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Lease Accounting Refresher

FASB ASU 2016-02, *Leases (Topic 842)*, is effective for most private companies for fiscal years beginning after December 15, 2021, and interim periods within fiscal year beginning after December 15, 2022, based upon the FASB's issuance of ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, to defer the effective date of ASU 2016-02.

At its November 10, 2021 meeting, the FASB voted against another deferral, so all private companies must prepare to adopt the new guidance. Public companies have already been subject to the new standard for a year.

This article is the first in a series of articles that provide a refresher on FASB ASC 842 and implementation issues that accountants should keep in mind as they adopt the new guidance. It's a high-level overview only, so it's important to refer to the detailed guidance in Topic 842 and the related ASUs.

Additional Leases ASUs

After ASU 2016-02 was issued, the FASB issued additional ASUs to address implementation issues and make improvements and corrections. These ASUs have the same effective date as ASU 2016-02, as amended, for nonpublic entities that haven't yet implemented ASU 2016-02. These subsequent ASUs are as follows:

- ASU 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*
- ASU 2018-10, *Codification Improvements to Topic 842, Leases*
- ASU 2018-11, *Leases (Topic 842): Targeted Improvements*
- ASU 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*
- ASU 2019-01, *Leases (Topic 842): Codification Improvements*
- ASU 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*

In this Issue:

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- ASU 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*

Transitioning to the New Guidance

When effective, the ASU will supersede FASB ASC 840, *Leases*, and add FASB ASC 842, *Leases*, to the FASB Codification. Lessees and lessors are required to apply the guidance in FASB ASC 842 using one of the following two methods:

- **Retrospectively to all prior periods presented with the cumulative effect adjustment of initial application recognized as of the beginning of the earliest period presented.** Under this method, the application date is the later of the beginning of the earliest period presented and the commencement date of the lease. The entity should adjust equity and other comparative amounts for all periods presented as if the guidance had always been applied.
- **Retrospectively at the beginning of the period of adoption through a cumulative-effect adjustment.** Under this method, the application date is the beginning of the reporting period of adoption.

Practical Consideration:

Most nonpublic entities will choose the second method of adoption given the relief from only having to apply the guidance to leases in place as of the adoption date.

The transition guidance provides a number of practical expedients that may be elected. One set of practical expedients must be elected as a package and applied to all leases.

Primary Differences between FASB ASC 842 and FASB ASC 840

The primary difference between FASB ASC 842 and FASB ASC 840 is the recognition of lease assets and lease liabilities in the balance sheet by lessees for operating leases.

In addition, the lease standard includes a number of specific qualitative and quantitative disclosure requirements. The objective is to provide more information about the amounts, judgments, timing, and cash flows related to leasing transactions.

Scope

The leasing guidance is applicable to all leases, including subleases. However, the guidance doesn't apply to leases—

- of intangible assets under FASB ASC 350,
- for the exploration or use of minerals, oil, natural gas, and other similar resources under FASB ASC 930 and FASB ASC 932,
- of biological assets, including timber under FASB ASC 905,
- of inventory under FASB ASC 330, and
- of assets under construction under FASB ASC 360.

General Requirements

At the beginning of a contract, an entity is required to determine whether the contract contains a lease. A *lease* is defined as a contract (or part of a contract) that, in exchange for consideration, conveys the right to control the use of an identified property, plant, or equipment for a period of time.

If a lease does exist, the entity is required to identify the separate lease components, if any, within the contract. For example, a lease may include multiple pieces of equipment. With certain exceptions, the right to use an asset conveyed in the lease should be considered a separate lease component if both of the following are met:

a. The lessee can benefit from the right to use the asset either individually or with other readily available resources.
b. The right of use isn't highly dependent (or highly interrelated) with other rights to use underlying assets in the contract.

Both lessees and lessors are required to allocate the consideration in the contract to each separate lease and non-lease component of the contract. Each lease component should be accounted for separately from non-lease components. However, a lessee may make an accounting policy election, in accordance with FASB ASC 842-10-15-37, to account for lease and non-lease components as a single lease component. FASB ASC 842-10-15-42A also allows lessors, by class of underlying asset, to account for lease and non-lease components as a single component if the non-lease components would be accounted for under FASB ASC 606, *Revenue from Contracts with Customers*, and meet certain other conditions. If the non-lease component(s) is the predominant component, the combined component would be accounted for under FASB ASC 606; if the lease component is predominant, it would be accounted for as an operating lease under FASB ASC 842.

An entity is required to classify each separate lease component as of the commencement date (unless the entity makes an accounting policy election). The *commencement date* is the date the lessor makes the specific asset available for the lessee to use. Lessees should classify a lease as either an operating or finance lease. Lessors should classify a lease as a sales type, direct financing, or operating lease. With certain exceptions, the classification of a lease shouldn't be reassessed after the commencement date unless the contract is modified and the modification isn't accounted for as a separate contract.

Practical Consideration:

The next article in the series will discuss lessee accounting after implementation of FASB ASC 842.

Implementation Considerations

Given that most nonpublic entities will be adopting the new standard for fiscal years ending in 2022, accountants and auditors need to consider the implications of transitioning to the new standard and begin preparation for adoption prior to the fiscal year of effectiveness. The following steps may be helpful:

- Become familiar with the new guidance.
- Gather and catalog documentation regarding leasing arrangements.
- Evaluate leasing arrangements and prepare calculations needed for cumulative effect adjustment journal entries.
- Consider the impact on debt covenants or other financial statement requirements.
- Consider the impact on financial reporting processes, including financial statement preparation.

FASB Issues Guidance on Revenue Contracts Acquired in a Business Combination

ASU 2021-08, *Business Combinations (Topic 805) Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*, was issued in October 2021 to address diversity in practice in accounting for acquired revenue contracts in a business combination.

ASU 2021-08 applies to all entities that enter into a business combination within the scope of FASB ASC 805-10, *Business Combinations—Overall*. The ASU applies to all contract assets and contract liabilities acquired in a business combination that result from contracts accounted for under FASB ASC 606. The ASU doesn't apply to customer or contract-related intangible assets recognized in a business combination. It also doesn't apply to other assets or liabilities that may be recognized under FASB ASC 606, such as refund liabilities or up-front payments to customers.

Main Provisions

ASU 2021-08 amends FASB ASC 805 to require acquirers to recognize and measure customer contract assets and liabilities acquired in a business combination in accordance with FASB ASC 606.

ASU 2021-08 requires contract assets and contract liabilities to be accounted for as if the acquirer had entered into the original contract at the same time and same date as the acquiree. This is different from existing GAAP, which requires the acquirer to recognize contract assets and contract liabilities at fair value as of the acquisition date.

For an acquirer of a business, this means that deferred revenue won't disappear. It will remain on the books as of the acquisition date, much like the treatment that would have occurred had the acquirer entered into the original contract.

But this doesn't mean that acquirer simply carries over the historical balances from the acquiree's

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accounting records. The acquirer needs to consider the reasonableness of the acquiree's application of FASB ASC 606 and whether the acquirer's accounting policies differ from the acquiree's accounting policies.

Effective Date

For public business entities, ASU 2021-08 is effective for fiscal years beginning after December 15, 2022, including interim periods within those years. For all other entities, it is effective for fiscal years beginning after December 15, 2023, including interim periods within those years. Early adoption is permitted.

Transition Requirements

The amendments should be applied prospectively to all business combinations that occur on or after the ASU's effective date. If adopted early, the amendments must be applied to all business combinations that occurred during the year of adoption. If adopted in an interim period, the amendments are to be applied retrospectively to all business combinations where the acquisition date is on or after the beginning of the year that includes the interim period, and prospectively to all business combinations on or after the date the ASU is applied.

Practical Consideration:

ASU 2021-08 can be found on the FASB's website at **www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176178784700&acceptedDisclaimer=true**.