

## Heads Up

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## Bring It On!

# FASB's New Standard Brings Most Leases Onto the Balance Sheet

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After working for almost a decade, the FASB has finally issued its new standard on accounting for leases, [ASU 2016-02](#).<sup>1</sup> The IASB issued its own version, IFRS 16,<sup>2</sup> in January, and although the project was a convergence effort and the boards conducted joint deliberations, there are several notable differences between the two standards. We have highlighted those in the table below.

The primary objective of the leases project was to address the off-balance-sheet financing concerns related to lessees' operating leases. However, developing an approach that requires all operating leases to be recorded on the balance sheet proved to be no small task. During the process, the boards had to grapple with questions such as (1) whether an arrangement is a service or a lease, (2) what amounts should be initially recorded on the lessee's balance sheet for the arrangement, (3) how to reflect the effects of leases in the statement of comprehensive income of a lessee (a point on which the FASB and IASB were unable to converge), and (4) how to apply the resulting accounting in a cost-effective manner.

Accordingly, the FASB's new standard introduces a lessee model that brings most leases on the balance sheet. The standard also aligns certain of the underlying principles of the new lessor model with those in ASC 606, the FASB's new revenue recognition standard (e.g., evaluating how collectibility should be considered and determining when profit can be recognized). Furthermore, the ASU addresses other concerns related to the current almost-40-year-old leases model. For example, it eliminates the required use of bright-line tests in current U.S. GAAP for determining lease classification. It also requires lessors to provide additional transparency into the exposure to the changes in value of their residual assets and how they manage that exposure.

The new standard, which is effective for calendar periods beginning on January 1, 2019, for public business entities and January 1, 2020, for all other entities (see the [Effective Date](#) section for more information), represents a wholesale change to lease accounting, and as a result, entities will face significant implementation challenges during the transition period and beyond, such as those related to:

- Applying judgment and making estimates.
- Managing the complexities of data collection, storage, and maintenance.
- Enhancing information technology systems to ensure their ability to perform the calculations necessary for compliance with reporting requirements.

Join us on  
March 15 at  
2:00 p.m. EDT  
for a *Dbriefs*  
webcast on the  
new standard.

<sup>1</sup> FASB Accounting Standards Update No. 2016-02, *Leases*. The ASU supersedes FASB Accounting Standards Codification (ASC) Topic 840, *Leases*, and creates ASC 842, *Leases*. For titles of additional ASC references, see Deloitte's "Titles of Topics and Subtopics in the FASB Accounting Standards Codification."

<sup>2</sup> IFRS 16, *Leases*. For more information on the IASB's standard, see Deloitte's January 13, 2016, *IFRS in Focus*.

- Refining internal controls and other business processes related to leases.
- Determining whether debt covenants are likely to be affected and, if so, working with lenders to avoid violations.
- Addressing any income tax implications.

See [Appendix F](#) of the *Heads Up* for more information about an entity’s implementation considerations.

This *Heads Up* provides a comprehensive overview of the FASB’s new leases accounting model under ASU 2016-02 and highlights a number of implementation considerations. The *Heads Up* also contains the following appendixes, which expand on certain key aspects of the standard:

- [Appendix A — Evaluating Whether an Arrangement Is or Contains a Lease.](#)
- [Appendix B — Other Significant Provisions.](#) (Topics discussed include lease modifications, separating lease and nonlease components, and accounting for sale-and-leaseback transactions.)
- [Appendix C — Presentation Requirements.](#)
- [Appendix D — Disclosure Requirements.](#)
- [Appendix E — Transition.](#)
- [Appendix F — Implementation Considerations.](#)

## A Snapshot of the New Guidance

The table below highlights the key provisions of the new leases accounting model under ASU 2016-02 and IFRS 16.

Key Provision	ASU 2016-02	IFRS 16
Scope	<p>Scope includes leases of all property, plant, and equipment (PP&amp;E) and excludes:</p> <ul style="list-style-type: none"> <li>• Leases of intangible assets.</li> <li>• Leases to explore for or use nonregenerative resources.</li> <li>• Leases of biological assets.</li> <li>• Leases of inventory.</li> <li>• Leases of assets under construction.</li> </ul>	<p>Scope includes leases of all assets (not limited to PP&amp;E). Exceptions are similar to those in ASU 2016-02. Also, lessees can elect to apply the guidance to leases of intangible assets.</p>
Short-term lease	<p>A lessee may recognize the payments on a short-term lease on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease today). These leases would not be reflected on the lessee’s balance sheet.</p> <p>A short-term lease is defined as a lease that has a lease term of 12 months or less and does not include a purchase option that the lessee is reasonably certain to exercise.</p>	<p>A lessee may recognize the payments on a short-term lease on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease today). These leases would not be reflected on the lessee’s balance sheet.</p> <p>A short-term lease is defined as a lease that has a lease term of 12 months or less and does not include a purchase option.</p>

Key Provision	ASU 2016-02	IFRS 16
Definition of a lease	<p>A lease is defined as a “contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.”</p> <ul style="list-style-type: none"> <li>• A leased asset must be specifically identifiable either explicitly (e.g., by a serial number) or implicitly (e.g., the only asset available to satisfy the lease contract). <ul style="list-style-type: none"> <li>◦ Substantive substitution rights will need to be considered.</li> <li>◦ A physically distinct portion of a larger asset could represent a specified asset (e.g., one floor of a building).</li> <li>◦ A capacity portion of a larger asset will generally not represent a specified asset (e.g., percentage of a storage tank).</li> </ul> </li> <li>• A lease contract conveys the right to control the use of the identified asset for a specified period of time. A customer controls an identified asset when the customer: <ul style="list-style-type: none"> <li>◦ Has the right to obtain substantially all of the economic benefits from its use.</li> <li>◦ Has the right to direct its use.</li> </ul> </li> </ul>	<p>A lease is defined as a “contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.”</p>
Leases of low-value assets	<p>No exemption under U.S. GAAP. However, the FASB believes that an entity will be able to adopt a reasonable capitalization policy under which the entity will not recognize certain lease assets and liabilities that are below a certain threshold.</p>	<p>A lessee may recognize the payments on a lease of low-value assets on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease today). These leases would not be reflected on the lessee’s balance sheet. IFRS 16 does not define “low value”; however, when the IASB was discussing the exception during deliberations, the Board referred to assets that were less than \$5,000.</p> <p>In addition, an entity will be able to adopt a reasonable capitalization policy under which the entity will not recognize certain lease assets and liabilities that are below a certain threshold.</p>
Lessee accounting	<p>As of the lease commencement date, a lessee recognizes:</p> <ul style="list-style-type: none"> <li>• A liability for its lease obligation (initially measured at the present value of the future lease payments not yet paid over the lease term).</li> <li>• An asset for its right to use the underlying asset (i.e., the right-of-use (ROU) asset) equal to the lease liability, adjusted for lease payments made at or before lease commencement, lease incentives, and any initial direct costs.</li> </ul> <p>The lessee will use the effective interest rate method to subsequently account for the lease liability.</p> <p>Two approaches are used for subsequently amortizing the ROU asset: (1) the finance lease approach and (2) the operating lease approach.</p> <p>Under the finance lease approach, the ROU asset is generally amortized on a straight-line basis. This amortization, when combined with the interest on the lease liability, results in a front-loaded expense profile in which interest and amortization are presented separately in the income statement. By contrast, the operating lease approach generally results in a straight-line expense profile that is presented as a single line item in the income statement.</p> <p>The determination of which approach to apply is based on lease classification criteria that are similar to the current requirements in IAS 17.<sup>3</sup></p>	<p>The lessee will use the effective interest rate method to subsequently account for the lease liability.</p> <p>A single approach (similar to the FASB’s finance lease approach) is used to subsequently amortize the ROU asset.</p>

<sup>3</sup> IAS 17, *Leases*.

Key Provision	ASU 2016-02	IFRS 16
Lessor accounting	<p>Retains the current lessor accounting approach for operating and capital (direct financing and sales-type) leases.</p> <p>However, the lease classification criteria will change, and the treatment of dealer's profit, if any, will be affected:</p> <ul style="list-style-type: none"> <li>• A dealer's profit would be recognized up front if the arrangement is a sales-type lease (i.e., the transaction qualifies as a sale under ASC 606).</li> <li>• A dealer's profit resulting from a direct financing lease, if any, would be deferred and recognized as interest income over the lease term.</li> </ul> <p>Eliminates leveraged lease accounting going forward (existing leveraged leases are grandfathered).</p>	<p>Retains the current lessor accounting approach for operating and finance leases. A dealer's profit for a finance lease is recognized up front without regard to the revenue guidance in IFRS 15.<sup>4</sup></p>
Lease term	<p>Lease term is the noncancelable period in which the lessee has the right to use an underlying asset together with optional periods for which it is reasonably certain that the lessee will exercise the renewal option or not exercise the termination option or in which the exercise of those options is controlled by the lessor. Lessees will be required to reassess the lease term after lease inception if (1) there is a significant event or change in circumstances that is directly attributable to the actions of the lessee, (2) a contract term obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease, or (3) the lessee elects to exercise (or not exercise) an option to renew or terminate the contract that it had previously determined was not reasonably certain to be exercised.</p> <p>A lessor is not required to reassess the lease term unless the lease is modified and the modified lease is a separate contract.</p>	<p>Lease term is the noncancelable period in which the lessee has the right to use an underlying asset together with optional periods for which it is reasonably certain that the lessee will exercise the renewal option or not exercise the termination option. Lessees will be required to reassess the lease term after lease inception if (1) there is a significant event or change in circumstances that is directly attributable to the actions of the lessee or (2) the lessee elects to exercise (or not exercise) an option to renew or terminate the contract that it had previously determined was not reasonably certain to be exercised.</p> <p>A lessor is not required to reassess the lease term unless the lease is modified and the modified lease is a separate contract.</p>
Lease payments	<p>Lease payments include:</p> <ul style="list-style-type: none"> <li>• Fixed payments (including in-substance fixed lease payments).</li> <li>• Variable payments that are based on an index or rate (e.g., LIBOR or the consumer price index (CPI)) calculated by using the index or rate that exists on the lease commencement date (i.e., the spot rate).</li> <li>• Amounts that it is probable will be owed under residual value guarantees (for lessees), and amounts at which residual assets are guaranteed by a lessee or by a third party (for lessors).</li> <li>• Payments related to renewal or termination options that the lessee is reasonably certain to exercise.</li> </ul> <p>Lease payments do not include variable lease payments that are based on the usage or performance of the underlying asset (e.g., a percentage of revenues).</p> <p>Variable payments based on an index or rate would only be reassessed when the lease obligation is reassessed for other reasons (e.g., change in the lease term, modification).</p>	<p>Variable payments based on an index or rate would be reassessed whenever there is a change in contractual cash flows (e.g., the lease payments are adjusted for a change in the CPI).</p>
Discount rate	<ul style="list-style-type: none"> <li>• Lessees use the rate charged by the lessor if the rate is readily determinable. If the rate is not readily determinable, lessees will use their incremental borrowing rate as of the date of lease commencement.</li> <li>• Lessors use the rate they charge the lessee.</li> </ul> <p>Private-company lessees can elect to use a risk-free rate.</p>	<p>No exemptions provided for private-company lessees.</p>

<sup>4</sup> IFRS 15, *Revenue From Contracts With Customers*.

Key Provision	ASU 2016-02	IFRS 16
Lease modifications	<p>A lease modification is any change to the contractual terms and conditions of a lease.</p> <ul style="list-style-type: none"> <li>• A lessee/lessor would account for a lease modification <b>as a separate contract</b> (i.e., separate from the original lease) when the modification (1) grants the lessee an additional ROU asset and (2) the price of the additional ROU asset is commensurate with its stand-alone price.</li> <li>• Lessees would account for a lease modification that is <b>not a separate contract</b> by using the discount rate as of the modification effective date to adjust the lease liability and ROU asset for the change in the lease payments. The modification may result in a gain or loss if the modification results in a full or partial termination of an existing lease.</li> <li>• Lessors would account for a lease modification in a manner generally consistent with the modification guidance in ASC 606 or IFRS 15.</li> <li>• See <a href="#">Appendix B</a> for more information.</li> </ul>	
Sublease	The intermediate lessor would classify a sublease by using the <i>underlying asset</i> of the head lease.	The intermediate lessor would classify a sublease by using the <i>ROU asset</i> of the head lease.
Sale-and-leaseback arrangements	<p>The transaction would not be considered a sale if (1) it does not qualify as a sale under ASC 606 or (2) the leaseback is a finance lease.</p> <ul style="list-style-type: none"> <li>• A repurchase option would result in a failed sale unless (1) the exercise price of the option is at fair value and (2) there are alternative assets readily available in the marketplace.</li> <li>• If the transaction qualifies as a sale, the entire gain on the transaction would be recognized.</li> </ul>	<p>The transaction would not be considered a sale if it does not qualify as a sale under IFRS 15.</p> <ul style="list-style-type: none"> <li>• A repurchase option would <b>always</b> result in a failed sale.</li> <li>• For transactions that qualify as a sale, the gain would be limited to the amount related to the residual portion of the asset sold. The amount of the gain related to the underlying asset leased back to the lessee would be offset against the lessee's ROU asset.</li> </ul>

## Scope

Like the scope under current requirements, the scope of the new guidance is limited to leases of PP&E. The scope excludes (1) leases of intangible assets; (2) leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources; (3) leases of biological assets; (4) leases of inventory; and (5) leases of assets under construction.

**Editor's Note:** Under the proposal issued by the boards in May 2013, the scope of the lease accounting guidance would have included inventory (e.g., spare parts and supplies) and construction work in progress (CWIP). However, constituents expressed concerns that if the guidance applied to CWIP, build-to-suit transactions (in which the customer is involved with the construction activity) may be accounted for as leases. In response, the FASB revisited the scope of the guidance in late 2015 and decided to limit it to PP&E. However, it also decided to include guidance on a lessee's control of an underlying asset that is being constructed before lease commencement and related considerations. See [Build-to-Suit Arrangements](#) in Appendix B for additional information.

## Short-Term Leases

Under the ASU, a lessee can elect (by asset class) not to record on the balance sheet a lease whose term is 12 months or less and does not include a purchase option that the lessee is reasonably certain to exercise (i.e., treat the lease like an operating lease under current U.S. GAAP). When determining whether the lease qualifies for this election, the lessee would include renewal options only if they are considered part of the lease term (i.e., those options the lessee is reasonably certain to exercise — see the [Lease Term](#) section below).

A lessee electing this option would recognize lease payments as an expense over the lease term on a straight-line basis. The lessee would also be required to disclose certain information about the short-term lease. If the lease term increases to more than 12 months, or if it is reasonably certain that the lessee will exercise an option to purchase the underlying asset, the lessee would no longer be able to apply the short-term lease exception and would account for the lease as it would other leases.

#### Example 1 — Short-Term Leases

##### **Scenario 1 — Short-Term Lease Criteria Met**

Company A (lessee) enters into an arrangement to lease a crane for a six-month period, with the option to extend the term for up to nine additional months (in three-month increments). After considering the nature of the project, A determines that it expects to use the crane for only nine months and is therefore reasonably certain that it will exercise only one of the three renewal options. Since the lease term is not more than 12 months (in this case 9 months), A would be able to elect the short-term lease exception.

##### **Scenario 2 — Short-Term Lease Criteria Not Met**

Company A (lessee) enters into an arrangement to lease a crane for a six-month period, with the option to extend the term for up to nine additional months (in three month increments). The project for which the crane is being used is expected to take 15 months to complete.

After considering the nature of the project, A determines that it expects to use the crane for 15 months and is therefore reasonably certain that it will exercise all three renewal options. Because the expected lease term is greater than 12 months, A would not be able to apply the short-term lease exception; rather, it would be required to record on the balance sheet an ROU asset and corresponding lease liability.

## Definition of a Lease

A contract is, or contains, a lease if the contract gives a customer the right to control the use of the identified PP&E (an identified asset) for a period of time in exchange for consideration. Control is considered to exist if the customer has both of the following:

- The “right to obtain substantially all of the economic benefits from use of [an identified] asset.”
- The “right to direct the use of that asset.”

An entity is required at inception to identify whether a contract is, or contains, a lease. The entity will only reassess whether the contract is or contains a lease in the event of a modification to the terms and conditions of the contract. The inception of a lease is the earlier of the date of an executed lease agreement or the date of commitment by the parties to the principal terms and conditions of the lease.

In many cases, the assessment of whether a contract is or contains a lease will be straightforward. However, the evaluation will be more complicated when an arrangement involves both a service component and a leasing component or when both the customer and the supplier make decisions about the use of the underlying asset. Accordingly, the ASU contains a number of examples of an entity’s evaluation of whether a contract is or contains a lease (see ASC 842-10-55-41 through 55-130 in the ASU).

The table below summarizes each key concept related to the definition of a lease. (See [Appendix A](#) for more information about the definition of a lease.)

Concept	Requirement <sup>5</sup>	Observation
Use of an identified asset	An asset is typically identified if it is explicitly specified in a contract or implicitly specified at the time the asset is made available for use by the customer. However, if the supplier has substantive rights to substitute the asset throughout the period of use, the asset is not considered "identified."	<p>This requirement is similar to the guidance in ASC 840-10-15 (formerly EITF Issue 01-8<sup>6</sup>). An entity does not need to be able to identify the particular asset (e.g., by serial number) but must instead determine whether an identified asset is needed to fulfil the contract.</p> <p>An entity will need to use significant judgment in distinguishing between a lease and a capacity contract. The standard clarifies that a capacity portion of an asset is an identified asset if it is physically distinct (e.g., a floor of a building). On the other hand, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a pipeline) is not an identified asset unless the portion represents substantially all of the asset's capacity.</p>
Substantive substitution rights	A supplier's right to substitute an asset is substantive only if both of the following conditions apply: (1) the supplier has the practical ability to substitute alternative assets throughout the period of use and (2) the supplier would benefit economically from the exercise of its right to substitute the asset.	<p>The FASB established this requirement because it reasoned that if a supplier has a substantive right to substitute the asset throughout the period of use, then the supplier — not the customer — controls the use of the asset.</p> <p>A contract to use a specified type of rail car to transport goods is an example of economic benefit from substitution rights. The supplier benefits from exercise of its right to substitute because it can use its pool of available rolling stock in the most efficient manner.</p>
Right to obtain economic benefits from use of the identified asset	To control the use of an identified asset, a customer must have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use.	The economic benefits from use of an asset include the primary output and by-products of the asset as well as other economic benefits from using the asset that could be realized from a commercial transaction with a third party.
Right to direct the use of the identified asset	A customer has the right to direct the use of an identified asset throughout the period of use if either (1) the customer has the right to direct how and for what purpose the asset is used throughout the period of use or (2) the relevant decisions about how and for what purpose the asset is used are predetermined and (a) the customer has the right to operate (or direct others to operate) the asset throughout the period of use and the supplier does not have the right to change the operating instructions or (b) the customer designed the asset in a way that predetermines how and for what purpose the asset will be used.	<p>The relevant rights to be considered are those that affect the economic benefits derived from the use of the asset. Some examples of customers' rights that meet the definition are (1) rights to change the type of output produced by the asset, (2) rights to change when the output is produced, and (3) rights to change where the output is produced. On the other hand, rights that are limited to maintaining or operating the asset do not grant a right to direct how and for what purpose the asset is used.</p> <p>The standard illustrates the concept of directing use through design of the asset in an example of a contract to purchase all of the output of a solar farm. In the example, the FASB concludes that although the customer makes no decisions during the life of the farm, it has the right to direct its use as a result of having designed the asset before it was constructed.</p>

<sup>5</sup> Text is adapted from the ASU.

<sup>6</sup> EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease" (codified in FASB Accounting Standards Codification Topic 840, *Leases*).

## Lease Classification

An entity is required to determine the classification of a lease as of the lease commencement date.<sup>7</sup> The ASU's classification criteria apply to both lessees (U.S. GAAP only)<sup>8</sup> and lessors (U.S. GAAP and IFRSs). The evaluation focuses on whether control of the underlying asset is effectively transferred to the lessee (e.g., substantially all of the risks and rewards related to ownership of the underlying asset are transferred to the lessee). Therefore, a lease would be classified as a finance lease (from the standpoint of a lessee) or a sales-type lease (from the standpoint of a lessor) if any of the following criteria are met:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
- "The lease term is for the major part of the remaining economic life of the underlying asset."<sup>9</sup>
- "The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset."
- "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

Leases that do not meet any of these criteria (i.e., a lease in which the lessee does not effectively obtain control of the underlying asset) would be classified as operating leases by the lessee and as either operating leases or direct financing leases by the lessor.

**Editor's Note:** Under the ASU's classification criteria, an arrangement that historically was classified by a lessor as a sales-type lease because the lessor transferred a portion of the risks and rewards of the underlying asset to the lessee and a portion to a third party through a residual value guarantee (e.g., residual value insurance) may no longer qualify as a sales-type lease. In the evaluation of whether a lease qualifies as a sales-type lease, the FASB decided to align the definition of control with its new revenue recognition requirements. Accordingly, the evaluation of whether a lease qualifies as a sales-type lease focuses on whether the *lessee effectively obtains control* of the underlying asset rather than whether the *lessor has relinquished control*.

If a lease does not meet any of the criteria for classification as a sales-type lease, the lessor would still need to assess whether it has relinquished control of the underlying asset to the lessee and other parties involved in the transaction. Accordingly, the lessor would classify a lease that does not meet any of the criteria for a sales-type lease as a direct financing lease if (1) the present value of the lease payments and any residual value guarantee (which could be provided entirely by a third party or could consist of a guarantee provided by the lessee along with a third party guarantee)<sup>10</sup> "equals or exceeds substantially all of the fair value of the underlying asset" and (2) it is probable that the lessor will collect the lease payments and any amounts related to the residual value guarantee(s).

<sup>7</sup> Lease commencement is defined as the date a lessor makes the underlying asset available to a lessee.

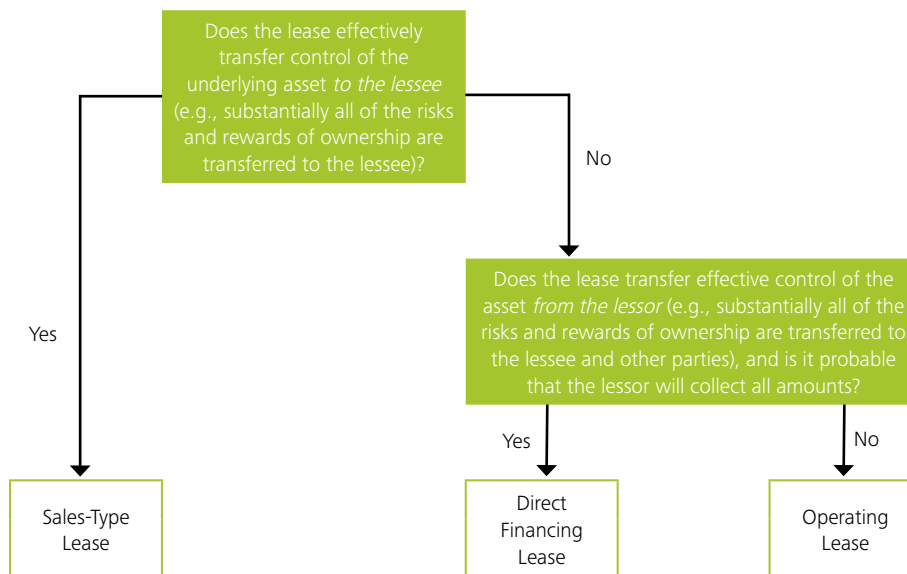
<sup>8</sup> A lessee is not required to determine the classification of a lease if the lease is accounted for in accordance with the short-term scope exception. See [Appendix B](#) for further details.

<sup>9</sup> The ASU provides an exception to this lease classification criteria for leases that commence "at or near the end" of the underlying asset's economic life. The ASU indicates that a lease that commences in the final 25 percent of an asset's economic life is "at or near the end" of the underlying asset's economic life.

<sup>10</sup> If the present value of lease payments plus a lessee-provided residual value guarantee represents substantially all of the fair value of the underlying asset, the lessor would classify the lease as a sales-type lease.



The following flowchart illustrates the classification of a lease by a lessor:



A lessee is not required to reassess its classification of a lease unless (1) the lease is subsequently modified and the modification is not accounted for as a separate contract or (2) there is a change in the lease term (e.g., there is a change in the assessment of whether the lessee is reasonably certain to exercise a renewal option) or a change in the assessment of the exercise of a purchase option. A lessor would only reassess its lease classification if the lease is subsequently modified and the modification is not accounted for as a separate contract. The accounting underlying each type of lease is discussed in greater detail below in the [Lessee Accounting](#) and [Lessor Accounting](#) sections.

**Editor’s Note:** While the ASU’s classification criteria are similar to those in IAS 17, they are different from the current requirements in U.S. GAAP. As a result, a lease that would have been classified as an operating lease may be classified as a finance lease under the ASU. In addition, as a reasonable approach to assessing significance, an entity is permitted to use the bright-line thresholds that exist under ASC 840 when determining whether a lease would be classified as a finance lease.<sup>11</sup>

In addition, an entity would assess land and other elements in a real estate lease as separate lease components unless the accounting result of doing so would be insignificant. This approach is consistent with the historical approach under IFRSs, but represents a change from current U.S. GAAP guidance, which requires a lessee to account for land and buildings separately only when (1) the lease meets either the transfer-of-ownership or bargain-purchase-price classification criteria or (2) the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception. This change may result in more bifurcation of real estate leases into separate lease elements.

## Lease Term

Under the ASU, the lease term, as determined at lease commencement, is the noncancelable lease period and any optional periods if (1) it is *reasonably certain*<sup>12</sup> that the lessee will exercise a renewal option or not exercise a termination option or (2) the exercise of those options is controlled by the lessor.

<sup>11</sup> Under ASC 840, a lease would be classified as a finance lease if the lease term is 75 percent or more than the remaining economic life of an underlying asset or if the sum of the present value of the lease payments and the present value of any residual value guarantees amounts to 90 percent or more than the fair value of the underlying asset.

<sup>12</sup> The FASB has indicated that “reasonably certain” is substantially the same as the “reasonably assured” threshold under current U.S. GAAP.

When assessing the likelihood of a lessee's exercise of an option, the lessor and lessee would consider the following:

- *Contract-based factors* — The terms of the lease agreement (e.g., a bargain renewal option, a contractual requirement for the lessee to incur substantial costs to restore the asset before returning it to the lessor).
- *Asset-based factors* — Specific characteristics of the underlying asset (e.g., the lessee has installed significant leasehold improvements that would still have economic value when the option becomes exercisable or the facility is in a geographically desirable location with no other viable locations).
- *Entity-specific factors* — The historical practice of the entity, management's intent, and common industry practice.
- *Market-based factors* — Market rentals for comparable assets.

Lessees are required to reassess the lease term when:

- A significant event or change in circumstances occurs that is directly attributable to and clearly within the control of the lessee, and the event or change in circumstances 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 contract term obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease.
- The lessee elects to (1) exercise an option to renew that it had previously determined was not reasonably certain to be exercised or (2) not exercise an option to terminate the contract that it had previously determined was reasonably certain to be exercised.

Lessors would not be required to reassess the lease term unless the lease is modified and the modified lease is a separate contract.

See [Appendix B](#) for more information about lease modifications.

#### Example 2 — Lessee Reassessment of Lease Term

On June 15, 20Y1, Company A leased a building to be used as a storage and distribution warehouse for a 10-year term, with two 5-year renewal options. Company A initially determined that on the lease commencement date it was not reasonably certain that it would exercise either of the renewal options and therefore concluded that the lease term was 10 years.

##### **Scenario 1 — Term Reassessment Would Not Be Required**

On January 15, 20Y5, the city in which the warehouse is located significantly improved its highway system, thereby making the warehouse location more desirable for A's distribution needs. This by itself would not result in the need for A to reassess whether it will exercise any remaining renewal options since the significant event or change in circumstances was outside of A's control.

##### **Scenario 2 — Term Reassessment Would Be Required**

On January 15, 20Y5, A installed leasehold improvements with a 10-year estimated useful life. The cost of the improvements was significant, and A is now reasonably certain to exercise at least one of its renewal options to avoid losing the value associated with the improvements. In this case, since the change in circumstances is directly attributable to A's actions, reassessment would be required.

## Lease Payments

In the calculation of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease, the lease payments are measured as the total of (1) fixed payments, including in-substance fixed payments; (2) variable payments based on an index or a rate; (3) amounts that it is probable a lessee will owe under a residual value guarantee (lessee) or the amount of the residual value guarantee (lessor); and (4) payments related to purchase or termination options that the lessee is reasonably certain to exercise. In addition, in measuring the ROU asset, the lessee would adjust its lease payments for any lease incentives that are paid or payable.

## Fixed Payments, Including In-Substance Fixed Payments

Fixed payments are payments that are specified in the lease agreement and fixed over the lease term. Fixed payments also include variable lease payments that are considered in-substance fixed payments (e.g., a variable payment that includes a floor or a minimum amount).

**Editor's Note:** Even if a variable lease payment is virtually certain (e.g., a variable payment for highly predictable output from a solar farm or a variable payment if a retail store meets a nominal sales volume), such a payment would not be considered an in-substance fixed payment. Therefore, it would not be included in the determination of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease.

## Variable Lease Payments

An entity would include variable lease payments that depend on an index or a rate in the initial measurement of the lease liability and ROU asset (lessee) or the net investment in the lease (lessor) by using the spot index or rate at lease commencement. By contrast, the entity would *not* include variable lease payments based on usage or performance of the asset. A lessee would recognize any variable payments not included in the original lease obligation as an expense in the period the obligation is incurred.<sup>13</sup> A lessor would recognize variable lease payments not included in the original net investment in the lease in the period a change occurs in the facts and circumstances on which the variable lease payments are based (e.g., "when the lessee's sales on which the amount of the variable payment depends occur").

A lessee is required to reassess variable lease payments when the lease liability is remeasured as a result of the following:

- The lease is modified and the modification is not treated as a separate contract.
- A contingency upon which a variable lease payment that is excluded from the measurement of lease payments becomes resolved such that the variable payment will now be included in the measurement of the lease payments (e.g., a variable lease payment that is based on a sales target subsequently converts to a fixed lease payment).
- There is a change in:
  - The lease term.
  - The assessment of whether the lessee will exercise a purchase option.
  - The amount that it is probable the lessee will owe under a residual value guarantee.

Any changes related to future periods would result in an adjustment to the lease obligation and ROU asset. A lessor is not required to reassess variable lease payments unless the lease is modified and the modification is not accounted for as a separate contract.

<sup>13</sup> The period in which the obligation is "incurred" refers to the period when it becomes *probable* that the specified target that triggers the variable lease payments will be achieved.

**Editor’s Note:** While the FASB aligned many of the lessor accounting requirements with the new revenue guidance in ASC 606, the treatment of variable consideration under the two models differs significantly. Under ASC 606, variable revenues are estimated and included in the transaction price subject to a constraint, whereas under the leases standard, variable lease payments would generally be excluded from the determination of a lessor’s lease receivable. Accordingly, there is a possibility that direct financing leases or sales-type leases that have a significant variable component may result in inception losses for the lessor if the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset being leased. This could occur if payments on a lease of, for example, a solar farm are based entirely on the production of electricity (i.e., 100 percent variable). Since many feel that this outcome does not faithfully represent the economics of these transactions, we are considering other possible approaches to applying the new standard to such contracts, including the use of a negative discount rate, which would avoid the inception loss. Lessors that are affected by this issue should consult with their professional advisers and monitor developments during the implementation phase of the ASU.

### Example 3 — Variable Lease Payments

On January 1, 20Y1, Company A leased a building for five years, payable in annual lease payments of \$100,000 at the beginning of each year. The lease is classified as an operating lease and contains a provision that on December 31 of each year, the lease payments will be adjusted by the change in the CPI for the preceding 12 months. At lease commencement, the CPI is 112. The implicit rate in the lease is not known, and A’s incremental borrowing rate is 7 percent. Any initial direct costs and lease incentives are ignored in this example.

#### ***Determining the Lease Payments***

At lease commencement, A makes its first annual payment of \$100,000. In addition, A records a lease liability of \$338,721 (the present value of the total remaining lease payments discounted at the incremental borrowing rate) and an ROU asset of \$438,721 (the total of the lease liability plus the prepaid rent of \$100,000). In measuring these amounts, A did not take into consideration the CPI in effect at lease commencement because the rent increase is based on a change in an index as opposed to the index itself.

On December 31, 20Y1 (the lease payment reset date), the CPI has changed to 126, representing a 12.5 percent increase (i.e., calculated as  $[(126 - 112) \div 112]$ ). Accordingly, A’s lease payment in year 2 would be \$112,500, comprising the fixed amount of \$100,000 and the variable amount of \$12,500 (calculated as the change in CPI multiplied by the fixed amount). Further, because A was not required to remeasure its lease liability for any other reason (e.g., a modification), there would be no adjustment to the liability to reflect changes in the CPI. That is, incremental amounts that will be paid in the future because of changes in the CPI would also be recognized as variable lease payments in the period the amounts are paid.

Had the rental increases been based on an index (as opposed to a change in an index), the current — or spot — value of the index would have been used to measure the initial lease liability and ROU asset. Changes in the index over the lease term would result in variable lease payments and would not require revision of the lease liability or ROU asset unless the lease is reassessed for other reasons.

## Residual Value Guarantees

The ASU defines a residual value guarantee as a “guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount.” Under current U.S. GAAP, a lessee includes in its minimum lease payments the entire amount of the residual value guarantee, whereas under the ASU, a lessee only includes those amounts that it is probable will be owed under the residual value guarantee at the end of the lease term. A lessee is required to remeasure lease payments when there is a change in the amount that it is probable will be owed by the lessee under a residual value guarantee. Revised lease payments would reflect changes in the amounts that it is probable will be owed by the lessee under residual value guarantees and would be recognized as an adjustment to the lease liability and the ROU asset.

A lessor would include in its lease receivable the full amount at which the residual asset is guaranteed by the lessee or a third party. Unlike a lessee, the lessor would not reflect any changes in the residual value in its lease receivable. However, changes in the unguaranteed residual value would be considered in the overall assessment of whether the net investment in the lease is impaired.

#### Example 4 — Residual Value Guarantee

A lessor leases equipment to a lessee for five years at \$10,000 per year. The lessee guarantees that the equipment will have a residual value of at least \$9,000 at the end of the lease. The expected residual value at the end of the lease term is \$20,000.

##### **Lessee Accounting**

In its lease payment calculation, the lessee would only include the amount that it is probable it will owe under the residual value guarantee at the end of the lease term. Accordingly, the lessee would not include any amount in the initial measurement of the lease liability and ROU asset, because the expected residual value is greater than the guaranteed amount. However, if the expected residual value of the asset subsequently decreased (e.g., to \$4,000) and, accordingly, the lessee now believes that it is probable that it will make a payment under the residual value guarantee, the lessee would need to adjust the lease liability and the ROU asset to reflect the present value of the \$5,000 expected to be owed.

##### **Lessor Accounting**

In the calculation of its lease receivable, the lessor would include the portion of the residual asset that is guaranteed by the lessee (or any other party). Accordingly, in addition to the present value of the five annual lease payments of \$10,000, the lessor would include the present value of the \$9,000 guaranteed amount in its calculation of the lease receivable. The lessor's net investment in the lease would consist of the total receivable (including the residual value guarantee) and the present value of the unguaranteed residual asset of \$11,000. The lessor would not make any subsequent adjustments to its net investment in the lease for changes in the guaranteed residual value. However, changes in the unguaranteed residual value would be considered in the overall assessment of whether the net investment in the lease is impaired.

**Editor's Note:** As discussed above, under the new standard a lessee would include in its lease payments only those amounts related to a residual value guarantee that it is probable the lessee will owe at the end of the lease term. Lease arrangements (such as a synthetic lease arrangement) in which a significant portion of the lease payments are structured as a residual value guarantee could therefore result in ROU assets and lease liabilities that are significantly lower than those in arrangements in which more of the lessee's obligation takes the form of rents. For example, since many real estate assets are expected to hold their value over the lease term, amounts that it is probable the lessee will owe under residual value guarantees may be nominal. Accordingly, while these arrangements will be brought onto the balance sheet, synthetic leases and other lease arrangements in which a significant portion of lease payments are structured as a residual value guarantee may continue to yield favorable accounting results (e.g., reduced leverage) under the new leasing guidance.

## Discount Rate

Under the ASU, the discount rate used by a lessee and a lessor is based on the information available as of the lease commencement date. A lessee should use the rate that the lessor charges in the lease (i.e., the rate implicit in the lease) if that rate is readily determinable. If the rate is not readily determinable, which is generally expected, the lessee should use its incremental borrowing rate as of the date of lease commencement. Lessors should use the rate they charge the lessee (i.e., the rate implicit in the lease) and are not required to reassess the discount rate used when there is a change in lease term. The discount rate must be updated by the lessee if there is a remeasurement of the lease liability unless the remeasurement results from changes in one of the following:

- The lease term or the assessment of whether a purchase option will be exercised, and the discount rate already reflects the lessee's option to extend or terminate the lease or purchase the asset.

- Amounts that it is probable the lessee will owe under a residual value guarantee.
- Lease payments resulting from the resolution of a contingency upon which some or all of the variable lease payments are based.

When there is a modification that does not result in a separate contract, a lessee and lessor would, in certain instances, be required to reassess the discount rate used when accounting for the modified lease. See the [Lease Modifications](#) section in Appendix B.

When measuring their lease liabilities, nonpublic business entities are permitted to make an accounting policy election to use the risk-free discount rate for all leases in lieu of their incremental borrowing rate. Using the risk-free rate would result in a larger lease liability and ROU asset.

## Lessee Accounting

### Initial Measurement

The initial measurement of a lease is based on an ROU asset approach. Accordingly, **all** leases (finance and operating leases) other than those that qualify for the short-term scope exception must be recognized as of the lease commencement date on the lessee's balance sheet. A lessee will recognize a liability for its lease obligation, measured at the present value of lease payments not yet paid (excluding variable payments) and a corresponding asset representing its right to use the underlying asset over the lease term. The initial measurement of the ROU asset would also include (1) initial direct costs (e.g., legal fees, consultant fees, commissions paid) that are directly attributable to negotiating and arranging the lease that would not have been incurred had the lease not been executed and (2) any lease payments made to the lessor before or at the commencement of the lease. The ROU asset would be reduced for any lease incentives received by the lessee (i.e., consideration received from the lessor would reduce the ROU asset).

### Subsequent Measurement

Although the FASB and IASB agreed on the lessee's initial measurement of a lease, they differed on the lessee's subsequent measurement of the ROU asset as follows:

- *Dual-model approach (FASB)* — Lessees classify a lease as either a finance lease or an operating lease (see the [Lease Classification](#) discussion above).
- *Single-model approach (IASB)* — Lease classification is eliminated, and all leases are accounted for in a manner consistent with the accounting for finance leases under the FASB's approach.

**Editor's Note:** The FASB adopted a dual-model approach because it believes that all leases are not created equal; that is, some leases are akin to a financing arrangement for the purchase of an asset, while others are simply rental of the underlying property. By contrast, the IASB believes that the single-model approach (i.e., one that eliminates lease classification) has greater conceptual merit and reduces complexity.

## ***Finance Leases***

For finance leases, the lessee will use the effective interest rate method to subsequently account for the lease liability. The lessee will amortize the ROU asset in a manner similar to that used for other nonfinancial assets; that is, the lessee would generally depreciate the ROU asset on a straight-line basis unless another systematic method would be appropriate. Together, these expense components would result in a front-loaded expense profile similar to that of a capital lease arrangement under current U.S. GAAP. Entities would separately present the interest and amortization expenses in the income statement.

## ***Operating Leases***

For operating leases, the lessee will also use the effective interest rate method to subsequently account for the lease liability. However, the subsequent measurement of the ROU asset would be linked to the amount recognized as the lease liability (unless the ROU asset is impaired). Accordingly, the ROU asset would be measured as the lease liability adjusted by (1) any accrued or prepaid rents, (2) unamortized initial direct costs and lease incentives, and (3) impairments of the ROU asset. As a result, the total lease payments made over the lease term would be recognized as lease expense (presented as a single line item) on a straight-line basis unless another systematic method is more appropriate.

**Editor's Note:** While the ASU discusses subsequent measurement of the ROU asset arising from an operating lease primarily from a balance sheet perspective, a simpler way to describe it would be from the viewpoint of the income statement. Essentially, the goal of operating lease accounting is to achieve a straight-line expense pattern over the term of the lease. Accordingly, an entity effectively takes into account the interest on the liability (i.e., the lease obligation consistently reflects the lessee's obligation on a discounted basis) and adjusts the amortization of the ROU asset to arrive at a constant expense amount. To achieve this, the entity first calculates the interest on the liability by using the discount rate for the lease and then deducts this amount from the required straight-line expense amount for the period (determined by taking total payments over the life of the lease, net of any lessor incentives, plus initial direct costs, divided by the lease term). This difference is simply "plugged" as amortization of the ROU asset to result in a straight-line expense for the period. By using this method, the entity recognizes a single operating lease expense rather than separate interest and amortization charges, although the effect on the lease liability and ROU asset in the balance sheet reflects a bifurcated view of the expense. Note, however, that the periodic lease cost cannot be less than the calculated interest on the lease liability (i.e. the amortization of the ROU asset, or "plug" amount, cannot be negative).

## ***Impairment***

Regardless of the lease classification, a lessee would subject the ROU asset to impairment testing in a manner consistent with other long-lived assets. If the ROU asset for a lease classified as an operating lease is impaired, the lessee would amortize the remaining ROU asset under the subsequent measurement requirements for a finance lease — evenly over the remaining lease term unless another systematic method would be appropriate. In addition, in periods after the impairment, a lessee would continue to present the ROU asset amortization and interest expense as a single line item.

### Example 5 — Lessee Expense Recognition: Differences Between Subsequent-Measurement Models

A lessee enters into a three-year lease and agrees to make the following annual payments at the end of each year: \$10,000 in year 1, \$15,000 in year 2, and \$20,000 in year 3. The initial measurement of the ROU asset and liability to make lease payments is \$38,000 at a discount rate of 8 percent.

The following table highlights the differences in accounting for the lease under the finance lease and operating lease approaches:

Year	Both Methods	Finance Lease Approach				Operating Lease Approach		
	Lease Liability <sup>(a)</sup>	Interest Expense <X>	Amortization Expense <Y> <sup>(b)</sup>	Total Lease Expense <X + Y>	ROU Asset	Lease Expense <Z>	Reduction in ROU Asset <Z - X> <sup>(c)</sup>	ROU Asset
0	\$ 38,000				\$ 38,000			\$38,000
1	31,038	\$ 3,038	\$ 12,666	\$ 15,704	25,334	\$ 15,000	\$ 11,962	26,038
2	18,520	2,481	12,667	15,148	12,667	15,000	12,519	13,519
3	—	1,481	12,667	14,148	—	15,000	13,519	—
Total		\$ 7,000	\$ 38,000	\$ 45,000		\$ 45,000	\$ 38,000	

(a) The effective-interest method is used to calculate the lease liability, regardless of the type of lease.

(b) Under the finance lease approach, the ROU asset would be amortized in the same manner as other nonfinancial assets (i.e., typically straight-line).

(c) Under the operating lease approach, amortization expense is calculated as the difference between lease expense and interest expense.

## Lessor Accounting

After proposing multiple different amendments to lessor accounting, the FASB ultimately decided to make only minor modifications to the current lessor model. The most significant changes align the profit recognition requirements under the lessor model with those under the FASB's new revenue recognition requirements and amend the lease classification criteria to be consistent with those for a lessee. Accordingly, the ASU requires a lessor to use the classification criteria discussed above to classify a lease, at its commencement, as a sales-type lease, direct financing lease, or operating lease:

- *Sales-type lease* — The lessee effectively gains control of the underlying asset. The lessor would derecognize the underlying asset and recognize a net investment in the lease (which consists of the lease receivable and unguaranteed residual asset). Any resulting selling profit or loss would be recognized at lease commencement. Initial direct costs would be recognized as an expense at lease commencement unless there is no selling profit or loss. If there is no selling profit or loss, the initial direct costs would be deferred and recognized over the lease term. In addition, the lessor would recognize interest income from the lease receivable over the lease term.

In a manner consistent with ASC 606, if collectibility of the lease payments plus the residual value guarantee is not probable, the lessor would not record a sale. That is, the lessor would not derecognize the underlying asset and would account for lease payments received as a deposit liability until (1) collectibility of those amounts becomes probable or (2) the contract has been terminated or the lessor has repossessed the underlying asset. Once collectibility of those amounts becomes probable, the lessor would derecognize the underlying asset and recognize a net investment in the lease. If the contract has been terminated or the lessor has repossessed the underlying asset, the lessor would recognize the deposit liability and recognize a corresponding amount of lease income.



- *Direct financing lease* — The lessee does not effectively obtain control of the asset, but the lessor relinquishes control. This would occur if (1) the present value of the lease payments and any residual value guarantee (which could be provided entirely by a third party or consist of a lessee guarantee coupled with a third-party guarantee)<sup>14</sup> represents substantially all of the fair value of the underlying asset and (2) it is probable that the lessor would collect the lease payments and any amounts related to the residual value guarantee(s). The lessor would derecognize the underlying asset and recognize a net investment in the lease (which consists of the lease receivable and unguaranteed residual asset). The lessor’s profit and initial direct costs would be deferred and amortized into income over the lease term.
- *Operating lease* — All other leases are operating leases. In a manner similar to current U.S. GAAP, the underlying asset remains on the lessor’s balance sheet and is depreciated consistently with other owned assets. Income from an operating lease would be recognized on a straight-line basis unless another systematic basis would be more appropriate. That is, a lessor would recognize uneven fixed lease payments (step payments) on a straight-line basis only when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (e.g., when there is significant front-loading or back-loading of payments or when there are rent-free periods in a lease). This may have a significant effect on a lessor’s recognition of revenue for operating leases, particularly those related to real estate. Any initial direct costs (i.e., those that are incremental to the arrangement and would not have been incurred if the lease had not been obtained) would be deferred and expensed over the lease term in a manner consistent with the way lease income is recognized.

**Editor’s Note:** Under the FASB’s model, the immediate recognition of any profit in the income statement is precluded if control of the asset has not been transferred to the customer in accordance with ASC 606 (i.e., control would not have transferred for direct financing and operating leases). Profit can exist in a direct financing lease, though it would be deferred and recognized over the lease term rather than recognized immediately. In contrast, under IFRS 16, a lessor is not required to evaluate whether the arrangement would qualify as a sale under IFRS 15 in determining whether it can recognize a profit at lease commencement.

#### Example 6 — Lessor Profit Recognition

A lessor leases equipment to a lessee. The leased asset has a carrying amount of \$20,000 and a fair value of \$25,000 at lease commencement. The terms of the lease are as follows:

Terms	
Lease term	8 years
Annual lease payments	\$3,500 due at the end of each year
Estimated useful life of the underlying asset	12 years
Rate the lessor charges the lessee (implicit rate in the lease)	6.98%
Estimated residual value at the end of the lease term	\$7,000

Ownership of the underlying asset does not transfer by the end of the lease, and there is no bargain purchase option. In addition, the leased asset is not specialized, and it is probable that the lessor will collect the lease payments and any amounts related to the residual value guarantee.

<sup>14</sup> If the present value of lease payments plus a lessee-provided residual value guarantee represents substantially all of the fair of the underlying asset, the lessor would classify the lease as a sales-type lease.

## Example 6 — Lessor Profit Recognition (continued)

### Scenario 1 — Lessee Residual Value Guarantee (Sales-Type Lease)

As part of the lease contract, the lessee guarantees the full residual value of the underlying asset that is expected at the end of the lease.

#### Analysis

In this scenario, the lessor would conclude that the lease represents a sales-type lease. The lessee effectively gains control of the underlying asset because the present value of the lease payments and the residual value guarantee provided by the lessee represent all of the fair value of the underlying asset, which satisfies one of the five classification criteria for a sales-type lease (i.e., the present value of the lease payments and the residual value guarantee represent substantially all of the asset's fair value). Since control of the underlying asset has effectively transferred to the lessee, the lessor would be permitted to recognize the profit at lease commencement.

### Scenario 2 — Third-Party Residual Value Guarantee (Direct Financing Lease)

As part of its risk management program, the lessor obtains a third-party guarantee that the residual value of the underlying asset at the end of the lease will be equal to \$7,000.

#### Analysis

In this scenario, the lessor would conclude that the lease represents a direct financing lease because the lessee **does not** effectively obtain control of the underlying asset. This is because the present value of the lease payments made by the lessee does not represent substantially all of the fair value of the underlying asset (i.e., the present value of the lease payments represents only 84 percent of the fair value of the asset). However, since the present value of the lease payments and the third-party residual value guarantee represent all of the fair value of the underlying asset, and it is probable that the lessor will collect the lease payments and any amounts related to the residual value guarantee, the lease is considered a direct financing lease. Because control of the underlying asset has not effectively transferred to the lessee, the lessor **would not** be permitted to recognize the profit at lease commencement.

Accordingly, although the lessor would derecognize the underlying asset, it would be required to defer the profit and recognize the profit at a constant periodic rate (as part of interest income) over the term of the lease.

### Comparison of Sales-Type Lease and Direct Financing Lease

The following table illustrates the accounting for the lease under the sales-type and direct financing approaches:

Year	Sales-Type Lease			Direct Financing Lease	
	Net Investment in Lease (Balance Sheet)	Interest Income	Selling Profit	Net Investment in Lease (Balance Sheet)	Interest Income
0	\$ 25,000		\$ 5,000	\$ 20,000	
1	23,244	\$ 1,744		18,953	\$ 2,453*
2	21,366	1,622		17,778	2,326
3	19,356	1,491		16,459	2,181
4	17,207	1,350		14,978	2,019
5	12,447	1,200		13,315	1,837
6	14,907	1,040		11,448	1,633
7	9,815	868		9,353	1,404
8	7,000	685		7,000	1,147
Total		\$ 10,000	\$ 5,000		\$ 15,000

\* Under the direct financing lease model, the lessor would not recognize the selling profit at lease commencement because the lease does not transfer control of the underlying asset to the lessee. Instead, the lessor would recognize the selling profit through higher interest income over the term of the lease.

## Effective Date

The new guidance is effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods thereafter. Early adoption is permitted for all entities. Further, an entity's ability to early adopt the new guidance would not be linked to its adoption of ASC 606.<sup>15</sup>

**Editor's Note:** Since early adoption is permitted, an entity could conceivably adopt the new standard for its year ended December 31, 2015, if its financial statements have not yet been issued or been made available for issuance. While an entity may believe that there are certain benefits to early adopting (e.g., the ability to derecognize assets and liabilities that resulted from deemed ownership under existing build-to-suit accounting guidance), it should carefully consider the implications of doing so. For example, it will need to ensure that it has systems, processes, and controls in place to appropriately implement the new guidance (see [Appendix F](#) for more information). Further, if an entity adopts the ASU before the issuance of any formal implementation guidance, its accounting for lease transactions may differ from that of its peers and thus the risk of regulatory scrutiny may increase.

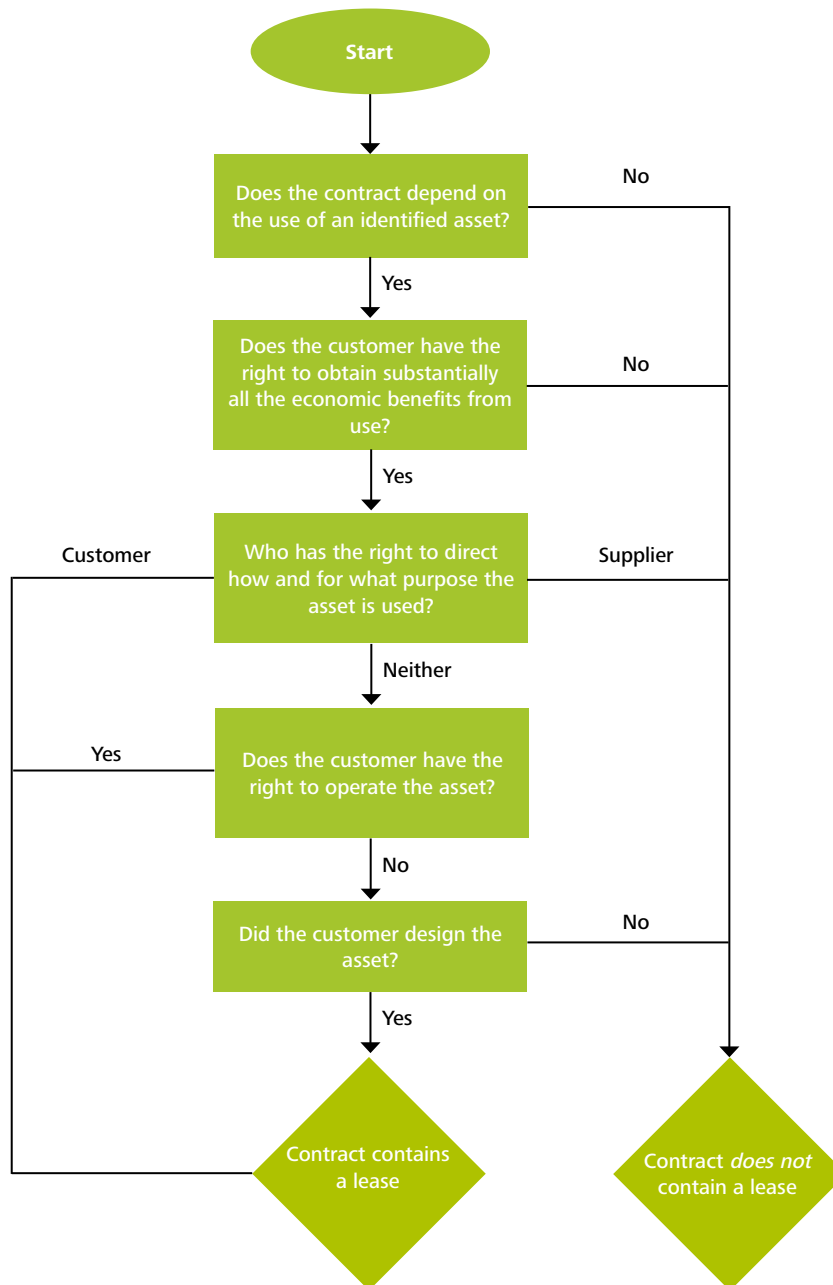
In addition, entities applying U.S. GAAP may adopt the new leases standard before they adopt the new revenue guidance (even though the new revenue standard has an earlier mandatory effective date). On the basis of discussions with the FASB staff, it is our understanding that such early adopters would be expected to apply the relevant guidance in the new revenue standard to the extent that it affects their lease accounting. They would wait to apply all other aspects of the new revenue standard until their full adoption of that standard.

<sup>15</sup> The effective date of IFRS 16 (the IASB's new leases standard) is similar to the FASB's effective date for public business entities. However, the IASB decided that an entity would only be allowed to early adopt IFRS 16 to the extent that the entity has also adopted IFRS 15 (the IASB's new revenue standard).

## Appendix A — Evaluating Whether an Arrangement Is or Contains a Lease

The determination of whether an arrangement is or contains a lease is critical under the new requirements. If a lessee concludes that a contract is a service arrangement and not a lease, the lessee is not required to reflect the contract on its balance sheet. However, the lessee’s balance sheet will need to reflect any lease arrangement that is not considered to be a short-term lease.

The following flowchart illustrates how to evaluate whether an arrangement is or contains a lease:



ASC 842-10-15-3 states that “[a] contract is or contains a lease if the contract conveys the right to control the use of identified [PP&E] (an identified asset) for a period of time in exchange for consideration.” At the inception<sup>16</sup> of a contract, an entity should assess whether a contract is or contains lease. ASC 842-10-15-4 specifies that in determining whether the customer has the right to control the use of the identified asset, an entity would need to evaluate whether the customer has both:

- “The right to obtain substantially all of the economic benefits from use of the identified asset.”
- “The right to direct the use of the identified asset.”

<sup>16</sup> Lease inception is defined as the “date of the lease agreement or commitment, if earlier.”

## Use of an Identified Asset

Like current U.S. GAAP, the ASU requires a leased asset to be identifiable either explicitly (e.g., by a serial number) or implicitly (e.g., the only asset available to satisfy the contract). A distinct portion of a larger asset may be the subject of a lease (e.g., a floor of a building). However, a capacity portion of an asset would generally not meet the definition of a lease (e.g., 50 percent of an oil pipeline) unless the arrangement is for substantially all of the capacity of the asset. In addition, the ASU states that “[i]f the customer has the right to control the use of an identified asset for only a portion of the term of the contract,” then only that portion of the term of the contract would be considered a lease.

### Example A1 — Identified Asset

#### **Scenario 1 — Contract Does Not Contain an Identified Asset**

A company enters into a contract with a warehouse operator to store up to 1,000 pallets of spare parts inventory at one of the operator’s warehouse locations for a three-year period. The operator’s warehouse has capacity to store up to 10,000 pallets of inventory. During the contract period, the warehouse operator can use the remaining space in its warehouse for other storage needs. In addition, the warehouse operator can relocate the customer’s pallets within the warehouse any time without incurring significant costs.

Because the customer does not have exclusive use of a specified portion of the warehouse, and the portion being used is not substantially all of the warehouse capacity, there is no identified asset. Although the contract specifies the amount of spare parts inventory that will be held, the warehouse operator can change the inventory’s location within its warehouse at any time.

#### **Scenario 2 — Contract Contains an Identified Asset**

Assume the same facts as those above, except the 1,000 pallets represent substantially all of the capacity of the operator’s warehouse, and the operator cannot relocate the inventory to a different facility.

Since the customer’s storage requirement accounts for substantially all of the capacity of the operator’s warehouse (more than 90 percent), the arrangement contains an identified asset.

## Substitution Rights

An entity must also evaluate whether the supplier has the right to substitute the underlying asset with an alternative asset. If the supplier has substantive substitution rights, the asset in the arrangement would not be identified, and the arrangement would not be considered a lease. For a substitution right to be considered substantive, the following two conditions must be met:

- The supplier must have the “practical ability” to substitute the identified asset. The customer cannot prevent the supplier from substituting the asset, and alternative assets must be readily available to, or readily obtainable by, the supplier. A supplier’s right (or obligation) to substitute alternative assets only if the asset is not operating properly would not meet this condition.
- The supplier must economically benefit from the substitution.

An entity should evaluate a substitution right by considering the facts and circumstances at the inception of the contract and would exclude from its assessment circumstances that are not likely to occur over the contract term. The entity should also consider the physical location of the asset. For example, it is more likely that the supplier will benefit from the substitution right if the identified asset is located at the supplier’s rather than the customer’s premises.

It may be difficult for a customer to determine whether the supplier’s substitution right is substantive. For example, the customer may not know whether the substitution right gives the supplier an economic benefit. A customer would presume that a substitution right is not substantive if it is impractical to prove otherwise; accordingly, they must exercise significant judgment in making the determination.

**Editor’s Note:** The requirement that a substitution right be economically beneficial to a supplier is a higher threshold than the requirements in current U.S. GAAP. Accordingly, we expect more arrangements to be subject to lease accounting under the new guidance.

#### Example A2 — Substantive Substitution Rights: Contract Does Not Contain a Substantive Substitution Right

Company A enters into an arrangement with Supplier B under which B will provide a customized Model 5000 copier to A for two years. Supplier B only has one customized Model 5000 copier. The arrangement allows B to replace the copier at will. However, if a replacement copier were needed, B would need several months to manufacture it. Since B only has one asset that can be used to satisfy the agreement with A and does not have the practical ability to substitute it, B's substitution right is not substantive.

### Right to Control the Use of the Identified Asset

A lease differs from a service arrangement because in a lease, the customer effectively obtains control of the identified asset during the lease term. A customer has the right to control an asset if it has the right to do both of the following:

- Obtain substantially all of the economic benefits from the use of the identified asset.
- Direct the use of the identified asset.

**Editor's Note:** The notion of control under the new standard is closely aligned with that under the FASB's new revenue standard, which states that control is "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." However, the definition differs from the concept of control in consolidation guidance, under which design decisions are secondary to ongoing activities (e.g., those activities related to operations and maintenance). Design decisions and those related to operations and maintenance responsibilities have equal weight under the new leases standard.

### *Obtain Substantially All of the Economic Benefits From the Use of the Identified Asset*

To control the use of an identified asset, the customer must have the right to obtain substantially all of the economic benefits from the use of the asset during the contract period. Economic benefits consist of direct or indirect benefits from the use of the asset (e.g., using, holding, or subleasing the asset) and include its primary output and its by-products (e.g., renewable energy credits from using the asset). Because a lease conveys only the right to use (and not ownership of) the underlying asset, benefits related to ownership of an asset (e.g., tax benefits) should not be included in the assessment of whether an arrangement contains a lease. Rather, this evaluation should be limited to those economic benefits resulting from the use of the asset during the contract period that can be realized from a commercial transaction with a third party.

### *Direct the Use of the Identified Asset*

The evaluation of whether a customer has the right to direct the use of an identified asset should focus on the customer's ability to direct the activities that determine "how and for what purpose" the asset is used during the term of the contract. Factors to consider include whether the customer has the right to change (1) the type of output produced by the asset, (2) when the output is produced, (3) where the output is produced and (4) whether the output is produced. However, a requirement that protects the supplier's interest in the asset or related assets, or ensures that the customer complies with laws or regulations (e.g., a contract that specifies the maximum use of an asset or requires prudent operating practices), would not by itself prevent the customer from directing the use of the identified asset.

In situations in which neither the customer nor the supplier has the ability to determine "how and for what purpose" the asset is used during the contract period, the customer should consider whether the relevant decisions are predetermined by the contract or are based on the design of the underlying asset. If the relevant decisions are predetermined and the customer has the right to operate the asset or direct others to operate the asset — and the supplier cannot change the operating instructions — during the period of use, it is presumed that the customer has the ability to direct the use of the asset over the lease term. Similarly, if the customer's involvement in the design of the asset results in the predetermination of the most relevant decisions about "how and for what purpose" the asset is used over the contract term, then it is presumed that the customer controls the use of the asset.

**Editor’s Note:** We anticipate that for certain industries the evaluation of control will require the use of significant judgment under the new standard, especially when the activities associated with the asset are predetermined. Although an entity may not have trouble determining whether the customer or supplier has control over the operating decisions related to the asset, the assessment of whether the customer designed the asset will often be more difficult given the different levels of influence a customer may have over the design decisions (e.g., siting, determining the technology to be used). Accordingly, an entity will need to use judgment when performing this evaluation.

For example, in a solar farm arrangement between a supplier and a utility company, the relevant decisions about how and for what purpose the assets are used are predetermined on the basis of the nature of the asset. Accordingly, the control evaluation would focus on whether the customer (the utility company) (1) has control over the operating decisions related to the asset (typically the operation and management will be performed by the asset owner (the supplier)) or (2) was involved in the decisions about the asset’s design before contract inception.

### Example A3 — Control of the Use of an Identified Asset

#### ***Scenario 1 — Customer Controls the Use of an Identified Asset***

Customer A enters into a contract with Supplier B for the use of a specific ship for a four-year period. Supplier B is not permitted to substitute the ship. Customer A decides whether and what cargo will be transported and when and to which ports the ship will sail throughout the contract period, subject to certain restrictions. The restrictions prevent A from sailing the ship in waters where there is a high risk of piracy or from carrying hazardous materials as cargo. During the contract period, B operates and maintains the ship and is responsible for the safe passage of the cargo onboard the ship. Customer A is prohibited from hiring another operator for the ship during the term of the contract or operating the ship itself.

In this scenario, A has the right to control the use of the ship throughout the four-year contract period. That is, A has the right to obtain substantially all of the economic benefits from the use of the ship during the contract period through its exclusive use of the ship. Further, A has the right to direct activities related to the use of the ship because it decides where and when the ship will travel, what cargo it will carry, or whether it will be transporting cargo at any given time. While there are contractual restrictions about where the ship can sail and the nature of the cargo to be transported, these are protective rights and do not prevent A from having the right to direct the use of the asset.

#### ***Scenario 2 — Customer Does Not Control the Use of an Identified Asset***

Customer A enters into a contract with Supplier B for the transportation of cargo from Greece to New York on a specified ship. The contract identifies the cargo to be transported on the ship as well as the route to be followed. During the contract term, B is responsible for the safe passage of the cargo and B’s crew is responsible for operating and maintaining the ship (e.g., A cannot replace the crew under any circumstances).

Customer A **does not** have the right to control the use of the ship because it does not have the right to direct its use. That is, the activities related to the use of the ship during its trip from Greece to New York are predetermined in the contract. In addition, A does not have any decision-making rights about the operation of the ship during the period of use, nor was A involved in the ship’s design.

## Appendix B — Other Significant Provisions

### Lease Modifications

Any change to the contractual terms and conditions of a lease that lead to a change in the scope of or consideration for the lease would be considered a lease modification. When assessing the changes, an entity should first evaluate whether the lease modification is to be accounted for as a separate contract (i.e., separately from the original lease). A lessee or lessor would account for a lease modification as a separate contract when, as a result of the modification, (1) the lessee is granted an additional ROU asset (physically distinct from the original ROU asset) and (2) the price of the additional ROU asset is commensurate with its stand-alone price (in the context of that particular contract). If the modification is considered a separate contract, the lessee or lessor would apply the new requirements to the separate contract.

#### Example B1 — Modification Resulting in a Separate Contract

Company A (lessee) enters into an arrangement to lease 15,000 square feet of retail space in a shopping mall for 20 years. At the beginning of year 10, A and the lessor agree to amend the original lease to include an additional 5,000 square feet of space adjacent to the existing space currently being leased when the current tenant vacates the property in 18 months. The increase in lease consideration as a result of the amendment is commensurate with the expected market rate for the additional 5,000 square feet of space in the shopping mall. Company A would account for this modification (i.e., the lease of the additional 5,000 square feet) as a separate contract because the modification provides A with a new ROU asset at a price that reflects its stand-alone price. While A would be required to disclose certain information about the lease modification, it would **not** be required to separately record any amounts in its statement of financial position until the separate lease's commencement date (i.e., 18 months from entering into the modification).

If the lease modification is **not a separate contract**, both the lessee and lessor would reassess the lease classification of the modified lease (by using the modified lease terms, including the discount rate as of the effective date of the modification). The lessee would account for the modification as follows:

Modification	Lessee's Accounting
Grants the lessee an additional ROU, changes the lease term (other than through the exercise of a contractual option), or results in a change to the lease consideration.	The lessee would use the updated lease payments and discount rate to revise the lease liability and would recognize any difference between the new lease liability and the old lease liability as an adjustment to the ROU asset.
Modification that reduces the scope of the original lease contract.	The lessee would adjust the lease liability by using the revised lease payments and an updated discount rate, derecognize a proportionate amount of the ROU asset, and recognize any difference as a gain/loss through earnings.

A lessee would subsequently account for the modified lease under the subsequent measurement guidance in the ASU (see discussion in the [Subsequent Measurement](#) section).

#### Example B2 — Modification Not Resulting in a Separate Contract

Company A (lessee) enters into an arrangement to lease 15,000 square feet in a shopping mall for 20 years. At the beginning of year 10, A and the lessor agree to amend the original lease by reducing the annual rental payments from \$60,000 to \$50,000 for the remaining 10 years of the agreement. Because the modification results in a change only to the lease consideration (i.e., the modification does not result in an additional ROU asset), A would remeasure its lease liability to reflect (1) a 10-year lease term, (2) annual lease payments of \$50,000, and (3) A's incremental borrowing rate (or the rate the lessor charges the lessee if such rate is readily determinable) as of the modification's effective date. Company A would recognize the difference between the new and old lease liabilities as an adjustment to the ROU asset.



A lessor would account for a lease modification that is **not a separate contract** as follows:

Original Lease Classification	Lease Classification After the Modification	Lessor's Accounting
Operating lease	Operating lease	Any prepaid or accrued lease rentals are treated as a lease payment on the modified lease.
	Direct financing or sales-type lease	Any deferred rent liability or accrued rent asset is derecognized, and the selling profit or loss is adjusted accordingly (see the <a href="#">Lessor Accounting</a> section for a discussion of the treatment of selling profit or loss for each type of lease).
Direct financing lease	Direct financing lease	The modification is accounted for prospectively by adjusting the discount rate.
	Sales-type lease	The profit or loss on the modification is the difference between the fair value of the underlying asset and the carrying value of the net investment in the lease immediately before the effective date of the modification.
	Operating lease	The modification is accounted for prospectively as an operating lease. The net investment in the lease is reclassified as the initial carrying value of the underlying leased asset.
Sales-type lease	Sales-type or direct financing lease	The modification is accounted for prospectively by adjusting the discount rate.
	Operating lease	The modification is accounted for prospectively as an operating lease. The net investment in the lease is reclassified as the initial carrying value of the underlying leased asset.

## Contracts That Contain Multiple Components

An entity is required to identify the lease and nonlease components of a contract that contains a lease. A contract may also contain multiple lease components. The right to use an underlying asset is considered a separate lease component if (1) a lessee can benefit from the use of the underlying asset either on its own or with other resources that are readily available **and** (2) the underlying asset is not highly dependent on or highly interrelated<sup>17</sup> with other assets in the arrangement. Accordingly, a contract may include multiple lease components for different underlying assets.

Notwithstanding its requirement related to identifying lease components, an entity must account for the right to use land and other assets separately unless the effect of doing so would be insignificant to the overall accounting for the transaction (e.g., if a lease includes both land and a building component, and the entity concludes that each component would be classified as an operating lease, accounting for the two lease components together would be reasonable since the overall impact of accounting for the components together would be insignificant).

**Editor's Note:** When evaluating whether an activity should be considered a separate nonlease component, an entity should consider whether the activity transfers a separate good or service to the lessee. A component includes only those items or activities that transfer a good or service to the lessee. For example, in a real estate lease, maintenance services (including common-area maintenance services or CAM) and utilities paid for by the lessor but consumed by the lessee would be separate nonlease components because the lessee would have been required to otherwise contract for these services separately. However, payments for property taxes or insurance would most likely be considered part of the lease component because they do not transfer a separate good or service to the lessee. Such treatment could have the effect of inflating the lease liability since it would include amounts that are currently considered executory costs. From a practical standpoint, however, such amounts are frequently variable and therefore would not be included in the measurement of the lease liability.

<sup>17</sup> The ASU states that "[a] lessee's right to use an underlying asset is highly dependent on or highly interrelated with another right to use an underlying asset if each right of use significantly affects the other."

When a contract includes both lease and nonlease components, an entity is required to allocate the consideration in the contract to the various elements (except when a lessee is applying the practical expedient discussed below). The ASU provides separate guidance on how lessees and lessors should allocate these amounts.

### ***Allocation by Lessees***

Lessees need to first consider whether the stand-alone prices of the various components are observable. If each component has an observable stand-alone price, the lessee would base its allocation on the relative stand-alone price of each component. If only certain components have observable stand-alone prices, the lessee is permitted to estimate stand-alone prices by maximizing observable information for those items that do not have an observable stand-alone price. In addition, a lessee would allocate initial direct costs to the various components in a manner similar to its allocation of lease payments to each component.

Lessees are permitted to elect, as an accounting policy by class of underlying asset, not to separate lease components from nonlease components and instead account for the entire contract as a single lease component. However, when applying this election, a lessee would not be permitted to combine multiple lease components.

### ***Allocation by Lessors***

A lessor must consider the allocation guidance in ASC 606 to determine how to allocate the payments between the lease and nonlease components. That guidance allows a lessor to use an estimated selling price when no observable price exists. In addition, a lessor would allocate any capitalized costs, such as initial direct costs, to the components to which the costs are related.

### ***Reallocation***

Both lessees and lessors are required to reallocate the consideration in a contract when the contract is modified and the modification is not considered a separate contract. Lessees are also required to reallocate the consideration in the contract upon a reassessment of the lease term or a change in the likelihood that a purchase option will be exercised.

### **Contract Combinations**

An entity is required to combine two or more contracts entered into at or near the same time with the same counterparty if any of the following criteria are met:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
- The rights or some of the rights to use underlying assets conveyed in the contracts are a single lease component.

This guidance is generally consistent with the contract combination guidance in ASC 606.

### **Initial Direct Costs**

In a manner consistent with the guidance in ASC 606, initial direct costs for both lessees and lessors would include only those costs that are incremental to the arrangement and would not have been incurred if the lease had not been obtained. This definition is considerably more restrictive than that under current requirements. For example, commissions paid and payments made to existing tenants to obtain the lease are considered initial direct costs, whereas allocated internal costs and costs to negotiate and arrange the lease agreement that would have been incurred regardless of lease execution (e.g., professional fees such as those paid for legal and tax advice) are not.

For sales-type leases, initial direct costs are recognized as an expense at lease commencement unless there is no selling profit or loss on the transaction. If there is no selling profit or loss, the initial direct costs are deferred and recognized over the lease term. For direct financing leases, a lessor would defer and include all initial direct costs in the initial measurement of the lease receivable. For operating leases, a lessor would defer the initial direct costs and amortize them as expenses over the term of the lease.

A lessee would include all initial direct costs in its initial measurement of the ROU asset.

## Sale-and-Leaseback Transactions

The seller-lessee in a sale-and-leaseback transaction must evaluate the transfer of the underlying asset (sale) under the requirements in ASC 606 to determine whether the transfer qualifies as a sale (i.e., whether control has been transferred to the customer). The existence of a leaseback by itself would not indicate that control has not been transferred (i.e., it would not preclude the transaction from qualifying as a sale) unless the leaseback is classified as a finance lease. In addition, if the arrangement includes an option for the seller-lessee to repurchase the asset, the transaction would not qualify as a sale unless (1) the option is priced at the fair value of the asset on the date of exercise and (2) alternative assets exist that are substantially the same as the transferred asset and are readily available in the marketplace.

If the transaction does not qualify as a sale, the seller-lessee and buyer-lessor would account for the transaction as a financing arrangement (i.e., the buyer-lessor would account for its payment as a financial asset and the seller-lessee would record a financial liability).

**Editor's Note:** The ASU will significantly affect equipment sale-and-leaseback arrangements that include purchase options. Under current U.S. GAAP, a sale-and-leaseback transaction of equipment that includes a repurchase option may not result in a failed sale if there are no economic penalties reasonably ensuring that the repurchase option will be exercised. By contrast, under the ASU, any arrangement that includes a substantive repurchase option (e.g., a fixed-price purchase option) would be considered a failed sale because control of the underlying asset is not transferred to the purchaser.

## Leaseback Accounting

If the transaction qualifies as a sale, the leaseback is accounted for in the same manner as all other leases (i.e., the seller-lessee and buyer-lessor would account for the leaseback under the new lessee and lessor accounting guidance, respectively).

## Gain or Loss Recognition

If a transaction is based on "market" terms, the seller-lessee would immediately recognize the full amount of any gain or loss resulting from the sale (in a manner consistent with the treatment of sales of nonfinancial assets that do not involve a leaseback).<sup>18</sup> However, a transaction based on "off-market" terms would affect the calculation of the gain or loss. Specifically, the ASU requires a seller-lessee and a buyer-lessor to recognize off-market adjustments if there is a difference between (1) the sales price and fair value of the asset sold or (2) the present value of the contractual lease payments and the present value of the lease payments at fair market value. The seller-lessee would account for any difference either as an adjustment to the ROU asset or additional financing from the buyer-lessor that is separate from the lease liability. The buyer-lessor would recognize any difference as a prepayment of rent or additional financing to the seller-lessee that is separate from the lease receivable.

## Accounting for Related-Party Leases

Lessees and lessors are required to account for related-party leasing arrangements on the basis of the legally enforceable terms and conditions of the lease rather than the substance of the arrangement. This is a significant change from current U.S. GAAP, under which a lessee and lessor would consider the substance of the contract as well as its legal form. The ASU requires a related-party lease to be accounted for in a manner similar to a lease between unrelated parties. Lessors and lessees are also required to disclose the information required by ASC 850 for all related-party lease arrangements.

## Sublease Accounting

When the original lessee subleases the leased asset to an unrelated third party, the lessee becomes the intermediate lessor in the sublease arrangement. As the intermediate lessor of a leased asset, the entity would determine the classification of the sublease independently from its determination of the classification of the original lease (i.e., the head lease). Under the ASU, the intermediate lessor would classify the sublease on the basis of the underlying asset<sup>19</sup> (i.e., it would assess the term of the sublease

<sup>18</sup> By contrast, a seller-lessee applying IFRSs would only recognize gains resulting from the sale to the extent of the amount associated with the residual asset.

<sup>19</sup> The accounting for subleases under the new U.S. GAAP model differs significantly from that under IFRSs, which require the classification to be based on the remaining economic life of the ROU asset.

relative to the remaining economic life of the underlying asset). When evaluating lease classification and measuring the net investment in a sublease classified as a sales-type or direct financing lease, the original lessee (as a sublessor) should use the rate implicit in the lease if it is determinable. If the implicit rate is not determinable, the original lessee would use the discount rate that it used to determine the classification of the original lease.

In addition, offsetting is generally prohibited on the balance sheet and income statement unless the arrangement meets the offsetting requirements of ASC 210-20.

#### Example B3 — Accounting for a Sublease Under ASC 842

Company A, as lessee, entered into a building lease with a 30-year term. The building has a depreciable life of 40 years. At the end of year 5, A entered into an agreement with Company B under which B would sublease the building for 20 years.

As lessor, A would account for the lease to B (the sublease) as an operating lease because the term of the sublease is not for a major part of the remaining life of the *underlying asset* of the sublease (i.e., the sublease term of 20 years represents only 57 percent of the remaining 35-year life of the building), and A has concluded that no other classification criteria would result in the transfer of control of the underlying asset.

## Build-to-Suit Arrangements

The ASU does not carry forward the requirements in current U.S. GAAP on lessee involvement in asset construction or “build-to-suit” leases. That guidance has long been criticized for being difficult to apply and punitive in nature. However, the new standard stipulates that an asset controlled<sup>20</sup> by a lessee during the construction period would be subject to sale-and-leaseback accounting upon completion of construction (i.e., the asset is effectively owned by the lessee during the construction period and is effectively sold — to the legal owner — and leased back upon completion of construction). The ASU provides guidance on how to account for certain costs incurred by the lessee related to the construction or design of the underlying asset if the lessee does not control the asset under construction. Costs incurred for goods or services provided to the lessee as well as other construction-related outflows or inflows for items such as loans, guarantees, and sales of component parts would be accounted for in accordance with other ASC topics.

**Editor’s Note:** The ASU’s Basis for Conclusions notes that (1) a lessee can be, and thus should assess whether it is, the owner of an asset under construction before lease commencement and (2) the assessment should be based on control (i.e., when the lessee controls the asset under construction). This is a departure from the requirements under current U.S. GAAP, which focus on construction risk assumed by a lessee, and is another example of the Board’s effort to align the guidance on leases and revenue when appropriate. ASC 842-40 provides indicators of a lessee’s control of an underlying asset that is under construction. Two of those indicators closely mirror those used by suppliers under ASC 606 to determine whether customers gain control of their work as they perform (i.e., as construction progresses). Under ASC 606, when a supplier’s “performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced,” the supplier is satisfying its performance obligation over time. A lessee that controls an asset as it is created or enhanced by the supplier’s performance owns the asset throughout the work in process and should therefore apply the sale-and-leaseback accounting guidance in ASC 842-40 upon lease commencement. ASC 842-40 also provides indicators of legal ownership of the asset under construction as well as control, through lease or ownership, of the underlying land.

However, it is important to differentiate control of an asset during construction from control of *the right to use an asset* during construction. The latter reflects the lease of an asset under construction, an arrangement that is specifically excluded from the scope of ASC 842.

## Leasehold Improvements

In a manner consistent with current U.S. GAAP, a lessee would generally capitalize a leasehold improvement as a separate asset and amortize it over the shorter of its useful life and the remaining lease term. However, a lessee would amortize a leasehold improvement over its useful life (even if such life is longer than the lease term) if (1) the lease transfers ownership of the underlying

<sup>20</sup> ASC 842-40-55-5 provides indicators for lessees to consider when determining whether the lessee controls the underlying asset being constructed.

asset to the lessee at the end of the lease term or (2) it is reasonably certain that the lessee will exercise an option to purchase the underlying asset.

A leasehold improvement acquired in a business combination will be amortized over the shorter of its useful life or remaining lease term as of the acquisition date.

## Accounting for Leases at a Portfolio Level

Lessees and lessors are permitted to apply the new lease guidance at a portfolio level if the resulting accounting would not be significantly different from that achieved when they apply the guidance on an individual-lease basis. This would apply to transition accounting as well as on a go-forward basis and is expected to be particularly useful for companies with a significant number of leases with similar economic characteristics. Applying the lease guidance at a portfolio level may facilitate the accounting when judgments or estimates are required under the model (e.g., using a single discount rate for an entire portfolio of leases may be appropriate if the resulting accounting would not be materially different from that resulting from the application of a unique discount rate to each individual lease).

## Leveraged Lease Accounting

On the effective date of the new standard, leases previously classified as leveraged leases under ASC 840 would be subject to the guidance in ASC 842-50. This approach is generally consistent with the legacy accounting requirements for leveraged leases and effectively grandfathers that guidance. If a leveraged lease is modified after the ASU's effective date, it would be accounted for as a new lease under the standard's lessee and lessor models. Entities would not be permitted to account for any new lease arrangements as leveraged leases after the ASU's effective date.

## Business Combinations

The ASU requires the acquiring entity in a business combination to retain the acquiree's previous lease classification. However, if the business combination results in changes to the contractual terms and conditions of the lease (i.e., a modification) and the modification is not accounted for as a separate contract, the acquirer would classify the lease on the basis of the modified terms. The initial measurement would be as follows:

- *Acquiree is a lessee* — In a manner similar to the short-term lease scope exception, an acquiring entity may, as an accounting policy election by asset class, choose not to recognize assets or liabilities related to acquired leases that have a remaining lease term of 12 months or less as of the acquisition date. For all other leases, the acquiring entity must initially measure (1) the lease liability at the present value of the remaining lease payments (as if the acquired lease were a new lease of the acquiring entity as of the acquisition date) and (2) an ROU asset at the same amount, adjusted to reflect favorable or unfavorable terms of the lease relative to market terms.
- *Acquiree is a lessor* — The initial measurement is based on the classification of the acquired lease:
  - *Operating lease* — The acquiring entity will recognize (separately from the underlying leased asset) (1) an intangible asset if the terms of the acquired lease are favorable relative to market terms and (2) a liability if the terms are unfavorable relative to market terms.
  - *Sales-type or direct financing leases* — The acquiring entity will measure its net investment in the lease (total lease receivable and unguaranteed residual asset) at the fair value of the underlying asset as of the acquisition date. The terms of the lease (favorable or unfavorable) relative to market terms should be considered in the calculation of the underlying asset's acquisition-date fair value.

## Appendix C — Presentation Requirements

ASU 2016-02 contains presentation requirements for lessees and lessors that are based on the classification of the lease agreement.

### Lessee Presentation Requirements

#### *Statement of Financial Position*

An entity is required to present in the statement of financial position, or disclose in its notes to the financial statements, ROU assets and liabilities resulting from finance leases and operating leases. These assets and liabilities should be presented or disclosed separately from each other and from other assets and liabilities. Further, the lessee is required to separately present the current and noncurrent portions of the ROU asset and lease liability.

**Editor's Note:** The ASU's separate presentation requirement for finance and operating leases may be viewed favorably by preparers because it may reduce an entity's exposure to potential debt covenant violations that could have resulted if all lease liabilities were required to be characterized as debt. See [Appendix F](#) for more information.

#### *Statement of Comprehensive Income*

Lessees would present the expense related to their lease arrangements as follows:

- *Finance leases* — Interest expense on the lease liability and amortization of the ROU asset would be presented in a manner consistent with the lessee's presentation of interest expense related to its other liabilities and depreciation or amortization of similar assets, respectively. Variable lease payments would be included as an expense in the lessee's income from continuing operations.
- *Operating leases* — Lease expense is included in the lessee's income from continuing operations as a single lease expense amount.

**Editor's Note:** Entities will need to consider the effect of their lease classification on certain financial statement metrics and non-GAAP measures, such as earnings before interest, taxes, depreciation, and amortization (EBITDA). The interest and amortization expense resulting from a finance lease would typically be excluded from an entity's calculation of EBITDA. By contrast, the entity's EBITDA calculation would include its expense resulting from an operating lease (which is classified as an operating expense in the statement of comprehensive income). Entities should also consider the effects of these changes on other business arrangements such as, for example, employee compensation plans tied to earnings metrics.

#### *Statement of Cash Flows*

The presentation of cash flows generally depends on whether the lease is a finance lease or an operating lease:

- *Finance leases* — Payments of principal and interest are presented as cash outflows from financing and operating activities, respectively.
- *Operating leases* — Operating lease payments are presented as cash outflows from operating activities.

However, irrespective of lease classification, both variable lease payments that are not included in the lease liability and payments on short-term leases are presented as cash outflows from operating activities. Further, any cash flows resulting from lease payments used to bring another asset to its intended location for its intended use would be classified in investing activities.

## Lessor Presentation Requirements

### *Statement of Financial Position*

A lessor's presentation of a lease agreement depends on whether the lease is a sales-type lease, direct financing lease, or an operating lease:

- *Sales-type and direct financing leases* — The net investment in a lease is separately presented in the statement of financial position.
- *Operating leases* — The underlying asset subject to an operating lease is presented in accordance with other ASC topics (e.g., ASC 360).

### *Statement of Comprehensive Income*

All income resulting from a lease is separately presented in the statement of comprehensive income or disclosed in the notes. An entity that does not separately present lease income in the statement must disclose where in the statement it is included. In addition, any profit or loss resulting from a lease should be recognized at lease commencement in a manner consistent with the lessor's business model (e.g., gross revenue and cost of goods as opposed to profit and loss in a single line item).

**Editor's Note:** Because the ASU allows a lessor to present profit or loss resulting from a lease in a manner consistent with its business model, the lessor may present such amounts on a gross or net basis. This presentation flexibility is designed to reflect institutions' various business models. For example, a manufacturing entity may enter into a leasing arrangement as opposed to selling directly to customers, whereas a financial institution may enter into a leasing arrangement as a means of providing financing. The standard also acknowledges that a lessor with multiple business models could present profit or loss resulting from leases on a gross or net basis depending on the particular model the lease is related to.

### *Statement of Cash Flows*

Regardless of lease classification, cash inflows related to a lease are presented as cash inflows from operating activities.

## Appendix D — Disclosure Requirements

The objective of ASU 2016-02's disclosure requirements is to help financial statement users understand the amounts, timing, and uncertainties of cash flows related to a lease. An entity is required to disclose certain qualitative and quantitative information about its leases, judgments used in applying the leasing guidance, and the related amounts recognized in the financial statements.

### Lessee Disclosures

#### *Qualitative Disclosures*

A lessee should disclose:

- Information about the nature of its leases and subleases (general description of the lease, variable lease payments, renewal or termination options, residual value guarantees, and restrictions imposed by the lease).
- Leases that have not yet commenced but give the lessee significant rights or impose significant obligations, including the nature of any involvement in the design or construction of the underlying asset.
- Significant assumptions and judgments used in applying the leases standard.
- Main terms and conditions of any sale-and-leaseback transactions.
- Lease transactions with related parties.
- Accounting policy regarding short-term leases.
- Accounting policy election of the practical expedient not to separate lease and nonlease components.

#### *Quantitative Disclosures*

A lessee should disclose the following amounts for each period presented (regardless of whether the amounts are capitalized as part of another asset):

- Finance lease costs (i.e., amortization of the ROU asset and interest on the lease liability).
- Operating lease costs.
- Short-term lease costs (except for leases with a term of one month or less).
- Variable lease costs.
- Sublease income, disclosed on a gross basis.
- Gain or loss resulting from sale-and-leaseback transactions.

A lessee should disclose the following amounts separately for its operating and finance leases:

- Separate maturity analyses of its operating lease liabilities and finance lease liabilities (undiscounted cash flows for each of the next five years and a total of the amounts for the remaining years, reconciled to the amounts presented in the statement of financial position).
- Cash paid for amounts included in its determination of lease liabilities (segregated between operating and financing cash flows).
- Supplemental noncash information on lease liabilities arising from obtaining ROU assets.
- Weighted-average remaining lease term.
- Weighted-average discount rate.

For a complete list of the disclosure requirements for lessees, see ASC 842-20-50 and ASC 842-40-50 in the ASU.



## Lessor Disclosures

### *Qualitative and Quantitative Disclosures*

A lessor is required to disclose certain qualitative and quantitative information, including:

- Information about the nature of its leases (general description of the lease, variable lease payments, renewal, purchase or termination options).
- Significant assumptions and judgments used in the application of leases guidance.
- Lease transactions with related parties.
- A tabular disclosure of lease-related income, including:
  - Profit and loss recognized at lease commencement for sales-type and direct financing leases.
  - Interest income.
  - Income from variable lease payments not included in the lease receivable.
- The components of the net investment in sales-type and direct financing leases, including the carrying amount of the lease receivable, the unguaranteed residual asset, and any deferred profit on direct financing leases.
- Information about how the entity manages its exposure to risk associated with the residual value of its leased assets.
- A maturity analysis for operating lease payments and a separate maturity analysis for the lease receivable (sales-type and direct financing leases). The maturity analysis should show the undiscounted cash flows to be received in each of the next five years after the reporting date, and a total of the amounts for the years thereafter. The maturity analysis of the lease receivable should be reconciled to the lease receivable balance.
- The information required by ASC 360 for all assets that are subject to an operating lease, presented separately from similar owned assets.

For a complete list of the disclosure requirements for lessors, see ASC 842-30-50 and ASC 842-50-50 (on leveraged leases) in the ASU.

## Appendix E — Transition

### Transition Requirements

Lessees and lessors<sup>21</sup> are required to use a modified retrospective transition method for existing leases. Accordingly, they would apply the new accounting model for the earliest year presented in the financial statements. The application of this approach is directly linked to the current lease classification under ASC 840 and the new lease classification under ASC 842.

### Lessee Requirements

The following table summarizes ASU 2016-02's modified retrospective transition requirements for lessees:

	Current U.S. GAAP (ASC 840)	
	Operating Lease	Capital Lease
New Model (ASC 842)	<p>Operating lease</p> <ul style="list-style-type: none"> <li>Recognize an ROU asset and lease liability at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date.</li> <li>Measure a lease liability as the present value of the remaining lease payments and expected residual value guarantee discounted by using a rate determined at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date.</li> <li>Measure an ROU asset equal to the lease liability, adjusted for prepaid/accrued rent, unamortized initial direct costs, impairment of the ROU asset, and the carrying amount of any liability recognized under ASC 420 (i.e., related to exit or disposal cost obligations).</li> <li>Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.</li> </ul>	<ul style="list-style-type: none"> <li>Derecognize the capital lease asset and lease obligation at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. Any difference between the amounts derecognized would be accounted for similarly to prepaid or accrued rent.</li> <li>Recognize an ROU asset and lease liability by using (1) the ASU's initial measurement guidance for leases entered into after the beginning of the earliest period presented or (2) the ASU's subsequent measurement guidance that applies to leases entered into before the beginning of the earliest year presented.</li> <li>Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.</li> </ul>
	<p>Finance lease</p> <ul style="list-style-type: none"> <li>Recognize an ROU asset and lease liability at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date.</li> <li>Measure a lease liability as the present value of the remaining lease payments and expected residual value guarantee discounted by using a rate determined at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date.</li> <li>Measure an ROU asset equal to a proportion of the lease liability as of the commencement date, adjusted for the carrying amount of previously recognized prepaid or accrued lease payments and the carrying amount of liabilities recognized under ASC 420. The proportionate amount is based on the remaining lease term (as of the beginning of the earliest period presented) relative to the total lease term.</li> <li>Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.</li> </ul>	<ul style="list-style-type: none"> <li>Recharacterize the capital lease asset as an ROU asset as of the later of (1) the beginning of the earliest year presented or (2) the lease commencement date.</li> <li>Include in the ROU asset established at transition any unamortized initial direct costs that meet the ASU's definition of initial direct costs.</li> <li>Write off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of such costs in ASC 842 and are not included in the measurement of the capital lease asset under ASC 840.</li> </ul>

Note that there are additional considerations under ASC 842-10-65-1 for modifications of a lease that occur on or after the standard's effective date and do not result in a separate contract.

<sup>21</sup> Lessors must account for leveraged leases under the requirements in ASC 842-50, which are similar to the current requirements in ASC 840 for leveraged leases. However, if the leveraged lease is modified, it would be accounted for as a new lease.

## Example E1 — Lessee Transition

A lease with the following terms was accounted for as an operating lease under current U.S. GAAP:

Lease term:	10 years (January 1, 2013, through December 31, 2022).
Adoption date:	January 1, 2019 (beginning of year 7 (4 years remaining)).
Lease payments:	\$100 in years 1 through 5; \$120 in years 6 through 10 (payments occur at the end of the year).
Discount rate:	4 percent (January 1, 2017).

The table below illustrates the adjustments made to the financial statements as a result of the adoption of the ASU if (1) the lease continues to be classified as an operating lease and (2) the lease is classified as a finance lease.

	Operating Lease				Finance Lease			
	Lease Liability	ROU Asset	Reversal of Straight-Line Accrual	Retained Earnings/Net Income	Lease Liability	ROU Asset	Reversal of Straight-Line Accrual	Retained Earnings/Net Income
Adjustment on 1/1/2017 (earliest period presented)	\$ 610 <sup>(a)</sup>	\$ 570 <sup>(b)</sup>	\$ 40 <sup>(c)</sup>	\$ 0	\$ 610 <sup>(a)</sup>	\$ 490 <sup>(c)</sup>	\$ 40 <sup>(c)</sup>	\$ 80
12/31/2017	534 <sup>(d)</sup>	484 <sup>(e)</sup>		110	534 <sup>(d)</sup>	408 <sup>(f)</sup>		106
12/31/2018	436 <sup>(d)</sup>	396 <sup>(e)</sup>		110	436 <sup>(d)</sup>	326 <sup>(f)</sup>		103

- <sup>(a)</sup> The lease liability is calculated as the present value of the remaining lease payments (\$120 for 5 years and one year at \$100 discounted at 4 percent).
- <sup>(b)</sup> The ROU asset under the operating lease model is calculated at the initial amount of the lease liability adjusted for the previously recorded straight-line accrual of \$40 (i.e., \$570 = \$610 – \$40).
- <sup>(c)</sup> The ROU asset under the financing approach is calculated in proportion (6 of 10 years remaining) to the lease liability as of the commencement date (present value of all lease payments or \$884), reduced by the straight-line accrual of \$40 (i.e., \$490 = [(\$884 × 6 ÷ 10) – \$40]).
- <sup>(d)</sup> The lease liability is subsequently calculated by using the effective interest method.
- <sup>(e)</sup> The ROU asset is subsequently measured at an amount equal to the lease liability, adjusted for the accrued lease expense of \$50 on 12/31/2017 and \$40 at 12/31/2018. This results in a straight-line expense of \$110 per year.
- <sup>(f)</sup> The ROU asset is subsequently amortized on a straight-line basis (\$490 over 6 years or \$82 per year).
- <sup>(g)</sup> This amount represents the straight-line lease accrual that results from recording a straight-line annual lease expense of \$110 per year for the four years from 2013 to 2016 compared to lease payments totaling \$400 during that period.

## Lessor Requirements

The following table summarizes the ASU's modified retrospective transition requirements for lessors:

		Current U.S. GAAP (ASC 840)	
		Operating Lease	Direct Financing or Sales-Type Lease
New Model (ASC 842)	Operating lease	<ul style="list-style-type: none"> <li>Continue to recognize the carrying amount of the underlying asset and any lease assets or liabilities at the later of (1) the initial application date or (2) the lease commencement date.</li> <li>Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.</li> </ul>	<p>As of the later of (1) the beginning of the earliest period presented or (2) the lease commencement date:</p> <ul style="list-style-type: none"> <li>Recognize an underlying asset at the carrying amount that would have existed had the lease been classified as an operating lease under ASC 840.</li> <li>Derecognize the carrying amount of the net investment in the lease.</li> <li>Recognize as an adjustment to equity the difference between the newly recognized asset and the derecognized net investment.</li> </ul>
	Direct financing or sales-type lease	<p>As of the later of (1) the beginning of the earliest period presented or (2) the lease commencement date:</p> <ul style="list-style-type: none"> <li>Derecognize the carrying amount of the underlying asset.</li> <li>Recognize a net investment in the lease as if the lease had been accounted for as a direct financing lease or sales-type lease since lease commencement.</li> <li>Recognize as an adjustment to equity the difference between the newly recognized net investment and the derecognized asset.</li> </ul>	<ul style="list-style-type: none"> <li>Continue to recognize a net investment in the lease, at the later of (1) the beginning of the earliest period presented or (2) the lease commencement date, at the carrying amount at that date.</li> <li>Before the effective date of the new guidance, the lease should be accounted for under ASC 840.</li> <li>Beginning on the effective date, the lease should be accounted for under the ASU.</li> </ul>

Note that there are additional considerations under ASC 842-10-65-1 for modifications of a lease that occur on or after the standard's effective date and do not result in a separate contract.

## Transition Relief

The ASU offers relief from implementing the standard's transition provisions by permitting an entity (lessee or lessor) to elect not to reassess:

- Whether any expired or existing contract is a lease or contains a lease.
- The lease classification of any expired or existing leases.
- Initial direct costs for any existing leases.

An entity that elects transition relief is required to adopt all three relief provisions and is prohibited from applying the relief on a lease-by-lease basis. In addition, the entity must disclose that it has elected the transition relief package. Separately, the entity is also allowed to use hindsight in its evaluation of the lease term (e.g., renewal, termination, and purchase options for existing leases).

**Editor's Note:** Electing the transition relief may significantly reduce the burden of adopting the new standard since entities would not be required to revisit old lease contracts and related documentation to reevaluate whether such arrangements meet the new definition of a lease or how to classify them under the ASU. Such an election does not, however, relieve an entity from its obligation to address any errors that may have resulted from the misapplication of past accounting (e.g., improperly accounting for an arrangement as a service rather than a lease or inappropriately classifying a lease as an operating lease rather than a capital lease).

## Sale-and-Leaseback Transactions

An entity is required to reassess its conclusion that a sale that was part of a failed sale-and-leaseback transaction continues to be disqualified from the application of sale accounting under ASC 606 upon transition as long as the transaction is still considered to be a failed sale as of the effective date of the new lease accounting guidance. In addition:

- The seller in a sale-and-capital-leaseback transaction is required to recognize any deferred gain or loss that exists as of the later of (1) the earliest period presented or (2) the date of the sale of the underlying asset as follows:
  - If the underlying asset is land only, on a straight-line basis over the remaining lease term.
  - If the underlying asset is not land only and the leaseback is a finance lease, in proportion to the amortization of the ROU asset.
  - If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the total lease cost.
- The seller in a sale-and-operating-leaseback transaction is required to recognize any deferred gain or loss resulting from off-market terms as an adjustment to the leaseback ROU asset (loss) or lease liability (gain) as of the date of initial application. The seller is required to recognize any deferred gain or loss not resulting from off-market terms as a cumulative-effect adjustment to opening equity (if the transaction occurred before the earliest year presented) or earnings in the comparative period (if the transaction occurred within one of the comparative periods presented).

## Build-to-Suit Lease Arrangements

The ASU supersedes current guidance on build-to-suit arrangements. A lessee must apply the modified retrospective transition approach to such arrangements. Accordingly, it should derecognize assets and liabilities from build-to-suit transactions under ASC 840 (those assets and liabilities that arose because the lessee was deemed the owner during construction and could not be derecognized under the legacy sale-and-leaseback requirements) as of the later of (1) the earliest financial statement period presented or (2) the date on which the entity was deemed the accounting owner. Any differences between the assets and liabilities derecognized would be recorded as an adjustment to equity on that date. Further, if the construction period ended before the earliest comparative period presented, and the transaction subsequently qualified for and was accounted for as a sale-and-leaseback transaction, the entity should consider the general lessee transition requirements.

## Business Combinations

On the effective date of the new guidance, any assets and liabilities related to favorable or unfavorable terms of an operating lease that resulted from prior business combinations would be derecognized upon transition (except for those arising from operating leases under which the entity is a lessor). A lessee would adjust the carrying amount of the ROU asset by a corresponding amount. By contrast, a lessor would make a corresponding adjustment to equity at the beginning of the earliest comparative period presented for its leases that are classified as sales-type or direct financing under ASC 840.

## Appendix F — Implementation Considerations

### Application of Judgment and Estimation

Entities must apply judgment and make estimates under a number of the new (as well as current) leases requirements. Judgment is often required in the assessment of a lease's term, which would affect whether the lease qualifies for the short-term exemption and therefore for off-balance-sheet treatment. In addition, since almost all leases will be recognized on the balance sheet, an entity's judgment in distinguishing between leases and services becomes more critical under the new guidance.

**Editor's Note:** In particular, upon transition, entities will need to recognize ROU assets and lease obligations by using an appropriate discount rate on the date of transition (see [Appendix E](#) for additional considerations). Compliance with this requirement may be difficult for entities with a significant number of leases since they will need to identify the appropriate incremental borrowing rate for each lease on the basis of factors associated with the underlying lease terms (e.g., lease tenor, asset type, residual value guarantees). In other words, entities would not be permitted to use the same discount rate for all of their leases unless the leased assets and related terms are similar in nature.

### Data Management

Entities may have numerous lease agreements at multiple decentralized locations and may, in many instances, maintain their lease data in spreadsheets or physical documents. Consequently, collecting and abstracting the data may be time-consuming and resource-intensive. Further, even if entities already have such information in an electronic format, it may reside in disparate systems or need to be enhanced to ensure that it complies with ASU 2016-02's accounting and disclosure requirements.

In addition, entities may need to gather information required by the ASU that may not be contained in lease agreements. For example, entities may need to acquire information about (1) the fair value of an asset, (2) the asset's estimated useful life, (3) the incremental borrowing rate, and (4) certain judgments related to lease options. Acquiring this data may be particularly challenging for multinational entities whose lease documentation may be prepared in a foreign language and could also vary as a result of local business practices.

As entities identify and collect the data they need for compliance with the ASU's requirements, they should also consider the challenges of ongoing data maintenance. Data gathering and abstraction efforts may take many months to complete, during which time new leases will be executed, renewed, modified, or terminated. Accordingly, management will need to establish an approach to data maintenance and controls during the implementation period and beyond.

Given the relationship between lease maturity disclosures under current guidance and lease liabilities that will be recognized upon adoption of the ASU (and will be subject to modified retrospective transition, which will affect 2017 financial reporting), we believe that in preparing their December 31, 2016, financial statements, entities should strive to ensure that they have identified a complete population of leases.

### Information Technology Systems

As a result of implementing the ASU's requirements, entities will most likely need to enhance their existing information technology systems. The extent of such enhancements will be based on the size and complexity of an entity's lease portfolio and its existing leasing systems. As with any change to existing systems, an entity will need to consider the business ramifications (i.e., the potential impact on existing processes, systems, and controls) and the requirements of system users (e.g., the entity's legal, tax, financial planning and analysis, real estate, treasury, and financial reporting functions).

Also, management may need to consider system changes that will enable the entity to estimate, before adoption, the ASU's effect on key performance indicators and metrics, tax filings, debt covenants, or other filings. In addition, to the extent that an entity prepares IFRS statutory reports for foreign subsidiaries, its systems will need to distinguish between the ASU and IFRS 16 and be equipped to handle the differences between the two standards.

## Internal Controls and Business Process Environment

To a significant extent, current lease data systems are used for operational purposes and thus some aspects of the related internal controls may be outside of the scope of the internal control requirements of the Sarbanes-Oxley Act of 2002. Given the increased relevance of leasing data to the financial statements as a result of the ASU, entities may face additional scrutiny from auditors and regulators regarding the design and effectiveness of associated controls. Accordingly, entities will need to examine their internal controls related to their processes for capturing, calculating, and accounting for their leases. If additional internal controls or processes are needed, entities may also need to issue organizational communications and establish change management and employee training programs.

In addition, during their implementation of the standard, entities may identify opportunities for potential enhancements to their current processes to achieve future operational efficiencies. For example, entities may seek to automate manually intensive processes or consider organizational changes such as a shared services model.

## Debt Covenants

Given the requirement to bring most leases on the balance sheet, many entities will reflect additional liabilities in their balance sheets after adopting the ASU. Such entities should determine whether the increased leverage will negatively affect any key metrics or potentially cause debt covenant violations. This may depend in part on how various debt agreements define and limit indebtedness as well as on whether the debt agreements use “frozen GAAP” covenants. The ASU requires entities to present operating lease liabilities outside of traditional debt, which may provide relief to some entities. Nevertheless, we believe that it will be critical for all entities to determine the ASU’s potential effects on debt covenants and begin discussions with lenders early if they believe that violations are likely to occur as a result of adopting the ASU.

## Income Taxes

A lease’s classification for accounting purposes does not affect its classification for tax purposes. An entity will therefore continue to be required to determine the tax classification of a lease under the applicable tax laws. While the classification may be similar for either purpose, the differences in tax and accounting principles and guidance often result in book/tax differences. Thus, once an entity implements the new standard, it will need to establish a process to account for these differences.

The ASU’s requirement for entities to reevaluate their leases under the new guidance presents an opportunity for them also to reassess the tax treatment of such leases as well as their data collection and processes. Since the IRS considers a taxpayer’s tax treatment of leases to be a method of accounting, any changes to existing methods may require IRS consent.

Entities should also consider the potential state tax issues that may arise as a result of the new guidance, including how the classification of the ROU asset may affect the apportionment formula in the determination of state taxable income and how the significant increase in recorded lease assets could affect the determination of franchise tax payable.

**Editor’s Note:** Since the potential tax implications are many and varied, it is essential for a company’s tax department to be involved in the evaluation of the lease standard as well as in discussions related to policy adoption and system modifications.

## Getting Started

Entities should develop a robust plan and establish a cross-functional implementation team to ensure an efficient and timely approach to implementation. In developing such a plan, they should consider doing the following:

- Performing a current-state assessment of their lease portfolio, including lease volume and types, availability of electronic lease data and data gaps, and any potential challenges related to accounting, taxes, or processes.
- Establishing a project plan for managing the implementation effort for multiple functions, business units, and countries, as necessary.

- Developing an approach to, and resources to perform, the abstraction of lease data.
- Determining their specific system requirements and developing a plan for enhancing system capabilities to satisfy the new storage, calculation, and reporting requirements while keeping in mind the associated internal control implications.
- Assessing the effect of the ASU on their key metrics and debt covenants.

By planning properly, entities can help ensure that their transition to the new leases standard is smooth and successful.



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