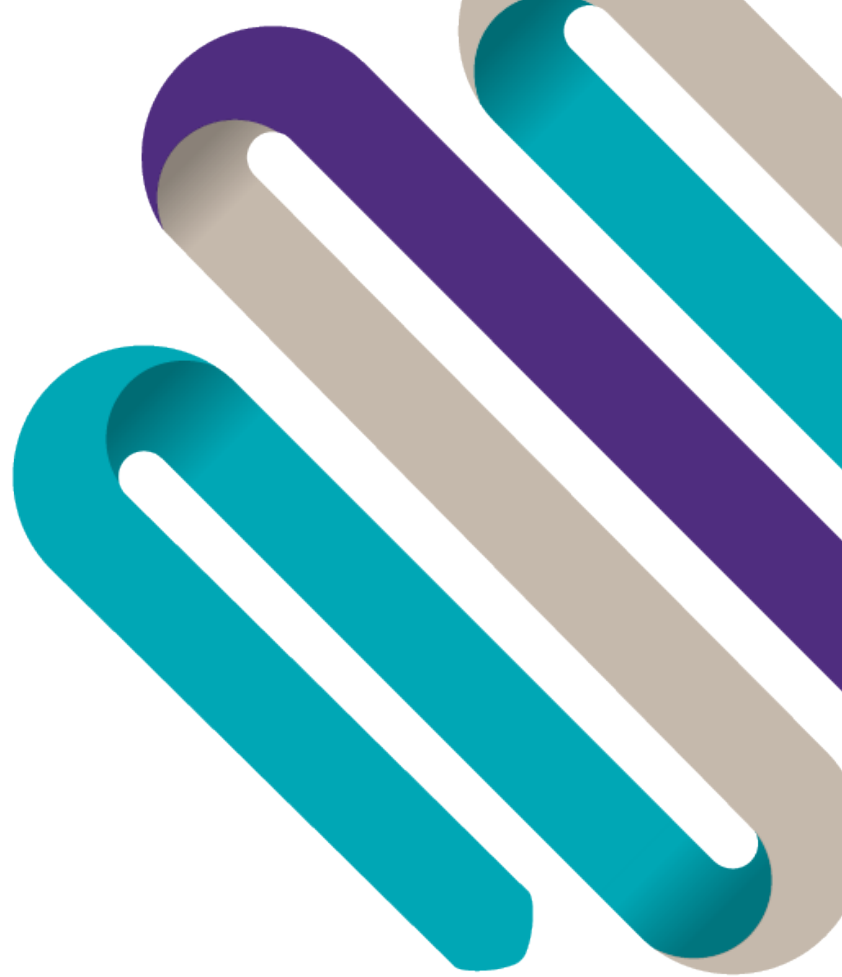


ASC 842, *Leases* – Navigating Post-Implementation Accounting Pitfalls

2023 GWSCPA Nonprofit Symposium



With you today



Nick Lazzaruolo

Partner
Atlantic Coast Not-for-Profit
Industry Leader
Grant Thornton



Brian Morgan

Senior Manager
Non-for-Profit Practice
Grant Thornton

Agenda

- 1 Lease modifications
- 2 Lease terminations
- 3 Rent concessions
- 4 Other events triggering remeasurement

Lease modifications for lessees

- When any modification or amendment is made to a lease, a lessee must determine whether the modification should be treated as:
 - **A separate contract** - A modification that is accounted for as a separate contract should be treated as a new lease and initially measured at the commencement date of the new lease. There is no impact on the accounting for the existing lease.
 - **A continuation of the existing contract** - A lessee must reassess lease classification for the modified lease, taking into account all modified terms and conditions and measuring all inputs as of the effective date of the modification.

Separate contract

ASC 842-10-25-8

- An entity shall account for a modification to a contract as a separate contract (that is, separate from the original contract) when **both** of the following conditions are present:
 - a. The modification grants the lessee **an additional right of use** not included in the original lease (for example, the right to use an additional asset).
 - b. The lease payments increase **commensurate with the standalone price for the additional right of use**, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.

Separate contract

Example

- Lessee enters into a 10-year lease for 10,000 square feet of office space.
- At the beginning of Year 6, Lessee and Lessor agree to modify the lease for the remaining 5 years to include an **additional 10,000 square feet** of office space in the same building.
- The increase in the lease payments is **commensurate with the market rate** at the date the modification is agreed for the additional 10,000 square feet of office space.
- Lessee would have 2 separate contracts, each of which contain a single lease component—the original, unmodified contract for 10,000 square feet of office space and the new contract for 10,000 additional square feet of office space, respectively.
- Lessee would not make any adjustments to the accounting for the original lease as a result of this modification.

Separate contract

Some considerations

- How does the organization determine whether the increase in the lease payments is commensurate with the stand-alone selling price of the additional right-of-use asset
 - Follow guidance in ASU 2016-02 BC156 (observable inputs and estimates based on observable inputs).
- What if in addition to the additional square footage, the lease term was also extended?
 - A contract modification can only be accounted for as a separate contract if the only change to the existing contract is to add an additional right-of-use asset.

Continuation of an existing contract

ASC 842-10-25-9 to 10

- If a lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the entity shall reassess the classification of the lease in accordance with paragraph 842-10-25-1 as of the effective date of the modification.
- An entity shall account for initial direct costs, lease incentives, and any other payments made to or by the entity in connection with a modification to a lease in the same manner as those items would be accounted for in connection with a new lease.

Continuation of an existing contract

Remeasurement

- The lessee must reallocate the remaining consideration in the contract among the lease and nonlease components, and remeasure the lease liability based on the discount rate as of the effective date of the modification.
- The adjustment to the right-of-use asset depends on the terms of the modification.

Continuation of an existing contract

- A modification that is not accounted for as a new lease fits into one of four broad categories:
 - It fully or partially terminates an existing lease
 - It grants an additional right of use
 - It extends or reduces the term of the existing lease, unless an existing option to extend or terminate the lease is exercised
 - It changes only the consideration in the contract.

Continuation of an existing contract

Example – Increase in term (ASC 842-10-55-162 to 165)

- Lessee enters into a 10-year lease for 10,000 square feet of office space.
- At the beginning of Year 6, Lessee and Lessor agree to modify the lease such that the total lease term increases from 10 year to 15 years. Annual lease payments also increase each year for the remaining 10 years after the modification.
- No additional right-of-use asset.
- Lease liability is remeasured as of the effective date of the modification with an adjustment to the right-of-use asset.

Continuation of an existing contract

Example – Change in payments (ASC 842-10-55-186 to 189)

- Lessee enters into a 10-year lease for 10,000 square feet of office space.
- At the beginning of Year 6, Lessee and Lessor agree to modify the lease for the remaining 5 years to reduce the lease payments for each of the remaining years.
- Lease liability is remeasured as of the effective date of the modification with an adjustment to the right-of-use asset.

Continuation of an existing contract

Example – Additional right of use (ASC 842-10-55-168 to 176)

- Lessee enters into a 10-year lease for 10,000 square feet of office space.
- At the beginning of Year 6, Lessee and Lessor agree to modify the lease for the remaining 5 years to include an **additional 10,000 square feet** of office space in the same building.
- The increase in the lease payments is **at a substantial discount to the market rate** at the date the modification is agreed to for leases substantially similar to that for the new 10,000 square feet of office space that cannot be attributed solely to the circumstances of the contract.
- Modified contract has 2 lease components (original and new space). Lessee allocates the lease payments to the components on a relative standalone price basis.
- Lease liability for the original space is remeasured as of the effective date of the modification with an adjustment to the right-of-use asset.
- Lease liability for the new space is measured as of the commencement date.

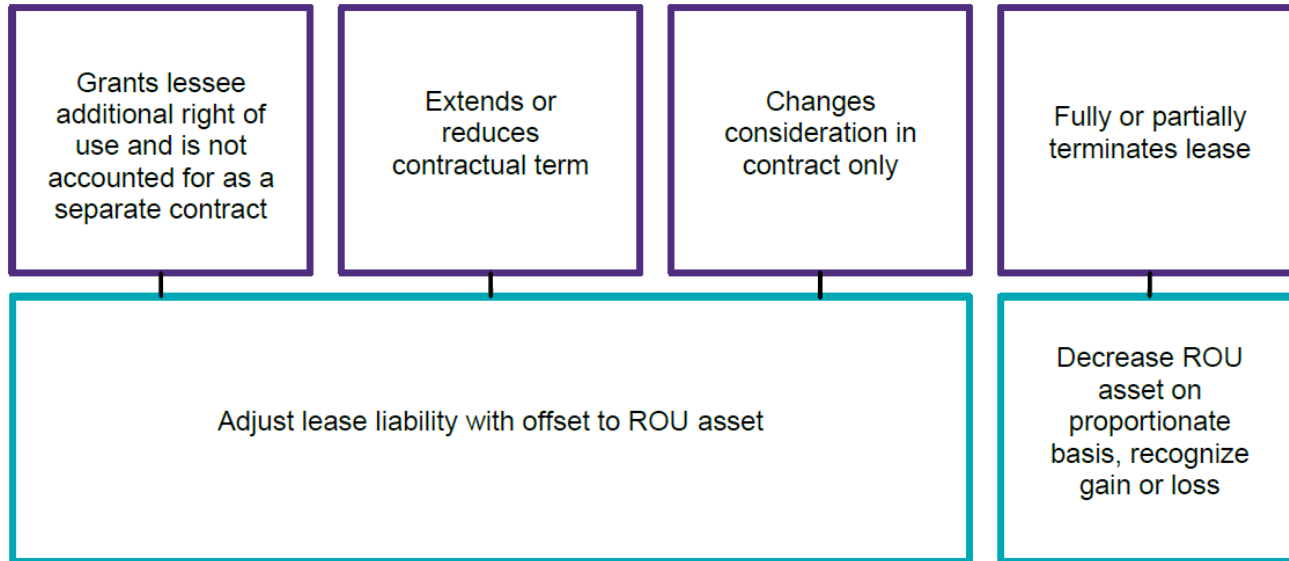
Continuation of an existing contract

Example – Partial termination

- The lessee reduces the carrying amount of the right-of-use asset on a basis proportionate to the full or partial termination of the lease. Any difference between the adjustment to the right-of-use asset and the lease liability is recognized as a gain or loss in the current period.
- For example, if a lessee modifies a lease of 10,000 square feet of office space so that it has the right to use only 5,000 square feet going forward, it could reduce both the right-of-use asset and the lease liability by 50 percent, with any difference recognized as a gain or loss in earnings.
- Then, the lessee would remeasure the lease liability, with the offset recognized as an adjustment to the right-of-use asset.

Continuation of an existing contract

Summary



Lease termination

ASC 842-20-40-1 to 2

- When a lease is terminated before the end of the lease term, the lessee should account for the termination by removing the right-of-use asset and the lease liability from the statement of financial position and recording the difference to gain or loss.
- However, when the lessee purchases the underlying asset, any difference between the purchase price of the asset and the carrying amount of the lease liability is recorded as an adjustment to the carrying amount of the asset.

Lease concessions

FASB Staff Q&A

- A lease concession may take the form of deferred rent, rent forgiveness, a combination of a deferral of rent with an extension of the lease term, or some other form of relief.
- The accounting for a lease concession depends on whether the lessee has an enforceable right to the concession.
- A lease contract may provide a lessee with an enforceable right to a concession, such as a “force majeure” clause, or the laws in the jurisdiction governing the lease may create an enforceable right when a concession is legally required. Whether or not an enforceable right to a concession exists is ultimately a legal determination.

Lease concessions

FASB Staff Q&A

- If the concession is based on an enforceable right and no other terms of the lease have changed, then the concession is generally not accounted for as a lease modification.
- If the concession is not based on an enforceable right, or if other changes are made to the terms of the lease, then the concession is generally accounted for as a lease modification.

Lease concessions

Example – Deferral of rent not accounted for as a lease modification

- Deferral of rent changes the timing, but not the amounts, of the rental payments.
- Account for using one of two methods:
 - Continue to account for the lease as if no deferral has been provided. Lessee recognizes a payable.
 - Account for the deferred payments as variable lease payments

Lease concessions

Example – Rent forgiveness

- This type of concession reduces the amount of lease payments rather than simply adjusting the timing of the lease payments.
- Accounted for as a variable lease payment.
- If a lessor forgives rent under an operating lease, the lessee would recognize negative lease expense.

Other events triggering remeasurement

ASC 842-10-35-4

- Resolution of a contingency associated with a variable payment that causes it to meet the definition of a lease payment.
 - Example: variable lease payments that were linked to performance or use of the underlying asset become fixed payments for the remainder of the lease
- A change in either the lease term, the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset, or the amount probable of being owed by the lessee under a residual value guarantee.
 - Lessee elects to exercise an option not previously determined to be reasonably certain
 - Lessee does not elect to exercise an option that was previously determined to be reasonably certain
- Changes to the lease payments cause the lessee to remeasure the lease liability, the offset to the lease liability adjustment should be an adjustment to the right-of-use asset, and not to gain or loss.

Questions?

