KPMG

Hot Topic: ASC 842

Using recognition thresholds under Topic 842

Companies should consider a number of factors before deciding whether to establish a lease recognition threshold and, if so, at what amount.

Key impacts

In finalizing Topic 842, the FASB observed that, in addition to accounting for some leases at a portfolio level, entities would likely be able to adopt reasonable thresholds below which lease assets and lease liabilities are not recognized; this should reduce the costs of applying the guidance. The Board noted that an entity's practice in this regard may be consistent with many companies' accounting policies in other areas of US GAAP – e.g. in capitalizing purchases of property, plant and equipment (PP&E). [ASU 2016-02.BC122]

As a result of this discussion and other factors, many companies have expressed a desire to establish a recognition threshold under which they would not recognize right-of-use (ROU) assets or lease liabilities. Some of those companies have further questioned whether they would still need to consider these leases in their required lease disclosures under Topic 842.

Applying a recognition threshold will generally be acceptable. However, setting that threshold at an appropriate level may require substantial judgment, and generally it would not be appropriate to:

— default to the company's PP&E capitalization threshold;
— evaluate the effect of the threshold on a net basis (ROU assets less lease liabilities); or
— ignore the effect of the threshold established on financial statement disclosures.

It may be helpful for many companies to think about the lease liability first when establishing the recognition threshold. This is because we would expect it to be relatively rare for a company to conclude that its capitalization threshold for ROU assets would be less than its recognition threshold for lease liabilities. Instead, a company should generally first consider its recognition threshold for lease liabilities.

The remainder of this Hot Topic discusses key items a company should consider in deciding whether to establish a recognition threshold, what that threshold will apply to (e.g. recognition only or recognition and disclosure), and what that threshold should be.

Whether to use a recognition threshold

Electing a non-GAAP accounting policy to recognize leases only over a certain threshold may provide substantive operational benefit to many companies. For example, use of a threshold, particularly if the company's non-GAAP policy includes both non-recognition and non-disclosure, may permit the company to (not exhaustive):

- avoid making various judgments and estimates – e.g. judgments such as whether a lease exists for certain contracts, determining discount rates or lease classification; and
- not accumulate and maintain some data it would otherwise need for disclosure purposes – e.g. information on variable lease cost.

However, it is possible that for some companies a recognition threshold will not provide significant benefit. For these companies, it may be simpler to account for all of their leases consistently, particularly if they have a robust IT lease accounting system or solution and their leases are relatively 'plain vanilla' – e.g. are not difficult to identify or assess for lease classification and are not subject to frequent remeasurement or modification.

Quantitative considerations

Companies have asked whether it is appropriate to:

- evaluate the effect of non-recognition on a 'net' basis – i.e. considering only the net effect on the balance sheet (ROU asset less lease liability);
- default to a threshold used for another non-GAAP policy – e.g. that used for not capitalizing PP&E or prepaid expenses; and/or
- evaluate the effect of the threshold without considering the effect on financial statement disclosures.

Our analysis that follows for each of those questions raised was influenced by discussions with the SEC staff.

Evaluation on net basis

While using recognition thresholds is likely acceptable, as would be true for any other non-GAAP policy, a lessee should measure the separate effects of not recognizing the lease liabilities and the ROU assets on the balance sheet (both individually for the leases and in the aggregate) when establishing a recognition threshold.

That's because there are numerous GAAP measures and financial ratios used by investors and analysts that ROU assets and lease liabilities will affect separately. Ignoring those effects would be contrary to the FASB's intent of providing better information to investors and analysts about leasing activities. It would also be inconsistent with accepted materiality considerations that could be affected by the 'missing' ROU assets and/or lease liabilities, such as whether the misstatement:

- masks a change in earnings or other trends (e.g. trends related to GAAP line-items or subtotals and certain financial ratios);
- hides a failure to meet analysts' consensus expectations for the enterprise;
- affects the registrant's compliance with regulatory requirements; and
- affects the registrant's compliance with loan covenants or other contractual requirements.

Use of PP&E threshold

Because the non-recognition of liabilities generally has a greater quantitative and qualitative effect on the financial statements than the non-recognition of assets, we believe lease recognition thresholds would typically need to be lower than those established for capitalizing PP&E.

Effect of disclosures

If a lessee also intends to exclude leases below the recognition threshold from its lease disclosures, the threshold should consider the effect on the completeness and accuracy of those disclosures. Depending on the facts and circumstances, considering the effect of excluding leases below the threshold from the lessee's lease disclosures may result in a lower threshold than one established for non-recognition of ROU assets and lease liabilities only.

Non-recognition of ROU assets only

While we expect most lessees' consideration of a recognition threshold would relate to non-recognition of the entire lease (i.e. both the ROU asset and the lease liability) on its balance sheet, we believe it would be acceptable for a lessee to establish a threshold whereby it recognizes the lease liability, but does not recognize the ROU asset.

For leases below the threshold, the lessee would expense at lease commencement an amount that would otherwise be the initial measurement of the ROU asset and account for the lease liability on an amortized cost basis, using the effective interest method, over the lease term. In that case, for operating leases, similar to when an ROU asset has been fully impaired,[1] we would expect the accretion of the lease liability to be presented as an operating expense, consistent with how the lessee's single lease cost would be presented if the ROU asset was recognized but impaired.

If a lessee adopts a recognition threshold that applies only to its ROU assets, it may be able to use a threshold similar to that used for its PP&E because the considerations will generally be similar. However, the lessee's existing PP&E recognition threshold that was deemed to be acceptable from a non-GAAP perspective will not have considered the incremental effect on the financial statements of the added non-recognition of ROU assets. Therefore, for the combined effect of not recognizing PP&E and ROU assets below the threshold to be immaterial, that threshold may need to be reconsidered.

In addition, consistent with the discussion of non-recognition of ROU assets and lease liabilities, the effect on the lease disclosures of expensing the ROU asset at lease commencement will need to be considered. The effect may be partially mitigated if:

— for operating leases, the lessee discloses (1) the amount of expense *recognized at lease commencement* for the cost of the ROU asset and (2) the accretion of the lease liability as 'operating lease cost' in the disclosure required by paragraph 842-20-50-4(b); and

— for finance leases, the lessee discloses the amount of expense recognized at lease commencement for the cost of the ROU asset as ROU asset amortization in the disclosure required by paragraph 842-20-50-4(a).

[1] See section 6.5 of KPMG's Handbook, Leases.

Effective date

Topic 842 is effective for public business entities for interim and annual periods in fiscal years beginning after December 15, 2018. It is effective for private companies for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning one year later. Early adoption is permitted for all entities.

For further information

For more information about the application of Topic 842, see KPMG's Handbook, Leases.

This Hot Topic is part of a series to highlight implementation issues that are discussed in KPMG's Handbook, Leases.