an entity wishes to treat executory costs differently than historical practice when making the transition from ASC 840 to ASC 842 and the inclusion (exclusion) of executory costs has a material impact on the financial statements (see Question 4a above).

[17] An entity should perform a well-reasoned preferability analysis to determine whether a change in executory costs is appropriate (see Question 4a above). The fact that the change enhances comparability between ASC 840 and ASC 842 is not solely determinative of whether a change in policy is preferable. Other factors to consider in a preferability analysis include, but are not limited to, whether the change in policy is consistent with guidance under ASC 842, the composition of costs associated with expected leasing activity after adoption, comparability with relevant peer companies, and whether the change results in relevant measurement of the liability upon adoption of ASC 842.

lower liability in this case is that property taxes and insurance would be excluded under ASC 840 but would be allocated primarily (or totally) to the lease component under ASC 842.

- Conversely, the lease liability in a gross lease of real estate that includes executory costs under ASC 840, and for which the lessee elects to separate nonlease components, will be **higher** if the lease commences before the effective date of ASC 842 than it will if the lease commences on or after the effective date of ASC 842. The reason for the higher liability in this case is that maintenance would be included under ASC 840 but would represent a nonlease component under ASC 842.
- The chosen approach for including or excluding executory costs under ASC 840 in a triple net lease should not have a significant impact, because the executory costs are typically variable (and reimbursed, or paid directly, by the lessee) and therefore are not included in the minimum rental payments.

Q&A 5 Derecognition of Existing Build-to-Suit Assets and Liabilities in Transition

The build-to-suit transition guidance specifies that any build-to-suit assets and liabilities recognized under ASC 840 should be derecognized in transition. However, the transition guidance does not explicitly address whether ASC 842's principles related to controlling an asset under construction should be applied during the comparative periods under ASC 842, if applicable.

Question 5a

Must ASC 842's principles related to controlling an asset during construction be applied when construction was completed and the lease commenced before ASC 842's effective date?

Answer

No. An entity is not required to assess ASC 842's principles of control (regardless of whether the lessee was the deemed owner under ASC 840) as long as construction is complete and the lease commenced before the ASU's effective date. The FASB staff agreed with this application of transition for build-to-suit arrangements. This answer is applicable regardless of whether an entity elects the Comparatives Under 840 Option.

Therefore, in such circumstances, the transition derecognition guidance in ASC 842-10-65-1(u) should be applied. ASC 842-10-65-1(u) states:

> 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 (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)) 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, the entity shall do the following:
>   - i. If an entity elects the transition method in (c)(1), the entity shall 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 in (i) or (ii) shall be recorded as an adjustment to equity at 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 date, the entity shall follow the general lessee transition requirements for the lease. [Emphasis added]

Accordingly, the lessee should (1) derecognize any build-to-suit assets and liabilities that were recognized *solely as a result* of the lessee's being the deemed accounting owner and (2) recognize the difference, if any, in equity. However, lessee-paid costs that were included in the build-to-suit asset may not have been capitalized *solely as a result* of the build-to-suit designation. For example, the deemed accounting owner may have funded part of the construction costs and such costs may be considered prepaid lease payments or payments for lessee-owned improvements when the arrangement is accounted for as a lease. Accordingly, in transition, these costs would be carried over and retained at their currently recognized amount (i.e., the amortized or depreciated balance). That is, these costs would have been recognized in the absence of the build-to-suit designation and therefore should not be derecognized through equity upon transition.

Example

Company C, a calendar-year public entity that has elected the option not to recast the comparative periods presented when transitioning to ASC 842 (the "Comparatives Under 840 Option"), entered into an agreement with Developer D to lease a newly constructed corporate headquarters.[18] Developer D began building the corporate headquarters on August 1, 2016, and construction is expected to be complete on November 12, 2018, at which time the lease will commence. Company C funded $6 million of the construction costs during the construction period, and the total project costs are expected to be $40 million. Therefore, D will fund $34 million of the construction costs. In addition, C incurred $1 million for furniture and fixtures (the "improvements"). Assume that C was considered the accounting owner of the corporate headquarters during construction and that sale-leaseback accounting would not be achieved upon lease commencement under ASC 840. The various journal entries to account for the construction project resulted in the following account balances as of November 12, 2018:

Property, plant, and equipment (PP&E)	41 million	
Cash		7 million
Financing obligation		34 million

Upon transition to ASC 842, C is required to derecognize the amounts related to the build-to-suit accounting because construction of the corporate headquarters was completed, and the lease commenced, before January 1, 2019 (the effective date of ASC 842). Therefore, on its adoption date (January 1, 2019), C would derecognize the entire financing obligation because it was recognized solely as a result of the build-to-suit designation. Company C would retain a portion of its PP&E balance related to the amount it paid before lease commencement less adjustments for subsequent measurement (i.e., depreciation), even though this amount was included in the carrying amount of the build-to-suit asset. As a result, the unamortized portion of the $6 million construction funding payment should be carried forward into the ROU asset because it represents a prepaid lease payment. Similarly, the unamortized balance of the $1 million for improvements paid by the lessee should be carried forward in transition and not written off as an equity adjustment. The remaining build-to-suit asset would be derecognized. The offset between the resulting build-to-suit asset balance and the financing obligation, if any, would be recognized in equity.

The subsequent accounting for the improvements should be consistent with that for other leasehold improvements. That is, the amortization period would be limited to the lease term in accordance with ASC 842-20-35-12.

The journal entries in transition are shown below. Note that, for simplicity, there are no adjustments for subsequent measurement between November 12, 2018, and the effective date of ASC 842 (i.e., depreciation of the building, amortization of the $6 million in prepaid rent, or payments on the financing obligation). These subsequent-measurement adjustments would most likely result in an adjustment to equity, which is not depicted below.

Financing obligation	34 million	
ROU asset	6 million	
PP&E		40 million*

* The balance of the $1 million of improvements paid for by the lessee was included in the PP&E account balance of $41 million as of November 12, 2018. Because this amount is retained, only $40 million of the PP&E account balance is removed in the transition journal entry.

Company C would also recognize any remaining lease payments as a lease liability, along with an offsetting ROU asset, in accordance with the lessee transition requirements in ASC 842-10-65-1(k) through 65-1(t).

[18] The outcome of this example would not be affected by whether the entity elected the Comparatives Under 840 Option.

Question 5b

How should a lessee approach the transition for a build-to-suit arrangement when construction was not completed, and the lease had not commenced, as of the effective date of ASC 842?

Answer

The table below summarizes the transition approach an entity should use in those circumstances.

ASC 840 Determination	ASC 842 Determination	Transition Approach
Lessee was the deemed owner	Lessee has control during construction	No change in accounting; asset and financing obligation remain on the balance sheet during the comparative periods and as of the effective date.
Lessee was the deemed owner	Lessee does not have control during construction	If the lessee was determined to be the deemed accounting owner under ASC 840 **before** the date of initial application, derecognize the asset and financing recognized *solely as a result* of the build-to-suit designation and reflect the difference, if any, in equity. If the lessee was determined to be the accounting owner of the asset **during** the comparative periods (i.e., construction commenced during the comparative periods), and the Comparatives Under 840 Option was not elected, the lessee should reverse the impact of the accounting for the appropriate line items and not reverse the impact through equity.
Lessee was not the deemed owner	Lessee has control during construction	Recognize the asset and financing obligation as of the later of the date of initial application or the date as of which the lessee is determined to be the accounting owner of the asset in accordance with ASC 842. If a lessee elects the Comparatives Under 840 Option, the asset and financing obligation will be recognized as of the effective date of ASC 842. See the example below.

Example

Company A, a calendar-year public entity that has not elected the Comparatives Under 840 Option, has entered into an agreement with Company B to lease a newly constructed television studio. Company B began building the television studio on June 8, 2017, and construction is expected to be complete on November 5, 2019. The lease will commence once construction is complete. During the construction period, A can acquire the television studio in process of construction and therefore is deemed to control the construction project under ASC 842. Assume that A was not determined to be the deemed owner in accordance with ASC 840. When A initially applies ASC 842, because A is deemed to control the construction project under ASC 842 as of the effective date, it must recognize the cost of the in-process asset (and an offsetting financing obligation) during the comparative periods beginning June 8, 2017.

If A had elected the Comparatives Under 840 Option, A would first recognize the asset and financing obligation as of January 1, 2019 (the ASC 842 effective date).

Q&A 6 Accounting for a Previously Impaired Build-to-Suit Asset

Under ASC 840, a build-to-suit asset and financing obligation may be recognized on a lessee's balance sheet as a result of a transaction's build-to-suit designation, as described in Q&A 5. Thereafter, under ASC 360, a lessee could have determined that the asset group containing the build-to-suit asset was impaired, resulting in the measurement of an impairment loss, of which a portion was recognized against the build-to-suit asset.

The general transition provisions in ASC 842 indicate that a lessee that recognized an asset because it was the deemed owner under the ASC 840 build-to-suit guidance would, in accordance with ASC 842-10-65-1(u),[19] (1) derecognize the asset and financing recognized *solely as a result* of the build-to-suit designation and (2) apply the general lessee transition requirements. Further, ASC 842-10-65-1(m)(2) and ASC 842-10-65-1(o), which apply to operating leases and finance

[19] See Q&A 5 for an excerpt of the transition guidance in ASC 842-10-65-1(u).

leases, respectively, provide the following guidance on accounting for the ROU asset at transition when there is an existing ASC 420 liability:

> (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: . . .
>
> 2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease. . . .
>
> (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) 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.

On the basis of the above guidance, it is clear that the initial ROU asset is generally recorded net of any ASC 420 liability at transition. However, under a deemed ownership model, entities have historically looked to the impairment guidance in ASC 360 instead of the exit cost guidance in ASC 420. As a result, entities have questioned how previous impairment charges recognized on a build-to-suit asset should be treated in transition given that the asset to which the impairment is related will be derecognized upon adoption of ASC 842. In other words, entities have asked whether the historical ASC 360 impairment charge should or could affect the measurement of the ROU asset in transition.

Question

When a lessee previously recognized impairment for a build-to-suit asset subject to derecognition under ASC 842-10-65-1(u)(1), how should the lessee consider the historical impairment when recognizing and measuring the related ROU asset at transition?

Answer

We believe that a lessee should subject the newly recognized ROU asset to a full impairment test in accordance with ASC 360 as of the effective date of ASC 842 if an impairment indicator continues to exist as of this date. Accordingly, a lessee would determine a "new" impairment amount on the basis of the test conducted as of the effective date. In addition, we believe that it is acceptable to recognize the impairment loss, if any, determined as of the date of initial application of ASC 842 through an adjustment to equity, with a corresponding reduction to the carrying amount of the ROU asset. We think that recognition of the impairment loss in equity is appropriate since it reflects a unique circumstance in which the adjustment effectively results from an impairment indicator that arose before the date of initial application of ASC 842.

However, since ASC 842 does not provide clear guidance on this situation, there may be other acceptable approaches. We encourage stakeholders who are affected by this issue to consult with their accounting advisers and auditors to understand their views.

Q&A 7 Transition Considerations Related to Lease Measurement When an Entity Ceases Use of a Leased Asset Before the Adoption of ASC 842

Under ASC 840, when an entity ceases use of an asset subject to an operating lease, the entity applies the guidance in ASC 420 to determine whether to recognize a liability for its costs related to terminating the operating lease and costs that will continue to be incurred without economically benefiting the entity. Provided that the criteria in ASC 420 related to recognizing a liability are met, the liability is measured as the difference between the remaining lease costs to be paid by the lessee, offset by an assumption for sublease income. In accordance with ASC 420-10-30-8, an entity would record the liability in this manner regardless of whether the lessee has the intent to sublease the asset. ASC 420-10-30-8 states:

> If the contract is an operating lease, the fair value of the liability at the cease-use date shall be determined based on the remaining lease rentals, adjusted for the effects of any prepaid or deferred items recognized under the lease, **and reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease**. Remaining lease rentals shall not be reduced to an amount less than zero. [Emphasis added]

Therefore, under ASC 420 and ASC 840, an entity is considered to have ceased use of an asset even if the entity has the intent and ability to sublease the asset. However, under ASC 842, the cease-use determination is no longer relevant; rather, an entity must determine whether the leased asset is abandoned in accordance with ASC 360.

Under ASC 842, if an entity plans to abandon the leased asset, we believe that the entity should change the useful life of the ROU asset prospectively in such a way that the ROU asset is fully amortized by the abandonment date.

Question 7a

Under ASC 842, is an ROU asset considered abandoned if an entity has ceased use of the underlying asset but is currently subleasing (or plans to sublease) the asset?

Answer

No. Under ASC 842, an ROU asset is recognized during the period in which an entity has the right to use an asset subject to a lease. One of the conditions for a lease is that the entity must obtain substantially all of the economic benefits from the use of the underlying asset. In a sublease scenario, although the entity itself is not using the asset, the entity's receipt of sublease payments would be considered as obtaining economic benefits from use of the underlying asset under ASC 842. ASC 842-10-15-17 provides evidence for this notion and states, in part:

> **A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset.** The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third party. [Emphasis added]

Because the entity is still obtaining economic benefits from use of the asset through subleasing the asset, we do not believe that a lessee has abandoned an asset if an entity has both the intent and ability to sublease. This holds true even if the lessee has not yet identified a sublessee before the lessee ceases use of the asset.

Question 7b

If an entity ceases use of a leased asset before adopting ASC 842 and does not have the intent and ability to sublease the asset, should the entity recognize an ROU asset upon adopting ASC 842?

Answer

No. We do not believe that it is appropriate to recognize an ROU asset upon adopting ASC 842 if an entity both (1) has ceased using an asset before the adoption date of ASC 842 and that designation has not changed as of the adoption date and (2) does not have the intent and ability to sublease the asset. However, the entity would still be required to recognize a lease liability equal to the present value of the remaining lease payments under the contract. Normally, the entity would recognize a corresponding ROU asset; however, in this situation, any liabilities previously recognized under ASC 420 (e.g., cease-use liabilities) would be recognized as a reduction to the carrying amount of the ROU asset. Furthermore, to the extent that the ASC 420 liability is less than the carrying amount of the ROU asset that would otherwise be recognized to offset the corresponding lease liability, any remaining portion of the ROU asset not offset by the ASC 420 liability would be written off as an adjustment to equity. We believe that it is appropriate to record the adjustment through equity because the cease-use event occurred before the date of initial application of ASC 842. See Q&A 8 below for discussion of the effect of a previously recognized ASC 420 liability that exceeds the lease liability that must be recognized in transition.

Q&A 8 Initial Measurement of an ROU Asset When a Previously Recognized ASC 420 Liability Exceeds the Lease Liability Recognized in Transition

Before adopting ASC 842, a lessee may have recognized, in accordance with ASC 420, a liability for the cost associated with an exit or disposal activity related to an operating lease. Specifically, ASC 420-10-30-9 states that a "liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity shall be [recognized and] measured at its fair value" when the entity ceases using the right conveyed by the contract. In addition, ASC 420-10-30-8 indicates that "[i]f the contract is an operating lease, the fair value of the liability at the cease-use date shall be determined based on the remaining lease rentals."

Under ASC 840, a lessee may have included amounts related to maintenance (including CAM), insurance, and property taxes in the measurement of its ASC 420 liability. The lessee would have done so regardless of whether such costs were fixed or variable, in which case they would be estimated.

When a lessee is applying the transition requirements in ASC 842, to the extent that ASC 420 liabilities were recognized, such balances should reduce the carrying amount of the ROU asset in accordance with ASC 842-10-65-1(m)(2), which states:

> 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: . . .
>
> 2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease.

In certain circumstances, the carrying amount of a lessee's ASC 420 liability immediately before the ASC 842 effective date for an existing operating lease may exceed the amount that will be recognized for the lease liability as of the effective date (e.g., if the lessee's ASC 420 liability included CAM, insurance, and property taxes). Consequently, measuring the ROU asset, including the full adjustment for an ASC 420 liability in accordance with ASC 842-10-65-1(m)(2), may result in an ROU asset carrying amount below zero.

Question

How should a lessee account for a lease at transition in which the existing ASC 420 liability exceeds the ROU asset that would otherwise be recognized at transition?

Answer

We do not believe that it would be appropriate for a lessee to recognize a negative ROU asset at transition. Although ASC 842 does not provide clear guidance on this situation, we think that it would be acceptable for a lessee to use one of the following approaches:

- *Approach 1: Retain the ASC 420 liability for amounts that exceed the initial ROU asset* — An entity could reduce the ROU asset to zero, with a corresponding decrease to the ASC 420 liability. The remaining portion of the ASC 420 liability would be retained and would be accounted for after the effective date in the same manner as it was accounted for before the effective date (i.e., in accordance with ASC 420). We believe that this approach is acceptable because it would allow a lessee to effectively "run off" its remaining liability. As part of this approach, an entity would not be required to recognize those costs through the income statement a second time (i.e., once when the ASC 420 liability was established before the effective date and again when those costs are actually incurred after the effective date).
- *Approach 2: Retain the portion of the ASC 420 liability related to the executory costs* — As discussed in Q&A 7, if an entity (1) has ceased using an asset before the adoption date of ASC 842 and that designation has not changed as of the adoption date and (2) does not have the intent and ability to sublease the asset as of the adoption date, we do not believe that it is appropriate for an entity to recognize an ROU asset upon adoption. Accordingly, the application of Approach 2 will depend on an entity's intent and ability to sublease.
  - *2A* — If the entity has the intent and ability to sublease, the entity could reduce the ROU asset by the portion of the ASC 420 liability related to the lease costs. An entity would also reduce the ASC 420 liability by a corresponding amount and retain the portion of the ASC 420 liability to the extent that it is related to executory costs.
  - *2B* — If the entity does not have the intent and ability to sublease, the entity could reduce the ROU asset to zero, with a corresponding decrease to the ASC 420 liability, retaining the ASC 420 liability only for the remaining portion related to executory costs.

  In both Approach 2A and Approach 2B, the ASC 420 liability that remains would be accounted for after the effective date in the same manner as it was accounted for before the effective date (i.e., in accordance with ASC 420). As with Approach 1, we believe that this approach is acceptable because it would allow a lessee to effectively "run off" its remaining liability. As part of this approach, an entity would not be required to recognize those costs through the income statement a second time (i.e., once when the ASC 420 liability was established before the effective date and again when those costs are actually incurred after the effective date).

- *Approach 3: Derecognize any remaining ASC 420 liability, after the ROU asset is written to zero, through an adjustment to equity* — An entity could reduce the ASC 420 liability by the same amount that reduced the ROU asset to zero. The remaining portion of the ASC 420 liability could be written off with an adjustment through equity. The costs underlying the amount that would be adjusted to equity would be recognized through the income statement in future periods as an expense since they are incurred after the effective date. Accordingly, under this approach, a lessee will recognize certain costs through the income statement twice (i.e., once in periods before the adoption of ASC 842 when the ASC 420 liability was established with its corresponding expense, and again when those costs are incurred after the adoption of ASC 842, because an offsetting liability on the balance sheet no longer exists). Although we do not think that this is an intended outcome of the transition guidance in ASC 842 or a desirable outcome for lessees, we do believe that this approach is acceptable because it would allow the removal of the existing ASC 420 liability, as contemplated under the ASC 842 transition guidance.

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