VALDES, GARCIA, MARIN & MARTINEZ, LLP
CERTIFIED PUBLIC ACCOUNTANTS & CONSULTANTS

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ASC 842 Lease Accounting Standard

Please contact your account service partner should you have any questions or comments or if you need additional information regarding these matters.

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Lease Accounting: ASC 842 Background

In February 2016, the Financial Accounting Standards Board (the "FASB") issued a comprehensive lease accounting standard, Accounting Standards Update No. 2016-02, *Leases* ("ASC 842"), impacting both lessees and lessors. ASC 842 sets out the principles for the recognition, measurement, presentation, and disclosures of leases transactions. Under its core principle, the lessee will recognize right-of-use ("ROU") assets on the balance sheet, representing its right to use the leased assets over the lease terms and the related lease liabilities for those arrangements that contain a lease. The presentation and pattern of expense recognition in the income statement will depend on the lease classification.[1]

Under prior U.S. GAAP, the key determination was whether a lease was an operating lease or a capital lease as that drove if a lease was recognized on the balance sheet. There were no major differences in accounting between an operating lease and an executory contract, and, accordingly, entities may not have historically put significant focus on the prior lease definition. ASC 842 carries forward lease classifications that are generally consistent with previous U.S. GAAP. For lessees, leases are classified as either an operating lease or a finance lease, while for lessors, leases are classified as sales-type, direct financing, or operating, with certain exceptions. However, under ASC 842, the key determination will be whether a contract is or contains a lease as it will drive if an asset is recognized in the balance sheet. Accordingly, entities may need to devote significant time on this aspect of the guidance to ensure that they comply with the new requirements.

What's new for Lessees under ASC 842

The following table summarizes lessee accounting for finance and operating leases under ASC 842:

Financial Statements	Finance Lease	Operating Lease
Balance Sheet	At the commencement date, recognize ROU asset and lease liability. The lease liability is initially measured at the present value of the unpaid lease payments. The ROU asset is initially measured at the amount of the lease liability initially recognized, plus initial direct costs and prepaid lease payments, less lease incentives received.	At the commencement date, recognize ROU asset and lease liability. The lease liability is initially measured at the present value of the unpaid lease payments. The ROU asset is initially measured at the amount of the lease liability initially recognized, plus initial direct costs and prepaid lease payments, less lease incentives received.
Income Statement	Recognize interest on the lease liability separately from the amortization of the ROU asset.	Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, generally on a straight-line basis.
Statement of Cash Flows	Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities.	Classify all cash payments for leases within operating activities.

[1] ASC 842 applies to most leases and subleases, but exceptions do exist. Here are the out-of-scope lease types, as detailed in Subtopic 842-10-15-1: Leases of intangible assets, such as cloud computing arrangements; leases for the exploration or use of non - regenerative natural resources such as oil, natural gas, and minerals; leases of biological assets such as plants, animals, and timber; leases of inventory; and leases of assets that are under construction.

The FASB also provides to lessees only (i.e., not lessors) with a recognition exemption for short-term leases. The short-term lease exemption applies to contracts with lease terms of 12 months or less and which do not include an option to purchase the underlying asset that is reasonably certain to be exercised. This election is made by asset class. If elected, leases that qualify for the exemption are not recognized on the balance sheet, and the lease payments related to those leases are recognized generally on a straight-line basis over the lease term in the income statement, essentially resulting in an accounting outcome that is consistent with the legacy lease accounting guidance in Topic 840, *Leases* ("Topic 840").

What's new for Lessors under ASC 842

Lessor accounting remains relatively consistent with previous U.S. GAAP. That is, leases will continue to be classified as sales-type, direct financing, or operating, and the accounting under those lease classifications will be substantially similar to current GAAP. The lessor accounting, however, has been updated for consistency with the new lessee accounting model and with the new revenue standard ASC 606, *Revenue from Contracts with Customers*, which will result in some important changes to certain aspects of lessor accounting (e.g., the separation and allocation guidance, the impact that collectability, uncertainties, and significant variable lease payments have on lease classification, what costs qualify as initial direct costs, and the accounting for sale and leaseback transactions).

Effective Dates (based on December 31 year-end):

Financial Statements	Annual Reporting	Interim Reporting
ASC 842 (Public Entities)	January 1, 2019	January 1, 2019
ASC 842 (Nonpublic Entities)[2]	January 1, 2020	January 1, 2021
IFRS 16 (All Entities)	January 1, 2019	January 1, 2019

A summary of ASC 842 transition provisions follows:

Transitions Methods

ASC 842 provides for two transition methods – the modified retrospective approach and the effective date approach. Regardless of the transition method elected, the new standard initially applies to all existing leases (like a full retrospective approach, but with modifications affecting when or how to recognize those existing leases).

- *Modified retrospective approach* – This method requires recognition at the beginning of the earliest comparative period presented of leases that exist at that date (for example at January 1, 2017 for a calendar public business entity that adopts ASC 842 on January 1, 2019), as well as adjusting equity at the beginning of the earliest

[2] In June 2020, the FASB issued ASU No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842)* ("ASU 2020-05") to defer to certain entities the effective dates of its revenue recognition and lease accounting standards in response to the coronavirus pandemic. ASU 2020-05 defers the effective date of the lease accounting standard for private companies and private-not-for-profits that have not yet applied this standard for fiscal years beginning after December 15, 2021, and to interim periods within fiscal years beginning after December 15, 2022. Early adoption continues to be permitted, which means that an entity may choose to implement the new lease standard before those deferred dates.

comparative period presented reflecting the effect of adopting the new standard as if ASC 842 had always been applied. The recognition requirement applies to all existing operating leases, including leases that expired before the adoption date. An entity (lessee or lessor) must also provide the new and enhanced disclosures in all periods presented, including the prior periods. The date of initial application is the later of the beginning of the earliest period presented and the commencement date for the lease.

- *Effective date approach* – In July 2018, the FASB issued Accounting Standards Update No. 2018-11, which provides an additional (and optional) transition method (the effective date approach). Under this method, an entity initially applies the new leases guidance at the adoption date (rather than at the beginning of the earliest period presented). Therefore, a calendar year-end entity with an initial adoption date of January 1, 2019 which elects the additional transition method would apply Topic 840 in the comparative periods and recognize the effects of applying ASC 842 as a cumulative adjustment to retained earnings as of January 1, 2019. If an entity elects the new transition method, it is required to provide the Topic 840 disclosures for all prior periods presented that remain under the legacy leases guidance. The date of initial application is the beginning of the period in which an entity adopts the new lease standard.

Practical Expedients

ASC 842 provides multiple practical expedients in order to simplify adoption, including the following:

- An entity need not reassess whether any expired or existing contracts are or contain leases.

- An entity need not reassess the lease classification for any expired or existing leases. Instead, any leases previously classified as operating leases will continue to be classified as operating leases, while any leases previously classified as capital leases will be classified as finance leases.

- An entity need not reassess initial direct costs for any leases.

The three practical expedients must be elected as a package and must be applied by an entity to all of its leases (those for which the entity is a lessee or a lessor).

In addition to the package of practical expedients, ASC 842 also provides the following two other expedients:

- An entity may use hindsight in determining the lease term, including consideration of renewal, termination and purchase options, and in assessing impairment of ROU assets. This expedient must also be elected at the entity level and may be elected separately or in conjunction with either or both the package of practical expedients and the land easements practical expedient.

- An entity may elect a practical expedient not to assess whether existing or expired land easements that were not previously accounted for as leases under Topic 840 are or contain a lease. This expedient must also be elected at the entity level and may be elected separately or in conjunction with either or both the package of practical expedients and the hindsight practical expedient.

Easing your transition to ASC 842

ASC 842 compliance is challenging, and the effective date of implementation for private companies and nonprofits is quickly approaching. The new standard applies to both lessees and lessors, and it brings significant changes to balance sheets. By proactively preparing for ASC 842 now, businesses can mitigate any potential financial reporting issues, including errors and restatements.

One of the first steps in this transition journey is to identify a key person to head the transition and to ensure your accounting team has been educated on the new standard and understands its implications across the organization. Companies should also begin identifying and assessing their current lease portfolios; evaluating lease management solutions; considering the adoption of appropriate processes and procedures; and finally develop a strategic plan to move forward. External resources are often required to become compliant, and selecting your advisor is a key decision. The right choice supplements your internal personnel with only the services you need, in addition to adopting best practices and timely implementation.

At Valdés, García, Marín & Martínez, LLP we help our clients prepare for the new compliance standard through a range of services that evaluate necessary changes and anticipate broader business implications as a result of the new requirements. We are committed to helping our clients prepare for ASC 842. Providing complete, end-to-end services, our professionals can help to:

- Discuss and establish a realistic adoption plan;
- Assist with implementation services and accounting, including but not limited to creation of journal entries, amortization schedules and disclosure reports;
- Identify any additional or new system needs (Excel or other); and
- Ensure continual review and improvements to the accounting and operational policies and controls.

Valdés, García, Marín & Martínez, LLP is a Puerto Rico based firm of Certified Public Accountants and Consultants organized as a partnership for the practice of public accounting since 1975. Over 45 years of experience in public accounting support our commitment to excellence and professionalism.

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