

To the Point

FASB – final guidance

FASB allows nonpublic lessees to make the risk-free rate election by class of underlying asset

The amendments address stakeholder feedback received during the Board's post-implementation review process.

What you need to know

- ▶ The FASB amended ASC 842 to allow a lessee that is not a PBE to elect to use a risk-free rate as its discount rate by class of underlying asset, rather than for all leases as originally required by ASC 842. A lessee that makes the election is required to disclose the class or classes of underlying assets to which it applied the risk-free rate.
- ▶ The amendments also require lessees to use the rate implicit in the lease when it is readily determinable, even if they make the risk-free rate election.
- ▶ Entities that have not adopted ASC 842 as of 11 November 2021, the date the amendments were issued, are required to apply the amendments when they adopt ASC 842 and follow the transition requirements in ASC 842.
- ▶ Entities that have adopted ASC 842 as of 11 November 2021 are required to apply the amendments on a modified retrospective basis to leases that existed at the beginning of the year of adoption. The amendments are effective for annual periods beginning after 15 December 2021 and interim periods beginning the following year. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) **amended**¹ Accounting Standards Codification (ASC) 842, *Leases*, to give a lessee that is not a public business entity (PBE) the flexibility to use a risk-free rate as its discount rate for leases of some classes of underlying assets and its incremental borrowing rate for others.

The FASB provided the risk-free rate election in ASC 842 to reduce the cost of applying the guidance for non-PBEs by giving them a simpler option than calculating their incremental borrowing rate for each lease. But some private company stakeholders told the FASB in its post-implementation review of the new standard that they were reluctant to make the election because using the risk-free rate for all of their leases, as was originally required by ASC 842, would result in the recognition of lease liabilities and right-of-use assets that are greater than those that would be recognized using an incremental borrowing rate or the rate implicit in the lease, when it is readily determinable. It could also result in finance lease classification for leases that would otherwise be classified as operating leases.

The amendments require a lessee that makes the election to disclose the class or classes of underlying assets for which it used the risk-free rate. The amendments also require a lessee to use the rate implicit in the lease for any individual lease for which it is readily determinable, even if the lessee makes the risk-free rate election for the associated class of underlying asset.

Key considerations

Level of accounting policy election

The amendments permit a non-PBE lessee, including a not-for-profit conduit bond obligor, to make an accounting policy election to use a risk-free discount rate for its leases, instead of its incremental borrowing rate, by class of underlying asset, rather than for all leases. The lessee is still required to determine the risk-free rate for a period comparable with the lease term.

Lessees that make the election are required to disclose the class or classes of underlying assets to which the risk-free rate election has been applied.

How we see it

The amendments provide additional flexibility for non-PBE lessees. For example, a non-PBE lessee could use its incremental borrowing rate for big-ticket leases that it enters into infrequently (e.g., real estate) and the risk-free rate for leases of lower-priced assets or leases that it enters into more frequently (e.g., office equipment) so it does not have to incur the cost of calculating its incremental borrowing rate for them.

Rate implicit in the lease

The amendments require a lessee to use the rate implicit in the lease for any individual lease for which it is readily determinable, even if it has made the risk-free rate election for the associated class of underlying asset. ASC 842 did not previously specify whether a lessee using the risk-free rate election must use the rate implicit in the lease when it is readily determinable. This amendment is not expected to affect practice for most lease arrangements because the rate implicit in the lease is not readily determinable by the lessee in most cases. However, a related-party lease is an example of when the rate implicit in the lease might be readily determinable by a non-PBE lessee.

Transition and effective date

Entities that have not adopted ASC 842 as of 11 November 2021, the date the amendments were issued, are required to apply the amendments when they adopt ASC 842 and follow the transition requirements in ASC 842. As a reminder, ASC 842 is effective for private companies and certain not-for-profit entities for annual periods beginning after 15 December 2021 and interim periods in annual periods beginning after 15 December 2022.

Entities that have adopted ASC 842 as of 11 November 2021 are required to apply the amendments for annual periods beginning after 15 December 2021 and interim periods in annual periods beginning after 15 December 2022. Early adoption is permitted.

Entities that have adopted ASC 842 as of 11 November 2021 are required to apply the amendments on a modified retrospective basis by adjusting the opening balances as of the beginning of the year of adoption of the affected lease liabilities and right-of-use assets for leases that existed at the beginning of the year of adoption.

The remeasurement of a lease liability that results from the initial application of the amendments is not considered an event that would require an entity to remeasure and reallocate the consideration in the contract (including lease payments) or reassess the lease term or classification. An entity is required to disclose the nature of and reason for the change in accounting principle, the cumulative effect of the change on retained earnings, if any, and the amount of the change in its lease liabilities and corresponding right-of-use assets resulting from the amendments.

When they adopt the amendments, entities that have already adopted ASC 842 also may choose to apply or discontinue using the risk-free rate election for any class of underlying asset. For example, an entity that did not make the risk-free rate election when it adopted ASC 842 may make the election without evaluating the change in accounting policy under ASC 250, *Accounting Changes and Error Corrections*. Conversely, an entity that made the risk-free rate election when it adopted ASC 842 may discontinue using it for any class of underlying asset and instead use the incremental borrowing rate without evaluating the change in accounting policy under ASC 250.

Endnote:

¹ Accounting Standards Update 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*.