ASC 842 Refresher: Modifications & Impairment

Now that the heavy lift of initial lease implementation is in the rearview mirror, do not forget about some potential year-two issues, most notably Accounting Standards Codification (ASC) 842's guidance on contract modifications/reassessments and impairment. Here is a quick refresher on key considerations.

Reassessment

Under ASC 842, a lessee should remeasure the lease liability and adjust the right-of-use (ROU) asset if any of the following occur:

- The lease is modified, and the modification is not accounted for as a new, separate contract.
- A contingency is resolved such that some or all variable payments become fixed. A change in a reference rate or index for variable lease payments does not constitute the resolution of a contingency.
- Changes in:
  - Lease term
  - Assessment of whether the lessee will exercise or not exercise a purchase option upon the occurrence of a triggering event
  - Probable amount the lessee will owe under a residual value guarantee (RVG)

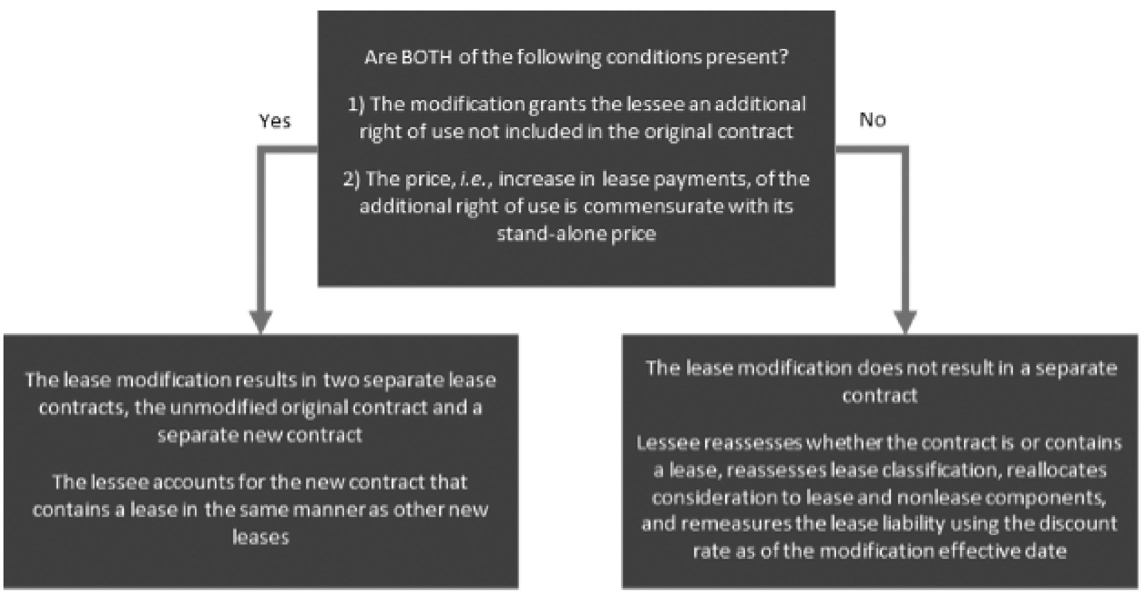
Lessees generally are required to use an updated discount rate when remeasuring the lease liability and ROU asset. Lessees do not have to update the discount rate for changes in probable RVG amounts or for contingency resolution on variable lease payments that become fixed.

Lessee – Lease Modification & Reassessment				
(Lessors are not subject to these reassessment requirements)	Reallocate contract consideration & remeasure the lease	Reassess classification	Update discount rate	Reassess if contract contains a lease
Lease modification	✓	✓	✓	✓
An event occurs that gives the lessee a significant economic incentive to exercise/not exercise a renewal/termination option	✓	✓	✓	
An event occurs that gives the lessee a significant economic incentive to exercise/not exercise a purchase option	✓	✓	✓	

Lessee – Lease Modification & Reassessment				
(Lessors are not subject to these reassessment requirements)	Reallocate contract consideration & remeasure the lease	Reassess classification	Update discount rate	Reassess if contract contains a lease
Variable payments become fixed	✓			
Amounts due under an RVG become probable of being owed	✓			

Lease Modification

A lease modification is any change to a contract's terms and conditions that results in a change in a lease's scope or consideration. A lease modification generally requires remeasurement of the lease liability and ROU asset by a lessee using a discount rate determined at the modification's effective date.



A lessee should reallocate the remaining consideration in the contract and remeasure the lease liability using a discount rate as of the effective date of the modification if:

- The contract modification grants the lessee an additional ROU not included in the original contract (and that modification is not accounted for as a separate contract).
- The contract modification extends or reduces the term of an existing lease, other than through the exercise of a contractual option to extend or terminate the lease.
- The contract modification fully or partially terminates an existing lease, *e.g.*, reduces the assets subject to the lease.
- The contract modification only changes the contract consideration.

For modifications that decrease the lease's scope, the lessee would reduce the carrying values of the lease liability and lease asset with any difference recognized as a gain or loss in the income statement. Both the lessee and lessor are required to reassess variable lease payments when the lease is remeasured due to a lease modification.

An entity should account for a lease modification as a separate contract when the modification grants the lessee an additional ROU not included in the original lease, and the additional ROU is priced commensurate with its standalone price (in the context of that particular contract). Lessors also are required to reallocate consideration when a contract modification does not result in a new, separate contract, requiring remeasurement of the lease receivable and adjusting the related residual asset, as applicable.

Modifications Reducing the Scope of a Lease Contract

ASC 842 currently requires a lessee and lessor to reconsider the lease classification and update inputs to adjust the accounting for a master lease's remaining lease components if a modification terminates some assets early. An update is required regardless of whether the remaining lease components are economically affected by the early termination.

Reallocation of Contract Components

Lessees also must reallocate consideration to multiple lease components if they remeasure the lease liability. Both lessees and lessors are required to reallocate contract consideration as of the effective date of a contract modification that is not accounted for as a new, separate contract.

Classification Reassessment

Lessors and lessees are required to reassess the classification of a lease when the lease is substantially modified and the modification is not accounted for as a separate contract, when there is a change in the lease term or there is a change in the assessment of exercising an option to purchase the underlying asset. When reassessing lease classification, the entity shall use the modified terms and conditions as of the date the reassessment is required (option exercise certainty) or the effective date of a lease modification, using the fair value and the remaining economic life of the underlying asset.

Lease Term Reassessment

A lessee must reassess the lease term when a significant event or change in circumstances that is within the lessee's control occurs that will affect whether the lessee would be reasonably certain to exercise an option to extend the lease, purchase the underlying asset, or terminate the lease. A lessee also would reassess the lease term when it elects to exercise a renewal option that it had previously determined was not reasonably certain to be exercised or elects not to exercise a termination option that it had previously determined was reasonably certain to be exercised. Examples of significant events or significant changes in circumstances a lessee should consider include, but are not limited to, constructing significant improvements that are expected to have significant value for the lessee when the option becomes exercisable or making significant modifications or customizations to the underlying asset. As a result of a change in lease term, lessees will reassess lease classification and remeasure the lease liability and ROU asset to reflect the cost of the additional rights. FASB's technical corrections note that the lessee will remeasure variable lease payments based on an index at the remeasurement date.

A lessor is not required to reassess the lease term or a lessee purchase option after initial determination unless the lease is modified and the modified lease is not a separate contract. When a lessee exercises an option to extend the lease or purchase the underlying asset the lessor previously determined the lessee was not reasonably certain to exercise, or exercises an option to terminate the lease the lessor previously determined the lessee was reasonably certain not to exercise, the lessor shall account for the exercise of that option in the same manner as a lease modification.

Short-Term Leases

If a change occurs in the lease term that causes the term to extend more than 12 months from the end of the previously determined lease term, or if the exercise of a purchase option becomes reasonably certain, the lease is no longer a short-term lease and must be accounted for under the regular lease guidance with the date of the change in circumstances as of the commencement date.

RVG

When there is a change in the amount that is probable to be owed by the lessee under an RVG, the lessee must remeasure the lease payments and adjust the lease liability and ROU asset.

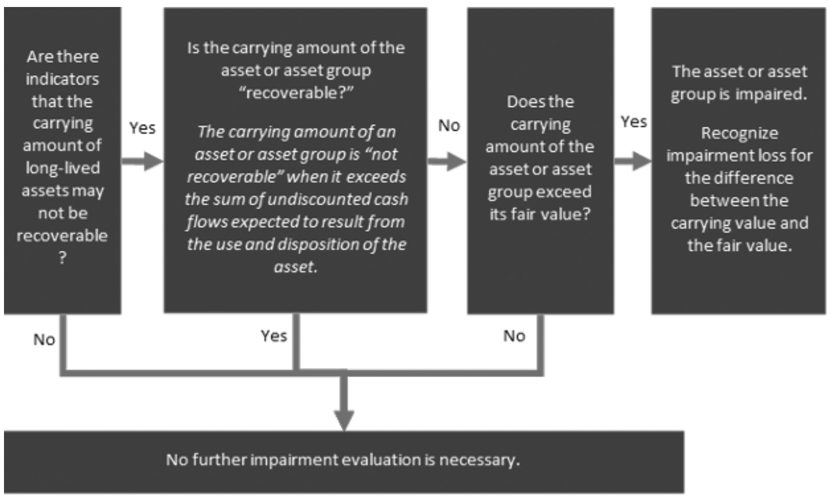
Exercise of Purchase Option During the Lease Term

If a lessee purchases a leased asset during the lease term, the lessee should settle the lease liability. If the ROU asset was not previously presented together with property, plant, and equipment, the lessee should reclassify the ROU and apply Topic 360 to the equipment beginning on the purchase option's exercise date. The lessee would record any difference between the purchase price and the carrying amount of the lease liability as an adjustment of the carrying amount of the asset with no gain or loss recognized.

Impairment

At the effective date, a lessee's ROU asset is subject to impairment guidance in ASC 360, *Property, Plant, and Equipment*. ASC 360 requires analysis of impairment indicators at each reporting date and is performed at the asset or asset-group level. A recoverability test is required if any indicators of impairment are present. Recoverability is determined by comparing the carrying amount of the asset group to the estimated future undiscounted cash flows expected from the company's use and eventual disposition of the asset group over the remaining life of the primary asset. If the ROU asset or group of assets fails the recoverability test, ASC 360 requires a fair value test. An impairment loss would be recognized based on the amount by which the carrying value of the asset group exceeds its fair value.

Once an ROU asset is impaired, lease expense is no longer recognized on a straight-line basis as the amortization of the ROU asset is "de-linked" from the lease liability. Prior to impairment, the amortization of the ROU asset is determined as the difference between the straight-line lease expense and the effective interest calculated on the lease liability. However, once the ROU asset is impaired, the lessee will continue to amortize the lease liability using the same effective interest method as before the impairment charge, whereas the ROU asset will be amortized on a straight-line basis. This causes the lease expense to be variable after impairment of the ROU asset. Under ASC 842, an entity must determine whether the leased asset is abandoned in accordance with ASC 360. Under ASC 842, an ROU asset is not considered to be abandoned if an entity has ceased use of the underlying asset but is currently subleasing (or plans to sublease) the asset.



Conclusion

Properly accounting for leases under ASC 842 was not a one-time adoption exercise but will need to be part of regular accounting considerations on an ongoing basis—**FORVIS** can help! If you would like assistance in complying with ASC 842, contact a professional at FORVIS.

Contributor

Anne Coughlan
Director
anne.coughlan@forvis.com