Executive View

ASC 842, Leases – Transition disclosures

February 2017

Companies should expect scrutiny of their SAB 74 disclosures related to their forthcoming adoption of the new leases standard.

Regulatory background

SEC Staff Accounting Bulletin Topic 11.M (SAB Topic 11.M or SAB 74) requires SEC registrants to evaluate new Accounting Standards Updates (ASUs) that they have not yet adopted when determining what financial statement disclosures to make about the potential material effects of adopting those ASUs.

These disclosures generally should include a discussion about the effect that adoption is expected to have on the financial statements, unless this is not known or reasonably estimable. In that case, a registrant should state that the effect of adoption is unknown.

At the September 22, 2016 EITF meeting, the SEC staff announced that, consistent with SAB Topic 11.M, when the effect is not known or reasonably estimable, a registrant should consider making additional qualitative financial statement disclosures to assist financial statement users in understanding the significance of the effect that a new standard will have on the financial statements when adopted.[1]

The SEC staff expects disclosures to include a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison with the current accounting policies.

Also, the SEC staff indicated that a registrant should describe its progress in implementing the new standards and the significant implementation matters that it still needs to address.

At the December 2016 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff stressed the importance of transition disclosures to investors. The SEC staff expects to issue comments on materially deficient disclosures in its review of 2016 Form 10-K filings. Accordingly, registrants should avoid boilerplate transition disclosures and provide investors with useful information about adoption and implementation efforts for new ASUs, including ASU 2016-02, *Leases*.

Example disclosures

The following examples, including combinations of these examples, can be a starting point for SAB Topic 11.M disclosures about the effect of adopting ASU 2016-02. Management should amend these examples to fit their circumstances and comply with SAB Topic 11.M and recent SEC staff guidance outlined above.

[1] The SEC staff announcement is codified in the FASB's Accounting Standards Codification at paragraph 250-10-S99-6.

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Lessee

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, Leases, which requires lessees to recognize leases on-balance sheet and disclose key information about leasing arrangements. The new standard establishes a right-of-use model (ROU) that requires a lessee to recognize a ROU asset and lease liability on the balance sheet for all leases with a term longer than 12 months. Leases will be classified as finance or operating, with classification affecting the pattern and classification of expense recognition in the income statement.

The new standard is effective for us on [January 1, 2019], with early adoption permitted. We expect to adopt the new standard [on its effective date (or earlier date; or we have not yet decided whether we will early adopt the new standard)]. A modified retrospective transition approach is required for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available.

We expect that this standard will have a material effect on our financial statements. While we are continuing to assess the effect of adoption, we currently believe the most significant changes relate to (1) the recognition of new ROU assets and lease liabilities on our balance sheet for [office and equipment] [retail store] [real estate] operating leases; (2) the derecognition of existing assets and liabilities for certain sale-leaseback transactions (including those arising from build-to-suit lease arrangements for which construction is complete and we are leasing the constructed asset) that currently do not qualify for sale accounting; and (3) the derecognition of existing assets and liabilities for certain assets under construction in build-to-suit lease arrangements that we will lease when construction is complete. We do not expect a significant change in our leasing activity between now and adoption.[2] We expect to elect all of the standard's available practical expedients on adoption[3]. Consequently, on adoption, we expect to:

- Recognize additional operating liabilities ranging from $X,XXX to $X,XXX, with corresponding ROU assets of the same amount based on the present value of the remaining minimum rental payments under current leasing standards for existing operating leases.
- Derecognize existing debt obligations ranging from $X,XXX to $X,XXX and existing fixed assets ranging from $X,XXX to $X,XXX for sale-leaseback transactions that currently do not qualify for sale accounting. Any gains or losses associated with this change in accounting will be recognized through opening retained earnings[4] on adoption, and we will recognize new ROU assets and lease liabilities ranging from $X,XXX to $X,XXX on our balance sheet for the associated leases.
- Derecognize existing debt obligations ranging from $X,XXX to $X,XXX, with corresponding construction in process of the same amount for assets under construction in build-to-suit lease arrangements for which we expect construction to be complete before the effective date. On completion of construction, we expect to recognize new ROU assets and lease liabilities ranging from $X,XXX to $X,XXX on our balance sheet for the associated leases. Debt obligations and construction-in-process arising from build-to-suit lease arrangements for which construction is not yet complete as of the effective date will be evaluated under the new standard, which may or may not result in those amounts being derecognized. If those amounts are not derecognized on adoption, they will be derecognized only when (and if) the sale-leaseback requirements in the new standard are met.

[2] Alternatively, we plan to explore alternative financing solutions for the leased [equipment] between now and adoption.

[3] Alternatively, we expect not to elect all of the standard's practical expedients on adoption. (The use of the hindsight practical expedient may be elected on its own or with the other package of practical expedients. The other practical expedients must be elected together as a package.)

[4] For sale-leaseback transactions that qualify for sale accounting under the new standard during the comparative periods preceding the effective date (2017 and 2018 for public companies that adopt on January 1, 2019), companies will recognize transition period gain or loss on the sale and lease expense in the income statements for the comparative periods.

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Lessor

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, *Leases*, which requires lessors to classify leases as a sales-type, direct financing, or operating lease. A lease is a sales-type lease if any one of five criteria are met, each of which indicate that the lease, in effect, transfers control of the underlying asset to the lessee. If none of those five criteria are met, but two additional criteria are both met, indicating that the lessor has transferred substantially all the risks and benefits of the underlying asset to the lessee and a third party, the lease is a direct financing lease. All leases that are not sales-type or direct financing leases are operating leases.

The new standard is effective for us on [January 1, 2019], with early adoption permitted. A modified retrospective transition approach is required for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available.

[We currently expect to early adopt the new standard effective January 1, 2018 in conjunction with our adoption of the new revenue standard. Our ability to early adopt is dependent on [system readiness and] the completion of our analysis of information necessary to restate prior period financial statements.] We are currently evaluating the effect of adoption of the new standard on our financial statements and do not expect a significant change in our leasing activity between now and adoption.

[We believe substantially all of our leases will continue to be classified as operating leases under the new standard.] [While a substantial number of our leases will now be classified as sales-type leases, rather than direct financing leases, we do not expect that change in classification to have a significant effect on the accounting for our leases.]

[On adoption of the new standard, maintenance services will no longer be considered part of the lease element of our equipment leasing contracts. Instead, they will be accounted for as a non-lease component within the scope of the new revenue standard. As a result, we will be required to recognize revenues associated with our equipment leases separately from revenues associated with maintaining the equipment. Our preliminary assessment is that approximately X-XX% of customer lease payments will be attributed to the maintenance services. At this time, we do not believe application of the recognition provisions in the new revenue standard to our maintenance services will affect the timing of recognition of our maintenance services revenue. In addition, due to the new standard's narrowed definition of *initial direct costs*, we expect to expense as incurred significant lease origination costs currently capitalized as initial direct costs and amortized to expense over the lease term.]

[Subsequent to our adoption of the new standard, common area maintenance provided in our real estate contracts will be accounted for as a non-lease component within the scope of the new revenue standard. As a result, we will be required to recognize revenues associated with our real estate leases separately from revenues associated with common area maintenance. We are continuing to evaluate whether the variable payment provisions in the new lease standard, or the allocation and recognition provisions of the new revenue standard, will affect the timing of recognition for our lease and non-lease revenue. In addition, due to the new standard's narrowed definition of *initial direct costs*, we expect to expense as incurred significant lease origination costs currently capitalized as initial direct costs and amortized to expense over the lease term.]

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A reminder: effective dates and transition

	Public business and certain other entities[5]	All other entities
Annual periods – Fiscal years beginning after	December 15, 2018	December 15, 2019
Interim periods – In fiscal years beginning after	December 15, 2018	December 15, 2020
Early adoption allowed?	Yes, immediately.	

For further reading

Defining Issues: EITF Reaches Final Consensus: SEC Staff Discusses Recent Accounting Standards

Issues and Trends: AICPA National Conference on Current SEC and PCAOB Developments

Issues In-Depth: Leases

[5] (1) public business entities; (2) not-for-profits that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market; and (3) employee benefit plans that file financial statements with the SEC.

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