SEC Comment Letters - ASC 842 Lease Accounting And Disclosures

SUMMARY AND OBSERVATIONS

DECEMBER 2019

EXECUTIVE SUMMARY

THE FIRST YEAR OF ADOPTION FOR TOPIC 842, LEASES

This report contains LeaseAccelerator's study of Securities and Exchange Commission (SEC) staff comments issued for the new lease standard, Leases (Topic 842) also known as ASC 842, in the first 10 months of 2019. Topic 842 was adopted by most calendar year-end public business entities (PBEs) in the interim first quarter of 2019 and, for many, was the most significant new accounting standard adopted in 2019. Overall, Topic 842 is one of the most significant new accounting changes in decades. An analysis of the financial disclosures of S&P 500 companies following the first quarter of adoption showed that most issuers brought a material amount of new right-of-use (ROU) assets and corresponding operating lease liabilities onto their balance sheet.[1] The adoption effort for many issuers necessitated a significant implementation process requiring the migration of hundreds, and sometimes thousands, of leases onto new systems with new controls, processes, and procedures. Although the sheer volume and magnitude of this feat may have been daunting, many issuers discovered one of the most significant challenges, both upon and post-adoption, related to the standard's accounting complexity and new disclosures reporting.

TWO THEMES EMERGE

SEC comment letters issued in the first 10 months after the initial effective date covered a wide range of areas including:

- Scope
- Lease Classification
- Discount Rates
- Lease Incentives
- Residual Value Guarantees
- Short-Term Lease Expense
- Variable Lease Expense
- Impairments
- Sale-Leaseback Transactions
- Comparative Reporting
- Divestitures
- Intercompany Accounting

Two common themes emerged across all the comments – (1) lease accounting complexity and (2) disclosure enhancement.

1. **Lease Accounting Complexity** – By "accounting complexity" we mean: *How did a company account for its leases, a part of a lease transaction, an individual transaction itself, or determine certain judgments and assumptions?* Many of the SEC comments were requests for additional details on a company's analyses, assumptions, judgments, and supporting documentation.

2. **Disclosure Enhancements** - Topic 842 requires several enhanced and new quantitative and qualitative disclosures that were not required or are more extensive than under the previous Topic 840 standard. SEC comments included various inquiries about specific interim disclosures and requests for enhanced disclosures. Most comments were requesting more robust disclosures about the nature of leases and the significant judgments and assumptions.

1. The First Quarter of ASC 842 - An Analysis of 10-Q Disclosures for S&P 500 Companies https://leaseaccounting.com/the-first-quarter-of-asc-842-infographic/

PURPOSE OF THIS REPORT

Working the wrinkles free after the adoption of a major new accounting standard requires many "hands-on" touches. One primary source of those touches originates from the SEC staff filing review and comment letter process. SEC staff reviews are intended to enhance and ensure compliance. Certain comments require minimal effort for compliance. These "low hanging fruit" comments consist of simple, easy enhancements or modifications to disclosures.

The goal of this report is to help preparers of financial statements and disclosures identify which Topic 842 areas have generated recent comments by the SEC staff. Our study was conducted in November 2019 and is based upon SEC comment letters issued year-to-date. We grouped Topic 842 related comments according to their subtopics:

1) Overall Lease Accounting
2) Lessee-Specific
3) Lessor-Specific
4) Sale-Leaseback Transactions
5) Leveraged Lease Arrangements

Our intent is that organizations reviewing this document may be able to identify the key issues and proactively address potential concerns, especially the "low-hanging fruit." At the time of this publication (December 2019), many of the initial adopters of Topic 842, PBEs with calendar-end fiscal years, are preparing to issue their first annual reports with financial statements and disclosures under the new standard. *(Yeah! No more lease interim disclosures; Q3 was it — the last time.)*

STUDY METHODOLOGY

We sourced our comments from MyLogIQ, which is a robust tool for quickly researching SEC comment letters as well as entire filings and other information in their databases. We did not include comments related to legacy GAAP (ASC 840) or lease comments not related to the financial statements, such as non-GAAP lease comments.

Similar comments are not repeated and are grouped into one comment type question, resulting in 15 types of comments, as identified below. Our comment wording is not word-for-word per the actual comments, nor do we provide company names or responses. This analysis was not meant to single out any company having received a comment, hence we paraphrased comment questions. The comments below, as we describe them, provide the general nature and a brief description of what the comments appear to be asking, followed by some of our observations from our own research, experience, or other sources. We don't provide the frequency of the comment as it's still early in the comment process for a newly adopted standard and frequency may not be relevant.

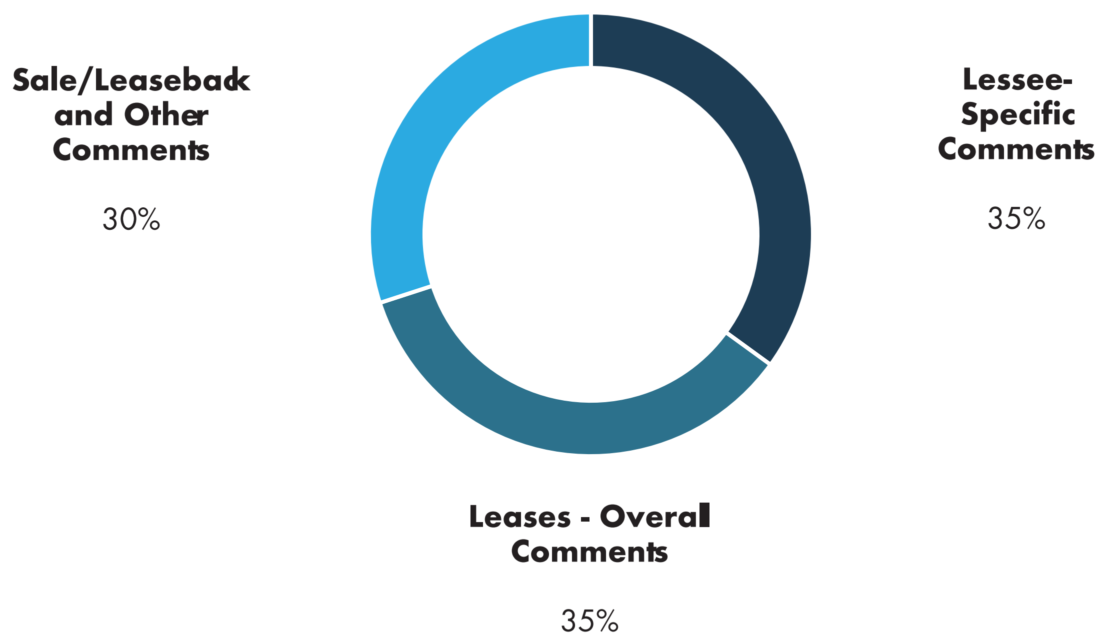
SEC COMMENTS AND LEASEACCELERATOR OBSERVATIONS

THREE CATEGORIES OF COMMENTS

As with any new accounting standard, the SEC will be closely reviewing interim and full year disclosures to offer suggestions for improvement or, as in the case of one early adopter, changing its accounting entirely (i.e. restatement). After classifying comments by subcategory, we found comments were sorted into the following subtopics:

- 35 percent lessee specific (Section 842-20)
- 35 percent leases overall (Section 842-10)
- 30 percent sale-leaseback transactions and other (Section 842-40)

SEC Comments on Topic 842 by Sub-Category



Source: Compiled from SEC comment codification references.
"Other" relates to comments with no codification reference and were grouped with the sale-leaseback subtopic.

SEC comments thus far are equally distributed among large accelerated, accelerated, and non-accelerated filers. The auditors of companies receiving comments included all Big 4 firms and certain mid-tier and smaller audit firms.

CATEGORY 1

LESSEE-SPECIFIC COMMENTS (SECTION 842-20)

Lessee comments relate to implementation guidance, subsequent measurement, and disclosure.

1. Discount Rate Assumptions and Judgments

Form of SEC Comment Inquiry (Paraphrased):
Revise to disclose information about significant assumptions and judgments made related to the determination of the discount rates for the company's leases (as described in paragraphs 842-20-30-2 through 30-4).

LeaseAccelerator Observation:
Many companies have not provided company specific information about how their discount rates were determined. This required disclosure often either does not exist or companies may only provide generic information (e.g. just repeating wording directly from Topic 842). ASC 842-20-50-3 states a lessee shall disclose, *"Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include… The determination of the discount rate for the lease."* Rather than copying wording from the standard, company specific information would be useful to readers and appears to be the SEC's focus and intent of this comment. The Connor Group conducted two separate lease disclosure studies,[2] one consisting of companies with market caps greater than $30 billion (78 companies) and another consisting of companies with market caps between $500 million and $1 billion (199 companies). Both studies revealed less than half of the companies provided company-specific information about how their discount rates were determined (see page 9 on each study). They also provide disclosure examples demonstrating a) company specific information included and, b) generic language included.

2. Disclosure of leases with rate implicit in a lease

Form of SEC Comment Inquiry (Paraphrased):
Describe the circumstances and how the entity obtained the inputs to determine the rate implicit in a lease.

LeaseAccelerator Observation:
We expect it will be rare for a lessee to be able to determine the rate implicit in a lease. On occasion we have seen discount rates specified for vehicle leases; however, the rates for other asset categories of leases, such as real estate, IT, machinery, and other types of equipment, are generally not transparent. If a company's disclosure about how it determines its discount rates merely copies the standard and states "*we use the rate implicit in a lease unless that rate cannot be readily determined,*" a company may receive an SEC comment. As discussed in #1 above, disclosing company specific information appears to be the SEC's focus with these two types of comments. ASC 842-20-30-3 states, *"A lessee should use the rate implicit in the lease whenever that rate is readily determinable. If the rate implicit in the lease is not readily determinable, a lessee uses its incremental borrowing rate."* Consider whether the company really has leases with rates 'implicit in the lease" and, if relevant, whether these are a material component of the lease portfolio before using this terminology.

2. Connor Group Releases ASC 842 Lease Disclosure Studies
https://www.connorgp.com/connor-group-releases-asc-842-lease-disclosure-studies/

3. Discount Rates for Finance and Operating Lease

Form of SEC Comment Inquiry (Paraphrased):
The weighted average discount rates for finance leases and operating leases were significantly different (i.e. one much higher than the other). How were the rates determined by each class of lease?

LeaseAccelerator Observation:
In the S&P 500 analysis LeaseAccelerator performed on first quarter data, we found that finance lease weighted average discount rates were generally higher than the operating lease rates, often by a significant percentage (i.e. more than a five percent delta). If you receive a comment of this type be prepared to explain why one weighted average rate is so much higher than the other (finance versus operating).[3] For example, rates could be higher after adjusting incremental borrowing rates to arrive at the fair value of the leased asset.

4. Impairment

Form of SEC Comment Inquiry (Paraphrased):
Provide the impairment analysis for a specific leased asset, including assumptions to determine fair value.

LeaseAccelerator Observation:
We identified more than fifty ROU asset impairments in first quarter filings, many of which were recorded as part of the transition adjustment. Judgment is required to determine when an impairment indicator under ASC 360 (i.e. a triggering event) has occurred. This type of comment may be more common when no ROU asset impairment exists, but a possible triggering event is described in a filing. For example, a company's MD&A disclosure, risk factors, press releases, or other financial disclosures may describe asset or business unit specific losses, assets no longer used, or adverse changes in legal factors. However, no impairments have been recorded but significant ROU assets related to these disclosure areas exist.

5. Variable and Short-Term Cost Disclosures in Lessee Cost Table

Form of SEC Comment Inquiry (Paraphrased):
Explain why discussion of variable lease type costs disclosed in other parts of the filing disclosures do not result in a variable component line item in the total lease cost table. Include variable lease expense and short-term lease expense in the disclosed lease costs table.

LeaseAccelerator Observation:
Variable lease and short-term lease costs are part of total lease costs, generally disclosed in a table format within the lease footnote. This disclosure may be important to a financial statement user (e.g. an investor) to help them understand a company's leasing strategy. Additionally, it illustrates whether leased assets subject to short-term or variable payments are not recorded on the balance sheet. In certain industries it's common for a company to engage in leases with variable payment structures or short-term leases. These types of leases may not result in an ROU asset. For example, variable lease payments not tied to an index or rate, but rather a performance metric (e.g. sales), are not included in the ROU asset measurement.

1. The First Quarter of ASC 842 - An Analysis of 10-Q Disclosures for S&P 500 Companies
https://leaseaccounting.com/the-first-quarter-of-asc-842-infographic/

6. Nature of Leases

Form of SEC Comment Inquiry (Paraphrased):
Provide disclosure about the nature of leases, specifically related to:

a. The basis and terms and conditions on which variable lease payments are determined and whether they depend upon an index or rate

b. The existence and terms and conditions of residual value guarantees provided by the lessee

LeaseAccelerator Observation:
842-20-50-3(a) states that a lessee shall disclose *"information about the nature of its leases…"*. Although only two of the five categories for disclosure listed in this codification section have received comments to date, we anticipate the SEC staff may focus efforts in future reviews on this area (i.e. disclosure enhancements about the nature of leases). The five subtopics related to the nature of leases are:

1. *A general description of those leases.*

2. *The basis and terms and conditions on which variable lease payments are determined.*

3. *The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its right-of-use assets and lease liabilities and those that are not.*

4. *The existence and terms and conditions of residual value guarantees provided by the lessee.*

5. *The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations.*

This is the type of information that allows investors to understand a company's leasing strategy and how it may impact financial results. The objective of lessee disclosures is to enable financial statement users to assess the amount, timing, and uncertainty of cash flows arising from leases. Judgment may be required to assess the appropriate level of disclosure that provides meaningful information but also reduces insignificant details which may obscure the overall disclosure usefulness. However, boilerplate wording that merely copies the standard and does not provide specific company information may result in an SEC staff comment.

CATEGORY 2

LEASES - OVERALL COMMENTS (SECTION 842-10)

Overall comments relate to scoping, transition, initial measurement, and subsequent measurement.

7. Scope and scope exceptions

Form of SEC Comment Inquiry (Paraphrased):
Provide an understanding of how certain leased assets are within the scope of 842 and the basis of accounting for those assets.

LeaseAccelerator Observation:
ASC 842-10-15-1 through 842-10-15-43 provides scope and scope exceptions guidance. 842-10-15-1 provides specific types of leases that are not within Topic 842 guidance. However, we anticipate the entire scoping section of the standard could be an area of focus in future SEC staff reviews. Potential focus areas could include judgments and assumptions made in whether a contract contains a lease for complex arrangements such as service or outsourcing arrangements (generally referred to as an "embedded lease"). The scoping section of Topic 842 also contains significant judgments such as whether assets are implicitly specified in a contract, which party controls an asset, physically distinct assets, whether a customer receives "substantially all" of the benefits of an asset, substitution rights, more than insignificant termination penalties, and more.

8. Reporting of Comparative Periods under ASC 840

Form of SEC Comment Inquiry (Paraphrased):
How does the disclosure for all comparative periods continue to be in accordance with ASC 840 when adopting using the modified retrospective approach at the company's effective date, as provided in the optional transition method in ASU 2018-11, Leases, Targeted Improvements.

LeaseAccelerator Observation:
Topic 842 did not change or create additional interim disclosures that were not required before. This comment was given to an early adopter of Topic 842. It should be a consideration for entities in their year-end annual disclosures, assuming transition using the modified retrospective approach as of the effective date.

9. Variable Payments Subject to an Index or Rate

Form of SEC Comment Inquiry (Paraphrased):
Provide an understanding of how the lessee is accounting for leases with an index or rate adjustment both at implementation and subsequent to implementation.

LeaseAccelerator Observation:
Lessee's should include variable payments in their measurement of lease liabilities when those payments are dependent upon an index or rate, such as a spot rate or CPI, initially measured using the index or rate at the commencement date. These types of variable payments are considered "unavoidable". In subsequent periods, lease payments dependent upon an index or rate are not remeasured. Rather, changes to variable payments due to a change in an index and rate are recognized in profit or loss in the period of the change.

Example 25 in Topic 842, *"Variable Lease Payments That Depend on an Index or a Rate and Variable Lease Payments Linked to Performance, Case A—Variable Lease Payments That Depend on an Index or a Rate"* provides an example of the initial and subsequent accounting for variable payments that depend upon an index or rate.

10. Lease Incentives

Form of SEC Comment Inquiry (Paraphrased):
Provide an understanding of the issuer's accounting for lease incentives.

LeaseAccelerator Observation:
Accounting for lease incentives may require a lot of judgment and can be a rather complex analysis. The SEC staff may request an issuer provide this analysis. Lease incentives include *a) payments made to or on behalf of the lessee* or *b) losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party.* Incentives may include upfront cash payments to the lessee, payments for expenses of the lessee (e.g. reimbursement for the costs of constructing leasehold improvements), or the assumption of an existing lease by the lessor. Judgment may be required when lease incentives are not paid or payable at lease commencement (i.e. contingent payments) for both the lessee and the lessor (e.g. an allowance for leasehold improvements). Further, lease payments are considered "incentives" unless they are for reimbursement of a distinct good or service (e.g. construction of leasehold improvements). This depends upon which party is the accounting owner based upon control of the asset. Is the lessee leasing fully built out space as opposed to constructing leasehold improvements? This determination will impact the accounting and may require considerable analysis.

11. Lease classification

Form of SEC Comment Inquiry:
Describe how you determined the classification of a company's leases as either operating or financing and how each of the criteria in ASC 842-10-25-2 was addressed. Specifically, whether the lease term is for a major part of the remaining economic life of the asset.

LeaseAccelerator Observation
Lease classification now involves greater judgment, although one "reasonable approach" would permit the use of bright-line criteria from the prior guidance. This is an area we anticipate could be an area of focus for the SEC in future reviews, especially in situations where there is significant reclassification between operating and financing classification upon re-assessment. Certain classification issues that require judgment include:

Classification Criteria	Detail
Economic Incentive to Purchase	Is an option to purchase the underlying asset reasonably certain of exercise because of an economic incentive to purchase the asset?
Remaining Term	Is the lease term for a major part of the remaining economic life of the asset?
Economic Life	What is the economic life of a leased asset or a group of leased assets?
End of Economic Life	Is the lease term at or near the end of an asset's economic life?
Practical Determination of Fair Value	Is it practical to determine the fair value of the underlying asset or group of assets?
Fair Value Estimate	What is the fair value of the underlying asset or group of assets?
Predominate Asset	What is the predominate asset when there are multiple assets?
Specialized Asset	Is the underlying asset of a specialized nature?
Close-calls for Lease Classification	Judgment required for lease classification for "close calls" and situations where it is not practical to estimate the fair value of the underlying asset.

CATEGORY 3

SALE-LEASEBACK TRANSACTIONS AND OTHER (SECTION 842-40)

12. Construction Projects

Form of SEC Comment Inquiry (Paraphrased):
Provide an understanding of how certain construction projects and the related leases were or are expected to be accounted for.

LeaseAccelerator Observation:
The prior "build-to-suit" lease guidance focusing on whether the lessee has substantially all of the construction-period risk has been eliminated and instead focuses on whether the lessee controls the asset being constructed (*that is, it can direct its use and obtain substantially all of its remaining benefits*). This has resulted in many issuers removing real-estate assets from their balance sheets (derecognition of build-to-suit asset/finance obligation). Also, the concept of "continuing involvement" under previous guidance has been eliminated, resulting in previously deferred gains recorded as part of the transition adjustment upon adoption. We anticipate SEC staff may focus its efforts on these types of transactions as they often include complex analysis with several judgments and assumptions involved, including a) determining control during asset construction, b) determining lease-classification upon commencement of the lease, c) determining if a forward or repurchase option by the seller-lessee in a sale-leaseback transaction precludes a sale, d) determining whether a sale has occurred, e) determining the accounting for the sale of construction-in-progress to be leased back when completed, and f) determining how pre-payments are recognized (under ASC 360 or as lease payments).

13. Terminology consistent with Topic 842 guidance

Form of SEC Comment Inquiry (Paraphrased):
Change cash flow description of operating lease amortization to operating lease costs.

LeaseAccelerator Observation:
Topic 842 contains a significant number of new terms or changes in terminology from the old Topic 840 standard. Terms used that are not consistent with the terminology in Topic 842 may result in an SEC comment.

14. Spin-Offs (also other divestitures)

Form of SEC Comment Inquiry (Para-phrased):
Provide an understanding of why certain leases were considered modified in a spin off transaction.

LeaseAccelerator Observation:
Spin-offs and sales of business units previously may have had inter-company leases with the former parent entity. Consider whether intercompany leases existed between the issue and a disposed of business, and how any new leases entered into with the acquirer or new company are accounted for subsequent to the transaction. This could result in new ROU assets since the leases are no longer eliminated in consolidation. Fair value determinations are critical as the deal is typically between two formerly related parties and determining fair market value may be skewed or awkward for a unique asset. This could also result in a remeasurement and reclassification assessment.

15. Intercompany leases

Form of SEC Comment Inquiry (Paraphrased):
Provide additional details about intercompany leases eliminated upon consolidation.

LeaseAccelerator Observation:
We anticipate the SEC staff may comment on intercompany accounting due to the potential for complexity. This could be due to different discount or foreign currency rates used by the parties in an intercompany arrangement that are in different countries. Also, under the previous guidance, rent expense and rent income were easily eliminated upon consolidation. Now there are multiple line items to be eliminated, such as ROU assets, lease liabilities, and potentially depreciation and interest expense. Issuers should consider lease terms, whether all intercompany leases have been identified, and whether the documentation is adequate. Intercompany leases may be driven by tax consequence, the parent entity's ability to negotiate better terms, beneficial pricing by consolidating similar leases, etc. Costs may have previously been allocated with other intercompany charges with little or no documentation in place. The current standard will require attention to intercompany leases. Issuers may need to update or put appropriate documentation in place and ensure their lease accounting is designed to appropriately account for these more complex transactions.

About LeaseAccelerator: