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Leases (Topic 842) Targeted Improvements – Modified Retrospective Transition Method

FASB Accounting Standards Update No. 2018-11 (Issue Date: July 2018)

Link to Standard: Update No. 2018-11

Overview

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2018-11, Leases (Topic 842) Targeted Improvements, in July 2018.

This update permits entities to use an optional transition method to Accounting Standards Codification (ASC) 842. The optional transition method allows an entity to continue to use guidance from ASC 840 in the comparative periods presented in adoption year of ASC 842. The optional election allows entities to implement the new lease standards of ASC 842 using an easier modified method to comparative financial statements by recognizing a cumulative-effect adjustment to the opening balance of retained earnings in the adoption year. This approach is thought to provide relief to adopters by simplifying the comparative reporting requirements presented in ASC 842, which would require entities to adjust all lease standard changes in the earliest period presented on their respective financial statements instead of a cumulative adjustment in the period of adoption.

Example: A lessee has an operating lease (under ASC 840) now determined to be a finance lease under ASC 842. The lease is for a 10-year period, and prior to the date of adoption of the new standard by the organization, 5 years has passed with a cumulative calculated interest expense of $1,250. The lease asset is $25,000. Total payments over the 10-year lease period are $27,500.

		Debit	Credit
Jan 1	Lease - Asset	$ 25,000	
	Lease - Liability		$ 25,000
Jan 1	Interest Expense (Opening RE)	$ 1,250	
	Lease - Liability		$ 1,250
Jan 1	Lease - Liability	$ 13,750	
	Lease Expense (Opening RE)		$ 13,750
	(Adjust lease expense recorded in first 5 years of lease term.)		
Jan 1	Depreciation Expense (Opening RE)	$ 12,500	
	Accumulated Depreciation		$ 12,500
	(($25,000/10 year life)*5)		

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The resulting change to the financial line items is summarized below.

	Year Ended 12/31/2018	Balances at 1/1/2019	Year Ended 12/31/2019
Lease expense	$ 13,750	-	$ -0-
Interest expense (2019)	-	-	250
Depreciation expense (2019)	-	-	2,500
Cash	-	-	(2,750)
Lease – Asset	-	25,000	25,000
Lease – Accumulated depreciation	-	(12,500)	(15,000) [6years]
Lease - Liability	-	(12,500)	(10,000)
Retained earnings – 2019 P&L	-	-	2,750
Retained earnings – Prior year	13,750	13,750	13,750

Background

This update amends ASC Topic 842 issued in February 2016. In ASC 842, the FASB announced significant changes that would address affecting lease accounting. The major change in this update is the classification of finance and operating leases. The new leasing standard, in general, will require an entity to recognize a right-of-use asset and a lease liability for each lease.

Under the optional guidance, a lessee would not have to measure and recognize leases that would have expired prior to the effective date of the new standard. For example, if a company were to use the modified retrospective adjustment they would have to measure and recognize all of their current leases at the adoption date. This will still require a full lease review to determine finance leases (capital leases) and operating leases. After the review, the company will then establish on the balance sheet any lease assets and any associated liabilities. There will be "catch up" entries to retained earnings for any newly categorized finance leases that had previously been recorded as operating leases under ASC 840, which will be presented as a line-item adjustment to opening retained earnings. Due to prior periods still being presented under the guidance of ASC 840 in this modified approached, the same disclosures will be required for those periods (i.e. minimum lease payments).

Insights

As noted, ASC 842 requires companies to retrospectively modify all comparative periods presented to comply with the new standards. We believe that this new ASU provides needed relief in the implementation of the standard. It should help companies reduce preparation time and resources needed to complete the reporting requirement.

Final Thoughts

Companies now have the option for a simplified reporting of the cumulative effect instead of showing the impact on the financial statements for each period presented. Entities should apply the amendments in this update in unison with the adoption of ASC 842, with the effective dates listed below for both public and non-public entities. Entities that early adopted the standard should apply the amendments in this update upon issuance.

	Effective Date	
	Public Entity	Non-Public Entity
Interim Periods	Beginning after December 15, 2018	Beginning after December 15, 2020

Early adoption is permitted if financial statements were not issued.

Annual Periods	Beginning after December 15, 2018	Beginning after December 15, 2019

Early adoption is permitted if financial statements were not made previously available for issuance.

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