KPMG

Executive View

ASC 842, Leases – Transition disclosures

October 2018

Companies’ SAB 74 disclosures about the new leases standard should become more detailed and provide quantitative information as the effective date nears.

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 of 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.

The SEC staff commented further about its expectations in a September 21, 2017 speech, stating that as the effective date nears, they expect a registrant’s transition disclosures to become “more informative to the users of the financial statements.”[2] We interpret the staff’s comments to mean that they expect additional and more precise quantitative and qualitative information will be disclosed as the effective date approaches.

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

[1] The SEC staff announcement is codified in the FASB’s Accounting Standards Codification at paragraph 250-10-S99-6.
[2] “Addressing Implementation Matters to Improve Financial Reporting,” Sagar Teotia, September 21, 2017

ASUs, including ASU 2016-02, *Leases (Topic 842).*

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.

Lessee

In February 2016, the FASB established Topic 842, Leases, by issuing Accounting Standards Update (ASU) No. 2016-02, which requires lessees to recognize leases on-balance sheet and disclose key information about leasing arrangements. Topic 842 was subsequently amended by ASU No. 2018-01, Land Easement Practical Expedient for Transition to Topic 842; ASU No. 2018-10, Codification Improvements to Topic 842, Leases; and ASU No. 2018-11, Targeted Improvements. 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. A modified retrospective transition approach is required, applying the new standard to all leases existing at the date of initial application. An entity may choose to use either (1) its effective date or (2) the beginning of the earliest comparative period presented in the financial statements as its date of initial application. If an entity chooses the second option, the transition requirements for existing leases also apply to leases entered into between the date of initial application and the effective date. The entity must also recast its comparative period financial statements and provide the disclosures required by the new standard for the comparative periods. We expect to adopt the new standard on January 1, 2019 and use the effective date as our date of initial application. Consequently, financial information will not be updated and the disclosures required under the new standard will not be provided for dates and periods before January 1, 2019. [We currently expect to adopt the new standard on January 1, 2019 and use January 1, 2017 – the beginning of the earliest comparative period that will be presented in our financial statements – as our date of initial application.]

The new standard provides a number of optional practical expedients in transition. We expect to elect the ‘package of practical expedients’, which permits us not to reassess under the new standard our prior conclusions about lease identification, lease classification and initial direct costs. We do not expect to elect the use-of-hindsight or the practical expedient pertaining to land easements; the latter not being applicable to us. [We expect to elect all of the new standard’s available transition practical expedients.][3]

We expect that this standard will have a material effect on our financial statements. While we continue to assess all of the effects of adoption, we currently believe the most significant effects relate to (1) the recognition of new ROU assets and lease liabilities on our balance sheet for our [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; (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; and (4) providing significant new disclosures about our leasing activities. We do not expect a significant change

[3] The package of practical expedients, the use of hindsight, and the land easement practical expedient may each be elected on its own or with either or both of the other practical expedients. The package of practical expedients must be elected entirely or not at all.

Lessee (continued)

in our leasing activities between now and adoption.[4]

On adoption, we currently expect to[5]:

- Recognize additional operating liabilities [ranging from $X,XXX to $X,XXX] [of approximately $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] [of approximately $X,XXX] and existing fixed assets [ranging from $X,XXX to $X,XXX] [of approximately $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 [as of the effective date] [as of the beginning of the earliest period presented[6]] on adoption, and we will recognize new ROU assets and lease liabilities [ranging from $X,XXX to $X,XXX] [of approximately $X,XXX] on our balance sheet for the associated leases.
- Derecognize existing debt obligations [ranging from $X,XXX to $X,XXX] [of approximately $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] [of approximately $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 we are the accounting owner under current US GAAP, and for which construction is not yet complete as of the effective date will be evaluated under the new standard. This 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.

The new standard also provides practical expedients for an entity's ongoing accounting. We currently expect to elect the short-term lease recognition exemption for [our vehicle and office equipment leases] [all leases that qualify]. This means, for those leases that qualify, we will not recognize ROU assets or lease liabilities, and this includes not recognizing ROU assets or lease liabilities for existing short-term leases of those assets in transition. We also currently expect to elect the practical expedient to not separate lease and non-lease components [for all of our leases] [for leases of vehicles and office equipment] [for all of our leases other than leases of real estate][7]

Lessor

In February 2016, the FASB established Topic 842, Leases, by issuing Accounting Standards Update No. 2016-02, which requires lessors to classify leases as a sales-type, direct financing, or operating lease. Topic 842 was subsequently amended by ASU No. 2018-01, Land Easement Practical Expedient for Transition to Topic 842; ASU No. 2018-10, Codification Improvements to Topic 842, Leases; and ASU No. 2018-11, Targeted Improvements. 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

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

[5] Quantitative disclosures about the effect of adopting ASU 2016-02 should become more precise over time, narrowing the range or providing a point estimate as the effective date nears.

[6] 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 if the company elects to use the beginning of the earliest comparative period presented as its date of initial application.

[7] The short-term lease recognition and measurement exemption and the non-separation practical expedient are elected by class of underlying asset.

Lessor (continued)	
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, applying the new standard to all leases existing at the date of initial application. An entity may choose to use either (1) its effective date or (2) the beginning of the earliest comparative period presented in the financial statements as its date of initial application. If an entity chooses the second option, the transition requirements for existing leases also apply to leases entered into between the date of initial application and the effective date. The entity must also recast its comparative period financial statements and provide the disclosures required by the new standard for the comparative periods. We expect to adopt the new standard on January 1, 2019 and use the effective date as our date of initial application. Consequently financial information will not be updated and the disclosures required under the new standard will not be provided for dates and periods before January 1, 2019. [We currently expect to adopt the new standard on January 1, 2019 and use January 1, 2017 – the beginning of the earliest comparative period that will be presented in our financial statements – as our date of initial application.] The new standard provides a number of optional practical expedients in transition. We expect to elect the 'package of practical expedients', which permits us not to reassess under the new standard our prior conclusions about lease identification, lease classification, and initial	direct costs. We do not expect to elect the use-of-hindsight or the practical expedient pertaining to land easements; the latter not being applicable to us. [We expect to elect all of the new standard's available transition practical expedients.][8] While we continue to evaluate certain aspects of the new standard, including those still being revised by the FASB,[9] we do not expect the new standard to have a material effect on our financial statements and we do not expect a significant change in our leasing activities 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.] [While most of our leases will continue to be classified as operating leases, a meaningful population of leases that will commence on or after the effective date of the new standard, and that were classified as operating leases under current US GAAP, will be classified as sales-type leases. This is because the new standard, unlike current US GAAP, does not preclude sales-type lease classification when most or all of the rental payments are variable.[10] [On adoption of the new standard, maintenance services will no longer be considered part of the lease element of our equipment leasing contracts. Instead, those services will be accounted for as a non-lease component within the scope of the new revenue standard. As a result, we will recognize revenues associated with our equipment leases separately from revenues associated with maintaining the equipment. Our preliminary assessment

[8] The package of practical expedients, the use of hindsight, and the land easement practical expedient may each be elected on its own or with either or both of the other practical expedients. The package of practical expedients must be elected entirely or not at all.

[9] The FASB issued a Proposed ASU, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, on August 13, 2018. The proposed ASU affects the accounting for sales and other similar taxes and certain lessor costs (e.g. of property taxes and insurance). As of the date of this publication, the FASB has not finalized those amendments to Topic 842.

[10] Refer to paragraphs 13A.4.140 – 13A.4.160 and Q&A 7.3.30 in KPMG's Handbook, Leases for additional discussion of when operating leases under the current guidance could be classified as sales-type leases under the new standard.

Lessor (continued)	
is that approximately X-XX% of customer lease payments will be attributed to the maintenance services. At this time, we do not believe applying the recognition provisions in the new revenue standard to our maintenance services will affect the timing of recognition of our maintenance services revenue.] [While the new standard identifies maintenance as a non-lease component of our equipment lease contracts, we expect to apply the practical expedient to account for our equipment leases and associated maintenance service components as a single, combined operating lease component. Consequently, we do not expect the new standard's changed guidance on contract components to significantly affect our financial reporting.] [A significant number of our lease contracts include services to operate the underlying asset on the lessee's behalf, and to maintain the asset. We expect to apply the practical expedient to account for those leases and associated operations and maintenance services as a single, combined component. We are continuing to evaluate whether the lease or the non-lease operations and maintenance services are 'predominant' in those contracts, which will affect whether we account for the combined component as an operating lease or as a single performance obligation under the new revenue guidance in ASC 606. Because of our decision to elect this practical expedient, we will no longer	present our lease and service revenues separately in our income statement beginning on the date we initially apply the new standard.] [Subsequent to adopting 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 recognize revenues associated with our real estate leases separately from revenues associated with common area maintenance. We continue 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.] [While the new standard identifies common area {building} maintenance as a non-lease component of our real estate lease contracts, we expect to apply the practical expedient to account for our real estate leases and associated common area maintenance service components as a single, combined operating lease component. Consequently, we do not expect the new standard's changed guidance on contract components to significantly affect our financial reporting.] 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.

A reminder: Effective dates and transition

	Public business and certain other entities[11]	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.	

[11] (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.

For further reading

Defining Issues: SEC staff comments on accounting for tax reform and implementation efforts for new standards

Defining Issues: SEC staff comments on implementation of new accounting standards

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

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

Handbook: Leases

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KPMG's Financial Reporting View

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