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In This Issue



# FASB Modifies Accounting Policy Election for Lessees That Are Not Public Business Entities

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## Background

On November 11, 2021, the FASB issued ASU 2021-09,[1] which allows lessees that are not public business entities (PBEs) to make an accounting policy election by class of underlying asset, rather than on an entity-wide basis, to use a risk-free rate as the discount rate when measuring and classifying leases.

In September 2020, the FASB held public roundtables to discuss lease implementation topics.[2] During those discussions, stakeholders expressed concerns about the cost and complexity of applying ASC 842,[3] specifically regarding the determination of the discount rate used to measure a lessee's lease liabilities and right-of-use (ROU) assets.

Before the issuance of ASU 2021-09, ASC 842-20-30-3 permitted non-PBE lessees to "use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term, as an accounting policy election **for all leases**" (emphasis added). However, during the roundtables, the FASB learned that many entities would not benefit from electing this practical expedient because such entities did not want to use the risk-free rate for **all** of their leases for which they are a lessee. In response, private-company stakeholders proposed a more practicable alternative that would allow lessees to elect to use the risk-free rate as their

[1] FASB Accounting Standards Update (ASU) No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities.*
[2] For more information about the roundtables, see Deloitte's September 28, 2020, *Heads Up*.
[3] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification.*"

discount rate for certain classes of underlying assets, as opposed to only having the option of making that election at an entity-wide level.[4]

## Key Provisions of the ASU

ASU 2021-09 amends the current guidance in ASC 842-20-30-3 to allow a non-PBE lessee to make an accounting policy election, by class of underlying assets, to use a risk-free rate as the discount rate when the rate implicit in the lease is not readily determinable. Specifically, ASU 2021-09 amends the guidance in ASC 842-20-30-3 to state:

> 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. A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease instead of its incremental borrowing rate, determined using a period comparable with that of the lease term, **as an accounting policy election made by class of underlying asset**. [Emphasis added]

In addition to allowing lessees to elect to use the risk-free rate as an accounting policy by asset class rather than on an entity-wide level, the ASU requires lessees to:

1. Disclose their election, including the asset class(es) for which they have elected the accounting policy.[5]
2. Use the rate implicit in the lease instead of the risk-free rate when the former is readily determinable, regardless of whether the practical expedient has been elected.

### Connecting the Dots

Before ASU 2021-09, it was unclear whether non-PBE lessees that made the entity-wide risk-free rate election were still required to use the rate implicit in the lease when it was readily determinable. The ASU clarifies that this requirement applies even if a lessee elected the risk-free rate for the relevant class of underlying asset. In practice, many lessees cannot readily determine the rate implicit in a lease since they may not know all material inputs in the lessor's calculation of that rate. See Section 7.2.1 of Deloitte's Roadmap *Leases* for further discussion of how to evaluate whether the rate implicit in a lease is readily determinable.

## Effective Date and Transition

Lessees that have not adopted ASC 842 on or before November 11, 2021, should apply the transition requirements in ASC 842-10-65-1 when adopting ASU 2021-09. The ASU should be adopted on the same date on which an entity adopts ASC 842.

Lessees that have adopted ASC 842 as of November 11, 2021, should apply the transition requirements below for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

1. An entity should apply a modified retrospective transition method to leases affected by the amendments existing as of the beginning of the year of adoption by adjusting the lease liability and corresponding ROU asset at the beginning of the fiscal year in which the ASU is adopted.[6]

[4] ASC 842 does not address what is meant by the phrase "class of underlying asset." Before ASU 2021-09, entities were allowed to make other accounting policy elections by class of underlying asset, so entities may already have policies in place on how they define asset class. See Section 4.3.3.1 of Deloitte's Roadmap *Leases* for information about applying this concept.

[5] As amended by this ASU, ASC 842-20-50-10 states: "A lessee that makes the accounting policy election in paragraph 842-20-30-3 to use a risk-free rate as the discount rate shall disclose its election and the class or classes of underlying assets to which the election has been applied."

[6] The cumulative-effect adjustment to the lease liability and corresponding ROU asset should be calculated by using the remaining lease term and the discount rate as of the date of the adoption of ASU 2021-09. This calculation applies to all leases existing as of the ASU's adoption date.

2. When adopting the ASU, an entity is *not* permitted to:
   - Remeasure and reallocate the consideration in the contract.
   - Reassess the lease term or a lessee's election to exercise a purchase option on the underlying asset.
   - Remeasure the lease payments.
   - Reassess lease classification.
3. The following must be disclosed as of the beginning of the year of adoption:
   - The applicable disclosures in ASC 250-10-50-1(a) and ASC 250-10-50-1(b)(3).
   - The amount of the change in the lease liability and the corresponding ROU asset resulting from the adoption of the ASU.

Early adoption of ASU 2021-09 is permitted, as long as an entity does not adopt the ASU before adopting ASC 842.

Before the issuance of this ASU, non-PBE lessees that had adopted ASC 842 were required to use the risk-free rate as the discount rate to measure all of their leases if they had elected this practical expedient.[7] Upon adopting the ASU, lessees that previously applied this requirement may choose to discontinue using the risk-free rate as the discount rate for any class of underlying asset. Conversely, lessees that did not elect to apply the risk-free rate to all their leases upon adopting ASC 842 may now choose to apply the risk-free rate as the discount rate for any class of underlying asset. A lessee's policy election regarding the classes of underlying asset to which it will apply the risk-free rate should be consistently applied.

[7] As clarified by ASU 2021-09, the risk-free rate can only be applied for lessee leases when the rate implicit in the lease is not readily determinable.

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