Concurrent Session: Deep Dive # 1: Implementing the Leases Standard

Thursday, March 23rd
9:45am – 11am
La Quinta Resort & Club, La Quinta, California

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Financial reporting developments

A comprehensive guide

Lease accounting

Accounting Standards Codification 842, *Leases*

January 2017

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Overview

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, *Leases*, in February 2016 after joint deliberations with the International Accounting Standards Board (IASB), which issued a similar standard (IFRS 16 *Leases*). However, there are significant differences between the FASB and IASB standards (e.g., lessees do not classify leases under IFRS and can elect to account for leases of low-value assets under a model similar to today's operating leases). These differences will result in certain transactions being accounted for differently under US GAAP and IFRS.

The current lease accounting guidance in Accounting Standards Codification (ASC) 840, *Leases*, has been criticized for failing to meet the needs of users of the financial statements, particularly because it doesn't require lessees to recognize assets and liabilities arising from operating leases. The new guidance that is codified in ASC 842, *Leases*, addresses those criticisms by requiring lessees to recognize most leases on their balance sheets and providing enhanced disclosures. The FASB believes this will result in a more faithful representation of lessees' assets and liabilities and greater transparency about the lessees' obligations and leasing activities.

Under ASC 842, leases are accounted for based on what the FASB refers to as a "right-of-use model." The model reflects that, at the commencement date, a lessee has a financial obligation to make lease payments to the lessor for its right to use the underlying asset during the lease term. The lessor conveys that right to use the underlying asset at lease commencement, which is the point in time when it makes the underlying asset available for use by the lessee.

Entities will need to focus on whether an arrangement contains a lease or a service agreement because there are significant differences in the accounting. Although ASC 842 changes how the definition of a lease is applied, we believe that the assessment of whether a contract contains a lease will be straightforward in most arrangements. However, judgment may be required in applying the definition of a lease to certain arrangements, particularly those that include significant services.

ASC 842 requires lessees to classify most leases as either finance or operating leases. Lessors classify all leases as sales-type, direct financing or operating leases. While ASC 842 and ASC 840 use the same or similar terms for lease types for lessees and lessors, lease classification under the two standards could differ because the classification tests are not identical. ASC 842 eliminates ASC 840's bright lines (e.g., the "75% of economic life" and "90% of fair value" tests) and modifies the lessor classification criteria. The guidance also eliminates ASC 840's real estate-specific provisions for lessees and lessors. Lease classification is important in determining how and when a lessee and a lessor recognize lease expense and revenue, respectively, and what assets a lessor records.

For lessees, the income statement presentation and expense recognition pattern for finance leases is similar to that of today's capital leases (i.e., separate interest and amortization expense with higher periodic expense in the earlier periods of a lease). For operating leases, the income statement presentation and expense recognition pattern is similar to that of ASC 840's operating leases (i.e., a single lease cost is generally recognized on a straight-line basis).

ASC 842 does not make fundamental changes to today's lessor accounting model. However, the guidance modifies what qualifies as a sales-type and direct financing lease as well as the related accounting.

ASU 2016-02 is effective for public business entities (PBEs)[1] and certain not-for-profit entities and employee benefit plans[2] for annual periods beginning after 15 December 2018 (i.e., 1 January 2019 for a calendar-year entity), and interim periods within those years. For all other entities, it is effective for annual periods beginning after 15 December 2019 (i.e., 1 January 2020 for a calendar-year entity), and interim periods the following year. Early adoption is permitted for all entities.

ASU 2016-02's transition provisions are applied using a modified retrospective approach at the beginning of the earliest comparative period presented in the financial statements. For example, a calendar-year entity that adopts ASU 2016-02 as of 1 January 2019 and presents three years of financial statements applies the transition provisions to the period beginning 1 January 2017. Full retrospective application is prohibited.

This publication discusses how ASU 2016-02 is applied and is intended to help companies consider the effects of adopting it. We encourage preparers and users of financial statements to read this publication carefully and consider the potential effects of the new standard.

The views we express in this publication represent our perspectives as of January 2017. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process.

Ernst & Young LLP

January 2017

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[1] See the ASC Master Glossary for the definition of a public business entity.

[2] Not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and employee benefit plans that file or furnish financial statements with or to the SEC.

Contents

1 Scope and scope exceptions

A lease is a contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment. Under a lease the party obtaining the right to use the leased property is referred to as a lessee and the party conveying the right to use the property is referred to as a lessor. Accounting guidance discussed in this publication for lease arrangements for both lessees and lessors under US GAAP is primarily contained in ASC 842 and is applicable to all entities.

1.1 Scope and scope exceptions

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-1

An entity shall apply this Topic to all **leases**, including **subleases**. Because 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, this Topic does not apply to any of the following:

a. Leases of intangible assets (see Topic 350, Intangibles — Goodwill and Other).

b. Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources (see Topics 930, Extractive Activities — Mining, and 932, Extractive Activities — Oil and Gas). This includes the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained (that is, unless those rights of use include more than the right to explore for natural resources), but not equipment used to explore for the natural resources.

c. Leases of biological assets, including timber (see Topic 905, Agriculture).

d. Leases of **inventory** (see Topic 330, Inventory).

e. Leases of assets under construction (see Topic 360, Property, Plant, and Equipment).

Master Glossary

Inventory

The aggregate of those items of tangible personal property that have any of the following characteristics:

a. Held for sale in the ordinary course of business

b. In process of production for such sale

c. To be currently consumed in the production of goods or services to be available for sale.

The term inventory embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for production may be used or consumed for the construction of long-term assets

> or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of certain types of entities such as oil producers are usually treated as inventory.

The scope of ASC 842 is limited to leases of property, plant and equipment (i.e., land and depreciable assets), including subleases of those assets. ASC 842 does not apply to any of the following:

- Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources, including the intangible rights to explore for those natural resources and rights to use the land in which those natural resources are contained (unless those rights of use include more than the right to explore for natural resources), but not equipment used to explore for the natural resources
- Leases of biological assets, including timber
- Leases of inventory (i.e., assets held for sale in the ordinary course of business, assets in the process of production for sale, assets to be currently consumed in the production of goods or services to be available for sale)
- Leases of assets under construction (refer to section 7.7, *Lessee involvement in asset construction ('build-to-suit' transactions)*)

1.1.1 Service concession arrangements

A service concession arrangement between a grantor and an operating entity lays out the terms (including the time period) under which the operating entity will operate the grantor's infrastructure (e.g., an airport, road, bridge, tunnel). Arrangements within the scope of ASC 853, *Service Concession Arrangements*, are excluded from the scope of ASC 842. Entities should evaluate whether ASC 853 applies to an arrangement before evaluating whether an arrangement contains a lease. Refer to section 1.8, *Service concession arrangements,* for further information.

1.1.2 Applicability to state and local governmental units

The accounting for leases by governmental units is governed by National Council on Governmental Accounting (NCGA) Statement 5 and Governmental Accounting Standards Board (GASB) Statement No. 13. NCGA Statement 5 requires governmental units to follow the provisions of FASB Statement No. 13, which was primarily codified in ASC 840. Users of this guide should see the appropriate governmental literature for further details. The GASB has undertaken a project with the objective of improving the accounting and financial reporting for leases for state and local governmental units from both a lessee and lessor perspective. The GASB issued an exposure draft of its proposed leases standard in January 2016 and, as of the date of this publication, continues redeliberation of the exposure draft based on comment letters received on the proposal. State and local governmental units should monitor the GASB's discussions on this project.

1.1.3 Land rights

The right to use land, for a period of time, may meet the definition of a lease and may therefore be in the scope of ASC 842. The FASB said in the Background Information and Basis for Conclusions of ASU 2016-02 (BC 113) that it decided not to exclude long-term leases of land from the scope of ASC 842 because there is no conceptual basis for differentiating between long-term leases of land and other leases, and any definition of a long-term lease of land would be arbitrary. Therefore, we believe that long-term rights to use land will often be evaluated under ASC 842 to determine whether the arrangement contains a lease.

Easements

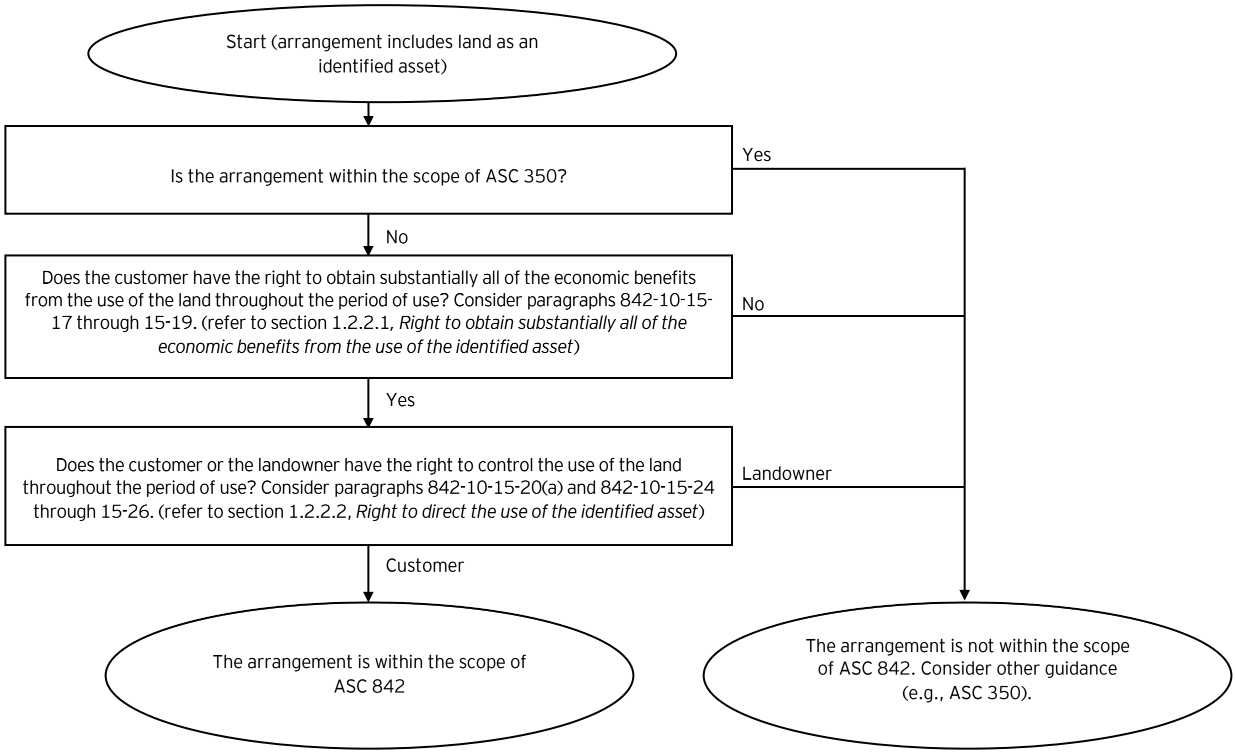
However, certain companies that own land easements (perpetual and time-based land easements) may currently (i.e., prior to the adoption of ASC 842) follow ASC 350-30-55 (Example 10) and account for these arrangements as intangible assets. Given that intangible assets are excluded from the scope of ASC 842, easements accounted for as intangible assets under ASC 350 are not in the scope of Topic 842 (refer to section 1.1, *Scope and scope exceptions*).

When an arrangement is not accounted for as an intangible asset within the scope of ASC 350, entities will consider whether an arrangement grants the customer the right to control the use of the land or whether the landowner retains the rights to control its use. For example, an arrangement may grant a customer the right to construct, purchase or lease an office building located on the landowner's property without the customer obtaining ownership of the underlying land. In such cases, the customer may have substantially all the benefit of the underlying land that the building occupies (or will occupy), throughout the term of the arrangement and thus would likely be a lease. In contrast, an arrangement that grants a customer only a right-of-way in order to access an adjacent property (e.g., to move equipment across the landowners property) may not convey the right to control the use of the land to the customer.

In making the assessment of whether long-term rights to use land are within the scope of ASC 842 or ASC 350, an entity should consider its past accounting practice and the terms and conditions of its arrangement to determine whether its arrangements are legally land easements (e.g., Merriam-Webster's dictionary defines an easement as: "an interest in land owned by another that entitles its holder to a specific limited use or enjoyment (as the right to cross the land or have a view continue unobstructed over it)").

For example, certain pipeline operators have historically accounted for a perpetual or time-based easement as an intangible asset rather than a lease within the scope of ASC 840. Such entities view the arrangement as a land easement providing the right to solely access the landowner's property for purposes of transporting natural resources. In such arrangements, the landowner typically grants the pipeline operator certain access rights for its pipeline, but continues to enjoy the benefits of the land for its own purposes as well (e.g., farming). We understand through informal conversations with the FASB staff that such entities may continue to apply ASC 350 to those arrangements and thus would be out of the scope of ASC 842.

The following flowchart illustrates a framework for evaluating the scope of long-term rights to use land:



1.1.4 Sales with repurchase options

Some arrangements include repurchase provisions, either as a component of a sales contract or as a separate contract that relates to the goods in the original agreement or similar goods. These provisions affect how an entity applies ASC 606's guidance on control to affected transactions. If the nature of a repurchase provision results in control of a good not transferring to the customer (e.g., a forward call option that could require the seller to repurchase an asset), the arrangement may be a lease within the scope of ASC 842. Refer to section 7.3, *Repurchase agreements,* of our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606)*, for further discussion of repurchase options that may result in an arrangement being accounted for as a lease rather than a sale to a customer.

1.2 Determining whether an arrangement contains a lease

Excerpt from Accounting Standards Codification

Master Glossary

Lease

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.

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

Period of Use

The total period of time that an asset is used to fulfill a **contract** with a customer (including the sum of any nonconsecutive periods of time).

Leases — Overall

Scope and Scope Exceptions

842-10-15-2

At inception of a **contract**, an entity shall determine whether that contract is or contains a **lease**.

842-10-15-3

A contract is or contains a lease if the contract 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. A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

842-10-15-4

To determine whether a contract conveys the right to control the use of an identified asset (see paragraphs 842-10-15-17 through 15-26) for a period of time, an entity shall assess whether, throughout the **period of use**, the customer has both of the following:

a. The right to obtain substantially all of the economic benefits from use of the identified asset (see paragraphs 842-10-15-17 through 15-19)

b. The right to direct the use of the identified asset (see paragraphs 842-10-15-20 through 15-26).

If the customer in the contract is a joint operation or a joint arrangement, an entity shall consider whether the joint operation or joint arrangement has the right to control the use of an identified asset throughout the period of use.

842-10-15-5

If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

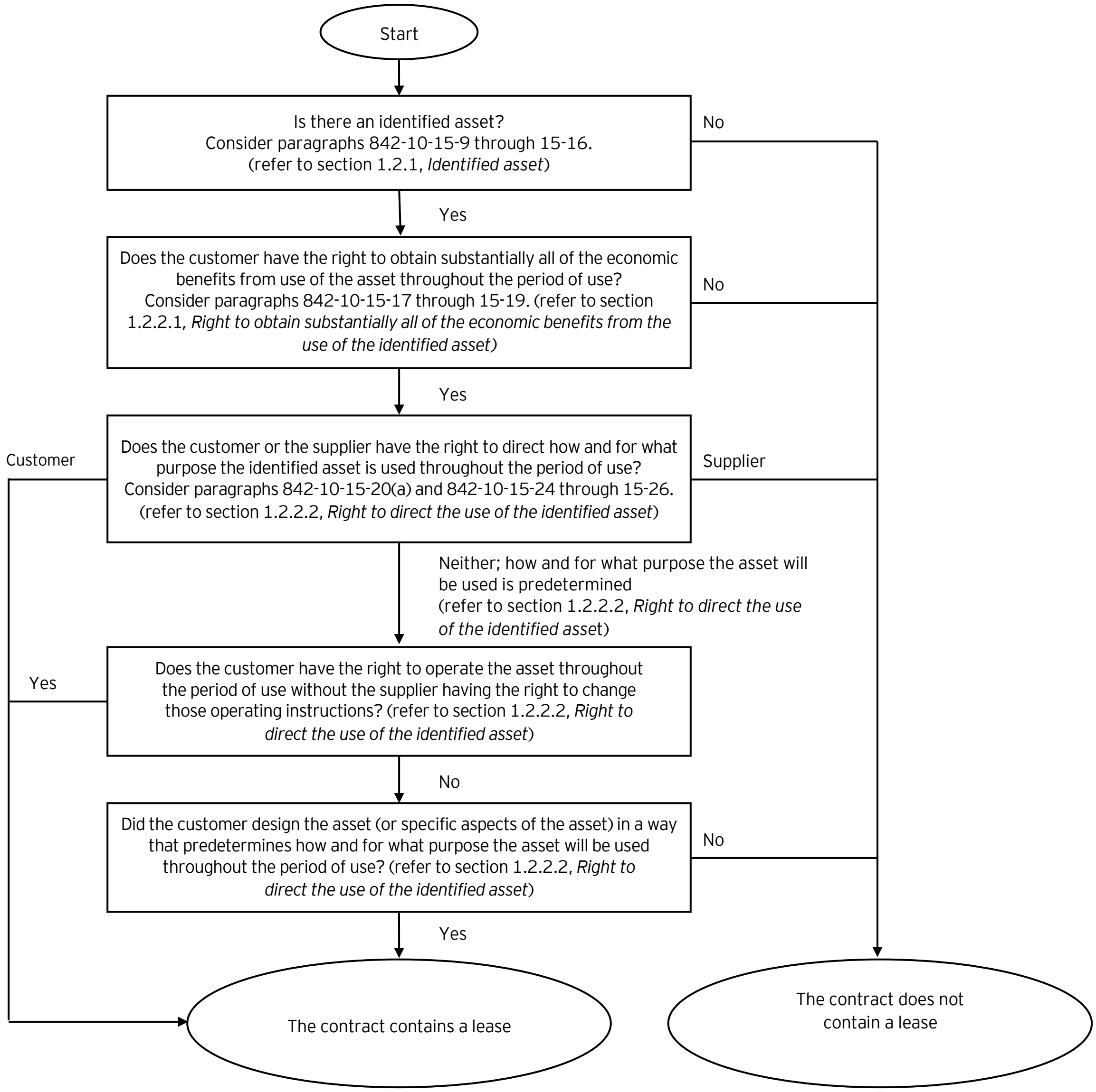
842-10-15-7

In making the determination about whether a contract is or contains a lease, an entity shall consider all relevant facts and circumstances.

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to control the use of identified property, plant or equipment (i.e., an identified asset) for a period of time in exchange for consideration.

ASC 842 requires an entity to determine whether a contract is a lease or contains a lease at the inception of the contract, considering all relevant facts and circumstances. For example, the fact that a contract is labeled a "transportation contract" or a "lease" does not necessarily mean the arrangement is or is not a lease. Therefore, the parties to the contract must carefully analyze the terms to determine whether the arrangement conveys the right to control the use of an asset. Executory contracts for services that involve the use of equipment but do not convey the right to use the equipment to the customer are not leases and should be accounted for as service agreements.

The following flowchart is included in ASC 842's implementation guidance and depicts the decision-making process for determining whether an arrangement is or contains a lease.



ASC 842's lease model is described in the following sections, using excerpts from ASC 842. Also, refer to Appendix C, *Illustrations from ASC 842 on the application of the definition of a lease*, for comprehensive illustrations from ASC 842 of the application of the definition of a lease.

1.2.1 Identified asset

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-9

An asset typically is identified by being explicitly specified in a **contract**. However, an asset also can be identified by being implicitly specified at the time that the asset is made available for use by the customer.

842-10-15-16

A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building or a segment of a pipeline that connects a single customer to the larger pipeline). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

The requirement that there be an identified asset is fundamental to the definition of a lease. Under ASC 842, an identified asset can be either implicitly or explicitly specified in a contract.

Illustration 1 — Implicitly specified asset

Customer X enters into a five-year contract with Supplier Y for the use of a railcar specifically designed for Customer X. The railcar is designed to transport materials used in Customer X's production process and is not suitable for use by other customers. The railcar is not explicitly specified in the contract, but Supplier Y owns only one railcar that is suitable for Customer X's use. If the railcar does not operate properly, the contract requires Supplier Y to repair or replace the railcar. Assume that Supplier Y does not have a substantive substitution right (refer to section 1.2.1.1, *Substantive substitution rights*).

Analysis: The railcar is an identified asset. While the railcar is not explicitly specified in the contract (e.g., by serial number), it is implicitly specified because Supplier Y must use it to fulfill the contract.

In another example, a power plant is an implicitly identified asset in a power purchase contract if the seller of the power is a special-purpose entity (SPE) that owns a single power plant. In this instance, the power plant is implicitly specified in the contract because it is unlikely that the SPE could obtain replacement power to fulfill its obligations under the contract because an SPE generally has limited capital resources.

In the case of a transportation contract, the supplier may have only a single pipeline, and it might not be economically feasible for the supplier to obtain access to a second pipeline. In that case, the seller's pipeline is implicitly identified in the contract.

An identified asset also can be a physically distinct portion of a larger asset. Examples include a floor of a building, the "last mile" of a telecommunications network that connects a single customer to a larger network or a segment of a pipeline that connects a single customer to a larger pipeline (i.e., the segment is used solely by one customer). However, a capacity portion or other portion of an asset that is not physically distinct (e.g., a capacity portion of a fiber optic cable) is not an identified asset unless it represents substantially all of the capacity of the asset and therefore provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

Illustration 2 — Identified asset — physically distinct portion of a larger asset

Customer X enters into a 12-year contract with Supplier Y for the right to use three fibers in a fiber optic cable between New York and London. The contract identifies three of the cable's 20 fibers for use by Customer X. The three fibers are dedicated solely to Customer X's data for the duration of the contract term. Assume that Supplier Y does not have a substantive substitution right (refer to section 1.2.1.1, *Substantive substitution rights*).

Analysis: The three fibers are identified assets because they are physically distinct and explicitly specified in the contract.

Illustration 3 — Identified asset — capacity portion of an asset

Scenario A

Customer X enters into a five-year contract with Supplier Y for the right to transport oil from Country A to Country B through Supplier Y's pipeline. The contract provides that Customer X will have the right to 95% of the pipeline's capacity throughout the term of the arrangement. Supplier Y has no right (substantively or contractually) to connect additional branch lines from the identified pipeline for the benefit of other customers.

Analysis: The capacity portion of the pipeline is an identified asset. While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents substantially all of the capacity of the pipeline and thereby provides Customer X with the right to obtain substantially all of the economic benefits from use of the pipeline.

Scenario B

Assume the same facts as in Scenario A, except that Customer X has the right to use 60% of the pipeline's capacity throughout the term of the arrangement.

Analysis: The capacity portion of the pipeline is not an identified asset because 60% of the pipeline's capacity is less than substantially all of the capacity of the pipeline. Customer X does not have the right to obtain substantially all of the economic benefits from use of the pipeline.

Substantially all

The term "substantially all" is not defined in ASC 842. However, entities might refer to the description in ASC 842-10-55-2 of how "substantially all of the fair value of the underlying asset" could be evaluated in the context of lease classification. In that paragraph, the FASB states that "one reasonable approach" would be to conclude that "[n]inety percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset."

1.2.1.1 Substantive substitution rights

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-10

Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

a. The supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).

b. The supplier would benefit economically from the exercise of its right to substitute the asset (that is, the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

842-10-15-11

An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception, are not considered likely to occur. Examples of future events that, at inception of the contract, would not be considered likely to occur and, thus, should be excluded from the evaluation include, but are not limited to, the following:

a. An agreement by a future customer to pay an above-market rate for use of the asset

b. The introduction of new technology that is not substantially developed at inception of the contract

c. A substantial difference between the customer's use of the asset, or the performance of the asset and the use or performance considered likely at inception of the contract

d. A substantial difference between the market price of the asset during the period of use and the market price considered likely at inception of the contract.

842-10-15-12

If the asset is located at the customer's premises or elsewhere, the costs associated with substitution are generally higher than when located at the supplier's premises and, therefore, are more likely to exceed the benefits associated with substituting the asset.

842-10-15-13

If the supplier has a right or an obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

842-10-15-14

The supplier's right or obligation to substitute an asset for repairs or maintenance, if the asset is not operating properly, or if a technical upgrade becomes available, does not preclude the customer from having the right to use an identified asset.

842-10-15-15

If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer shall presume that any substitution right is not substantive.

Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use (i.e., the total period of time that an asset is used to fulfill a contract with a customer, including the sum of any nonconsecutive periods of time). A substitution right is substantive when both of the following conditions are met:

- The supplier has the practical ability to substitute alternative assets throughout the period of use (e.g., the customer cannot prevent the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).
- The supplier would benefit economically from the exercise of its right to substitute the asset (i.e., the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

The FASB indicated in the Basis for Conclusions (BC 129) that the conditions above are intended to differentiate between substitution rights that result in a supplier controlling the use of an asset, rather than the customer, and rights that do not change the substance or character of the contract.

An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract. At inception of the contract, an entity should not consider future events that are not likely to occur. ASC 842 provides the following examples of circumstances that at inception of the contract are not likely to occur and thus are excluded from the evaluation of whether a supplier's substitution right is substantive throughout the period of use:

- An agreement by a future customer to pay an above-market rate for use of the asset
- The introduction of new technology that is not substantially developed at inception of the contract
- A substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract
- A substantial difference between the market price of the asset during the period of use and the market price considered likely at inception of the contract

The requirement that a substitution right must benefit the supplier economically in order to be substantive is a new concept. The FASB indicated in the Basis for Conclusions (BC 130) that, in many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset. The physical location of the asset may affect the costs associated with substituting the asset. For example, if an asset is located at the customer's premises, the cost associated with substituting it is generally higher than the cost of substituting a similar asset located at the supplier's premises. However, simply because the cost of substitution is not significant doesn't mean that the supplier would benefit economically from the right of substitution.

ASC 842-10-15-15 further clarifies that a customer should presume that a supplier's substitution right is not substantive if the customer cannot readily determine whether the supplier has a substantive substitution right. That is, the customer would conclude a substitution right is not substantive absent appropriate evidence to the contrary. This requirement is intended to clarify that a customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive and that effectively there is a presumption it is not substantive. We believe that the FASB did not include a similar provision for suppliers because they should have sufficient information to make a determination of whether a substitution right is substantive.

Contract terms that allow or require a supplier to substitute alternative assets only when the underlying asset is not operating properly (e.g., a normal warranty provision) or when a technical upgrade becomes available do not create a substantive substitution right.

A supplier's right or obligation to substitute alternative assets only on or after a particular date or the occurrence of a specified event also does not create a substantive substitution right because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

Illustration 4 — Substitution rights

Scenario A

Assume that an electronic data storage provider (supplier) provides services, through a centralized data center, that involve the use of a specified server (Server No. 9). The supplier maintains many identical servers in a single, accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute another server without the customer's consent throughout the period of use. Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimize the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

Analysis: The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute the server and would benefit economically from such a substitution. However, if the customer could not readily determine whether the supplier had a substantive substitution right (e.g., there is insufficient transparency into the supplier's operations), the customer would presume the substitution right is not substantive and conclude that there is an identified asset.

Scenario B

Assume the same facts as in Scenario A except that Server No. 9 is customized, and the supplier does not have the practical ability to substitute the customized asset throughout the period of use. Additionally, it is unclear to the customer whether the supplier has the practical ability to substitute or whether it would benefit economically from sourcing a similar alternative asset.

Analysis: Because the supplier does not have the practical ability to substitute the asset (lessor), and there is no evidence of economic benefit to the supplier for substituting the asset (lessee), the substitution right is non-substantive from the perspective of both the lessee and the lessor. Therefore, Server No. 9 would be an identified asset. In this case, neither of the conditions of a substantive substitution right is met. As a reminder, both conditions must be met for the supplier to have a substantive substitution right.

1.2.2 Right to control the use of the identified asset

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset (see section 1.2.2.1, *Right to obtain substantially all of the economic benefits from the use of the identified asset*)
- The right to direct the use of the identified asset (see section 1.2.2.2, *Right to direct the use of the identified asset*)
- If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term in accordance with ASC 842-10-15-5.

1.2.2.1 Right to obtain substantially all of the economic benefits from the use of the identified asset

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-17

To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third party.

842-10-15-18

When assessing the right to obtain substantially all of the economic benefits from use of an asset, an entity shall consider the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset in the contract (see paragraph 842-10-15-23). For example:

a. If a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle within that territory and not beyond.

b. If a contract specifies that a customer can drive a motor vehicle only up to a particular number of miles during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle for the permitted mileage and not beyond.

842-10-15-19

If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from use of an asset as consideration, those cash flows paid as consideration shall be considered to be part of the economic benefits that the customer obtains from use of the asset. For example, if a customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use, that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. That is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space.

A customer's right to control the use of an identified asset depends on its right to obtain substantially all of the economic benefits from the use of the identified asset throughout the period of use. The term "substantially all" is not defined in ASC 842. Refer to section 1.2.1, *Identified asset*, for a discussion about how an entity might evaluate this term.

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through the use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realized from a commercial transaction with a third party. However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset and therefore are not considered when assessing whether a customer has the right to obtain substantially all the economic benefits.

When assessing whether the customer has the right to obtain substantially all the economic benefits from the use of an asset, an entity must consider the economic benefits that result from the use of the asset within the defined scope of the customer's right to use the asset. A right that solely protects the supplier's interest in the underlying asset (e.g., limits on the number of miles a customer can drive a supplier's vehicle, limits on where the asset may be used) does not, in and of itself, prevent the customer from obtaining substantially all of the economic benefits from the use of the asset (refer to section 1.2.2.3, *Protective rights*). Instead, it simply limits the economic benefits that are to be evaluated.

If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from the use of an asset as consideration (e.g., a percentage of sales from the use of retail space), those cash flows are considered to be economic benefits that the customer derives from the use of the asset.

1.2.2.2 Right to direct the use of the identified asset

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-20

A customer has the right to direct the use of an identified asset throughout the period of use in either of the following situations:

a. The customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs 842-10-15-24 through 15-26).

b. The relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph 842-10-15-21) and at least one of the following conditions exists:

    1. The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use without the supplier having the right to change those operating instructions.

    2. The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

842-10-15-21

The relevant decisions about how and for what purpose an asset is used can be predetermined in a number of ways. For example, the relevant decisions can be predetermined by the design of the asset or by contractual restrictions on the use of the asset.

A customer has the right to direct the use of an identified asset throughout the period of use when either:

- The customer has the right to direct how and for what purpose the asset is used throughout the period of use.
- The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either (1) has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use without the supplier having the right to change the operating instructions or (2) designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

The right to direct how and for what purpose an asset is used throughout the period of use

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-24

A customer has the right to direct how and for what purpose an asset is used throughout the period of use if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout that period. In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose an asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract.

842-10-15-25

Examples of decision-making rights that, depending on the circumstances, grant the right to direct how and for what purpose an asset is used, within the defined scope of the customer's right of use, include the following:

a. The right to change the type of output that is produced by the asset (for example, deciding whether to use a shipping container to transport goods or for storage, or deciding on the mix of products sold from a retail unit)

b. The right to change when the output is produced (for example, deciding when an item of machinery or a power plant will be used)

c. The right to change where the output is produced (for example, deciding on the destination of a truck or a ship or deciding where a piece of equipment is used or deployed)

d. The right to change whether the output is produced and the quantity of that output (for example, deciding whether to produce energy from a power plant and how much energy to produce from that power plant).

842-10-15-26

Examples of decision-making rights that do not grant the right to direct how and for what purpose an asset is used include rights that are limited to operating or maintaining the asset. Although rights such as those to operate or maintain an asset often are essential to the efficient use of an asset, they are not rights to direct how and for what purpose the asset is used and often are dependent on the decisions about how and for what purpose the asset is used. Such rights (that is, to operate or maintain the asset) can be held by the customer or the supplier. The supplier often holds those rights to protect its investment in the asset. However, rights to operate an asset may grant the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph 842-10-15-20(b)(1)).

A customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used throughout the period of use (i.e., it can change how and for what purpose the asset is used throughout the period of use). How and for what purpose an asset is used is a single concept (i.e., "how" an asset is used is not assessed separately from "for what purpose" an asset is used).

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract.

The FASB indicated in the Basis for Conclusions (BC 137) that decisions about how and for what purpose an asset is used can be viewed as similar to the decisions made by a board of directors. Decisions made by a board of directors about the operating and financing activities of an entity are generally the most relevant decisions rather than the actions of individuals in implementing those decisions.

ASC 842 provides the following examples of decision-making rights that grant the right to change how and for what purpose an asset is used:

- The right to change the type of output that is produced by the asset (e.g., deciding whether to use a shipping container to transport goods or for storage, deciding on the mix of products sold from a retail unit)

- The right to change when the output is produced (e.g., deciding when an item of machinery or a power plant will be used)
- The right to change where the output is produced (e.g., deciding on the destination of a truck or a ship, deciding where a piece of equipment is used or deployed)
- The right to change whether the output is produced and the quantity of that output (e.g., deciding whether to produce energy from a power plant and how much energy to produce from that power plant)

ASC 842 also provides the following examples of decision-making rights that do not grant the right to change how and for what purpose an asset is used:

- Maintaining the asset
- Operating the asset

Although the decisions about maintaining and operating the asset are often essential to the efficient use of that asset, the right to make those decisions, in and of itself, does not result in the right to change how and for what purpose the asset is used throughout the period of use.

The customer does not need the right to operate the underlying asset to have the right to direct its use. That is, the customer may direct the use of an asset that is operated by the supplier's personnel. However, as discussed below, the right to operate an asset will often provide the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined.

We believe that the assessment of whether a contract is or contains a lease will be straightforward in most arrangements. However, judgment may be required in applying the definition of a lease to certain arrangements. For example, in contracts that include significant services, we believe that determining whether the contract conveys the right to direct the use of an identified asset may be more complex.

The relevant decisions about how and for what purpose an asset is used are predetermined

In some cases, it will not be clear whether the customer has the right to direct the use of the identified asset. This could be the case when the most relevant decisions about how and for what purpose an asset is used are predetermined by contractual restrictions on the use of the asset (e.g., the decisions about the use of the asset are agreed to by the customer and the supplier in negotiating the contract, and those decisions cannot be changed). This could also be the case when the most relevant decisions about how and for what purpose an asset is used are, in effect, predetermined by the design of the asset. The FASB indicated in the Basis for Conclusions (BC 138) that it would expect decisions about how and for what purpose an asset is used to be predetermined in few cases. When decisions about how and for what purpose an asset is to be used are predetermined, a customer has the right to direct the use of an identified asset throughout the period of use when the customer either:

- Has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use without the supplier having the right to change those operating instructions
- Designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use

Significant judgment may be required to assess whether a customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use. The following provides an example of the evaluation of whether a customer designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Excerpt from Accounting Standards Codification

Example 9 — Contract for Energy/Power

Case A — Contract Contains a Lease

842-10-55-108

A utility company (Customer) enters into a contract with a power company (Supplier) to purchase all of the electricity produced by a new solar farm for 20 years. The solar farm is explicitly specified in the contract, and Supplier has no substitution rights. The solar farm is owned by Supplier, and the energy cannot be provided to Customer from another asset. Customer designed the solar farm before it was constructed — Customer hired experts in solar energy to assist in determining the location of the farm and the engineering of the equipment to be used. Supplier is responsible for building the solar farm to Customer's specifications and then operating and maintaining it. There are no decisions to be made about whether, when, or how much electricity will be produced because the design of the asset has predetermined these decisions. Supplier will receive tax credits relating to the construction and ownership of the solar farm, while Customer receives renewable energy credits that accrue from use of the solar farm.

842-10-55-109

The contract contains a lease. Customer has the right to use the solar farm for 20 years.

842-10-55-110

There is an identified asset because the solar farm is explicitly specified in the contract, and Supplier does not have the right to substitute the specified solar farm.

842-10-55-111

Customer has the right to control the use of the solar farm throughout the 20-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the solar farm over the 20-year period of use. Customer has exclusive use of the solar farm; it takes all of the electricity produced by the farm over the 20-year period of use as well as the renewable energy credits that are a by-product from use of the solar farm. Although Supplier will be receiving economic benefits from the solar farm in the form of tax credits, those economic benefits relate to the ownership of the solar farm rather than the use of the solar farm and, thus, are not considered in this assessment.

b. Customer has the right to direct the use of the solar farm. Neither Customer nor Supplier decides how and for what purpose the solar farm is used during the period of use because those decisions are predetermined by the design of the asset (that is, the design of the solar farm has, in effect, programmed into the asset any relevant decision-making rights about how and for what purpose the solar farm is used throughout the period of use). Customer does not operate the solar farm; Supplier makes the decisions about the operation of the solar farm. However, Customer's design of the solar farm has given it the right to direct the use of the farm (as described in paragraph 842-10-15-20(b)(2)). Because the design of the solar farm has predetermined how and for what purpose the asset will be used throughout the period of use, Customer's control over that design is substantively no different from Customer controlling those decisions.

Case B — Contract Does Not Contain a Lease

842-10-55-112

Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for three years. The power plant is owned and operated by Supplier. Supplier is unable to provide power to Customer from another plant. The contract sets out the quantity and timing of power that the power plant will produce throughout the period of use, which cannot be changed in the absence of extraordinary circumstances (for example, emergency situations). Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices. Supplier designed the power plant when it was constructed some years before entering into the contract with Customer; Customer had no involvement in that design.

842-10-55-113

The contract does not contain a lease.

842-10-55-114

There is an identified asset because the power plant is explicitly specified in the contract, and Supplier does not have the right to substitute the specified plant.

842-10-55-115

Customer has the right to obtain substantially all of the economic benefits from use of the identified power plant over the three-year period of use. Customer will take all of the power produced by the power plant over the three-year term of the contract.

842-10-55-116

However, Customer does not have the right to control the use of the power plant because it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the plant is used. How and for what purpose the plant is used (that is, whether, when, and how much power the plant will produce) are predetermined in the contract. Customer has no right to change how and for what purpose the plant is used during the period of use, nor does it have any other decision-making rights about the use of the power plant during the period of use (for example, it does not operate the power plant) and did not design the plant. Supplier is the only party that can make decisions about the plant during the period of use by making the decisions about how the plant is operated and maintained. Customer has the same rights regarding the use of the plant as if it were one of many customers obtaining power from the plant.

Case C — Contract Contains a Lease

842-10-55-117

Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for 10 years. The contract states that Customer has rights to all of the power produced by the plant (that is, Supplier cannot use the plant to fulfill other contracts).

842-10-55-118

Customer issues instructions to Supplier about the quantity and timing of the delivery of power. If the plant is not producing power for Customer, it does not operate.

842-10-55-119

Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices.

842-10-55-120

The contract contains a lease. Customer has the right to use the power plant for 10 years.

842-10-55-121

There is an identified asset. The power plant is explicitly specified in the contract, and Supplier does not have the right to substitute the specified plant.

842-10-55-122

Customer has the right to control the use of the power plant throughout the 10-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the power plant over the 10-year period of use. Customer has exclusive use of the power plant; it has rights to all of the power produced by the power plant throughout the 10-year period of use.

b. Customer has the right to direct the use of the power plant. Customer makes the relevant decisions about how and for what purpose the power plant is used because it has the right to determine whether, when, and how much power the plant will produce (that is, the timing and quantity, if any, of power produced) throughout the period of use. Because Supplier is prevented from using the power plant for another purpose, Customer's decision making about the timing and quantity of power produced, in effect, determines when and whether the plant produces output.

842-10-55-123

Although the operation and maintenance of the power plant are essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the power plant is used. Consequently, Supplier does not control the use of the power plant during the period of use. Instead, Supplier's decisions are dependent on Customer's decisions about how and for what purpose the power plant is used.

Specifying the output of an asset before the period of use

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-22

In assessing whether a customer has the right to direct the use of an asset, an entity shall consider only rights to make decisions about the use of the asset during the period of use unless the customer designed the asset (or specific aspects of the asset) in accordance with paragraph 842-10-15-20(b)(2). Consequently, unless that condition exists, an entity shall not consider decisions that are predetermined before the period of use. For example, if a customer is able only to specify the output of an asset before the period of use, the customer does not have the right to direct the use of that asset. The ability to specify the output in a contract before the period of use, without any other decision-making rights relating to the use of the asset, gives a customer the same rights as any customer that purchases goods or services.

If a customer can only specify the output from an asset before the beginning of the period of use and cannot change that output throughout the period of use, the customer does not have the right to direct the use of that asset unless it designed the asset, or specific aspects of the asset, as contemplated in ASC 842-10-15-20(b)(2). If the customer did not design the asset or aspects of it, the customer's ability to specify the output in a contract that doesn't give it any other relevant decision-making rights relating to the use of the asset (e.g., the ability to change when, whether and what output is produced) gives the customer the same rights as any customer that purchases goods or services in a service arrangement (i.e., a contract that does not contain a lease).

1.2.2.3 Protective rights

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-23

A contract may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with laws or regulations. These are examples of protective rights. For example, a contract may specify the maximum amount of use of an asset or limit where or when the customer can use the asset, may require a customer to follow particular operating practices, or may require a customer to inform the supplier of changes in how an asset will be used. Protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset.

A supplier's protective rights, in isolation, do not prevent the customer from having the right to direct the use of an identified asset. Protective rights typically define the scope of the customer's right to use the asset without removing the customer's right to direct the use of the asset. Protective rights are intended to protect a supplier's interests (e.g., interests in the asset, its personnel, compliance with laws and regulations) and might take the form of a specified maximum amount of asset use, a restriction on where an asset may be used or a requirement to follow specific operating instructions.

Illustration 5 — Right to direct the use of an asset

Customer X enters into a contract with Supplier Y to use a vehicle for a three-year period. The vehicle is identified in the contract. Supplier Y cannot substitute another vehicle unless the specified vehicle is not operational (e.g., it breaks down).

Under the contract:

- Customer X operates the vehicle (i.e., drives the vehicle) or directs others to operate the vehicle (e.g., hires a driver).
- Customer X decides how to use the vehicle (within contractual limitations, discussed below). For example, throughout the period of use, Customer X decides where the vehicle goes as well as when or whether it is used and what it is used for. Customer X can also change these decisions throughout the period of use.
- Supplier Y prohibits certain uses of the vehicle (e.g., moving it overseas) and modifications of the vehicle to protect its interest in the asset.

Analysis: Customer X has the right to direct the use of the identified vehicle throughout the period of use. Customer X has the right to direct the use of the vehicle because it has the right to change how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for.

Supplier Y's limits on certain uses for the vehicle and modifications to it are considered protective rights that define the scope of Customer X's use of the asset but do not affect the assessment of whether Customer X directs the use of the asset.

1.2.3 Leases involving joint arrangements

A customer that is a joint operation or joint arrangement (JOA) is required to consider whether the joint arrangement has the right to control the use of an identified asset to determine whether an arrangement is a lease. Joint arrangements, which are generally not legal entities and are not defined by US GAAP, are common in extractive industries.

In a joint operation or joint arrangement, an operator (e.g., an operator of an oil and gas property) may agree with other parties (i.e., non-operators) to perform certain activities necessary to develop or operate the property. To fulfill its responsibilities, the operator often enters into contracts with third-party suppliers to obtain the use of equipment (e.g., a drilling rig) to perform the activities. Many of these arrangements may contain leases. Less frequently, the JOA (as a group) may enter into such agreements directly with the suppliers. The counterparty to each contract (i.e., the operator, the JOA, the supplier) will have to carefully evaluate these agreements to determine whether it controls the use of an identified asset throughout the period of use.

For example, when the operator enters into an arrangement with a supplier, the operator would evaluate whether it controls the use of the identified asset, and if so, a right-of-use asset and lease liability would generally be recognized (refer to chapter 4, *Lessee accounting*). Next, the operator and the JOA (as if it were a legal entity) should evaluate whether a sublease exists (between the operator and JOA). If the JOA controls the use of the identified asset under the term of the arrangement between the operator and the JOA, and the arrangement between the operator and JOA is determined to be a lease, the operator would recognize a sublease to the joint arrangement, and the parties with interest in the joint arrangement would recognize their proportionate share of the leased asset, liability and rental expense when proportionate consolidation is permitted (e.g., based on the industry guidance for extractive industries).

1.3 Reassessment of the contract

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-6

An entity shall reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed.

Under ASC 842, an entity reassesses whether a contract is or contains a lease only if the terms and conditions of the contract are changed (e.g., a change in the scope or consideration of a contract, addition of a right to use an underlying asset). This reassessment requirement also applies to modifications of contracts that were not previously determined to be or contain a lease.

A change that provides the supplier with a substitution right or that changes the extent of the supplier's or customer's decision-making authority related to the underlying asset are examples of changes in the terms and conditions of a contract that would require an entity to reassess whether the contract is or contains a lease.

Refer to sections 4.6, *Lease modifications*, and 5.6, *Lease modifications*, for discussion of accounting by lessees and lessors, respectively, for a modified contract that continues to be a lease.

1.4 Identifying and separating lease and non-lease components of a contract and allocating contract consideration

1.4.1 Identifying and separating lease components of a contract

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-28

After determining that a **contract** contains a **lease** in accordance with paragraphs 842-10-15-2 through 15-27, an entity shall identify the separate lease components within the contract. An entity shall consider the right to use an **underlying asset** to be a separate lease component (that is, separate from any other lease components of the contract) if both of the following criteria are met:

a. The **lessee** can benefit from the right of use either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the **lessor** or other suppliers) or resources that the lessee already has obtained (from the lessor or from other transactions or events).

b. The right of use is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract. 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.

842-10-15-29

The guidance in paragraph 842-10-15-28 notwithstanding, to classify and account for a lease of land and other assets, an entity shall account for the right to use land as a separate lease component unless the accounting effect of doing so would be insignificant (for example, separating the land element would have no effect on lease classification of any lease component or the amount recognized for the land lease component would be insignificant).

For contracts that contain the rights to use multiple assets but not land (e.g., a lease of a building and equipment, multiple pieces of equipment), the right to use each asset is considered a separate lease component if both of the following criteria are met:

- The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee (i.e., goods or services that are sold or leased separately, by the lessor or other suppliers, or that the lessee has already obtained from the lessor or in other transactions or events).
- The right of use is neither highly dependent on, nor highly interrelated with, the other right(s) to use the underlying assets in the contract.

If one or both of these criteria are not met, the right to use multiple assets is considered a single lease component.

For contracts that involve the right to use land and other assets (e.g., land and a building), ASC 842 requires an entity to classify (refer to chapter 3, *Lease classification*) and account for the right to use land as a separate lease component, even if the criteria above for separating lease components are not met, unless the accounting effect of not separately accounting for the land is insignificant. In assessing whether the effect of separately accounting for the land would be significant, entities should consider the potential differences in accounting, including:

- Lease classification
- The balance sheet presentation of right-of-use assets and lease liabilities

- The timing and classification of expense or income recognition
- The classification of lease payments in the statement of cash flows
- Footnote disclosure (e.g., disclosure of lease costs, non-cash information on lease liabilities, the weighted-average lease term and discount rate)

The FASB indicated in the Basis for Conclusions (BC 147) that since land, by virtue of its indefinite economic life, is substantively different from other assets, it should be assessed separately regardless of whether the separate lease component criteria are met.

An entity that leases an entire building (i.e., 100% of the building) is inherently leasing the land underneath the building and would potentially account for the land and the building as separate lease components. However, we believe this would not necessarily be the case when an entity only leases part of the building (e.g., one floor of a multistory building).

ASC 842 includes the following example for separating lease components of a contract (refer to section 1.4.5, *Examples — identifying and separating components of a contract and determining and allocating the consideration in the contract*, for additional examples).

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

Example 13 — Lease of a Turbine Plant

842-10-55-146

Lessor leases a gas-fired turbine plant to Lessee for eight years so that Lessee can produce electricity for its customers. The plant consists of the turbine housed within a building together with the land on which the building sits. The building was designed specifically to house the turbine, has a similar economic life as the turbine of approximately 15 years, and has no alternative use. The lease does not transfer ownership of any of the underlying assets to Lessee or grant Lessee an option to purchase any of the underlying assets. Lessor does not obtain a residual value guarantee from Lessee or any other unrelated third party. The present value of the lease payments is not substantially all of the aggregate fair value of the three underlying assets.

842-10-55-147

While the lease of the plant includes the lease of multiple underlying assets, the leases of those underlying assets do not meet the second criterion necessary to be separate lease components, which is that the right to use the underlying asset is neither dependent on nor highly interrelated with the other rights of use in the contract. Therefore, the contract contains only one lease component. The rights to use the turbine, the building, and the land are highly interrelated because each is an input to the customized combined item for which Lessee has contracted (that is, the right to use a gas-fired turbine plant that can produce electricity for distribution to Lessee's customers).

842-10-55-148

However, because the contract contains the lease of land, Lessee and Lessor also must consider the guidance in paragraph 842-10-15-29. Lessee and Lessor each conclude that the effect of accounting for the right to use the land as a separate lease component would be insignificant because Lessee's right to use the turbine, the building, and the land is coterminous and separating the right to use the land from the right to use the turbine and the building would not affect the lease classification of the turbine/building lease component. Lessee and Lessor each conclude that a single lease component comprising the turbine, the building, and the land would be classified as an operating lease, as would two separate lease components comprising the land and the turbine/building, respectively.

842-10-55-149

The predominant asset in the single lease component is the turbine. Lessee entered into the lease primarily to obtain the power-generation capabilities of the turbine. The building and land enable Lessee to obtain the benefits from use of the turbine. The land and building would have little, if any, use or value to Lessee in this contract without the turbine. Therefore, the remaining economic life of the turbine is considered in evaluating the classification of the single lease component.

1.4.2 Identifying and separating lease from non-lease components of a contract

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-30

The **consideration in the contract** shall be allocated to each separate lease component and nonlease component of the contract (see paragraphs 842-10-15-33 through 15-37 for lessee allocation guidance and paragraphs 842-10-15-38 through 15-42 for lessor allocation guidance). Components of a contract include only those items or activities that transfer a good or service to the lessee. Consequently, the following are not components of a contract and do not receive an allocation of the consideration in the contract:

a. Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service to the lessee

b. Reimbursement or payment of the lessor's costs. For example, a lessor may incur various costs in its role as a lessor or as owner of the underlying asset. A requirement for the lessee to pay those costs, whether directly to a third party or as a reimbursement to the lessor, does not transfer a good or service to the lessee separate from the right to use the underlying asset.

842-10-15-31

An entity shall account for each separate lease component separately from the nonlease components of the contract (that is, unless a lessee makes the accounting policy election described in paragraph 842-10-15-37). Nonlease components are not within the scope of this Topic and shall be accounted for in accordance with other Topics.

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). The non-lease components are identified and accounted for separately from the lease component in accordance with other US GAAP (except when a lessee applies the practical expedient as discussed in section 1.4.2.3, *Practical expedient — lessees*). For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to ASC 606, *Revenue from Contracts with Customers*, by lessors (suppliers).

Some contracts contain items that do not relate to the transfer of goods or services by the lessor to the lessee (e.g., fees or other administrative costs that a lessor charges a lessee). These items should not be considered separate lease or non-lease components, and lessees and lessors do not allocate consideration in the contract to these items. Refer to sections 1.4.3.2, *Allocating the consideration in the contract — lessees,* on lessee allocation of consideration in the contract and 1.4.4.2, *Allocating the consideration in the contract — lessors*, on lessor allocation of consideration in the contract.

However, if the lessor provides services (e.g., maintenance, including common area maintenance, supply of utilities) or operates the underlying asset (e.g., vessel charter, aircraft wet lease), the contract would generally contain non-lease components.

1.4.2.1 Executory costs

Payments for maintenance activities, including common area maintenance (e.g., cleaning a lobby of a building, removing snow from a parking lot for employees and customers), are considered non-lease components. In some leases, a lessee also may reimburse the lessor, or make certain payments on behalf of the lessor, that relate to the leased asset such as payments for insuring the lessor's asset and real estate taxes associated with such asset. Insurance that protects the lessor's interest in the underlying asset and taxes related to such asset (e.g., real estate taxes on the underlying asset) are not separate components of the contract because they do not represent payments for goods or services (i.e., the payments are for the use of the leased asset and are attributable to the lease component or allocated between the lease and non-lease components). Entities should also evaluate whether lease payments made for insurance that protects the lessor's interest in the underlying asset and taxes relating to such asset are fixed (or in-substance fixed) lease payments or variable lease payments. Refer to section 2.4, *Lease payments*.

For lessees, if an arrangement does not contain a non-lease component, fixed and variable payments for insuring the lessor's asset and real estate taxes associated with such asset are attributable to the lease component. Refer to Example 12 — Activities or Costs That Are Not Components of a Contract, Case A — Payments for Taxes and Insurances are Variable, included below. If the same arrangement contains a lease and a non-lease component (e.g., maintenance), fixed payments are included in the consideration in the contract and allocated between the lease and non-lease components on a relative standalone price basis. Variable payments for insuring the lessor's asset and real estate taxes are excluded from consideration in the contract and, when recognized, are allocated to the lease and non-lease components on the same basis as the allocation of consideration in the contract determined at lease commencement. Refer to Example 14 — Determining the Consideration in the Contract — Variable Payments, Case A — Variable Payments That Related to the Lease Component and the Nonlease Component, in section 1.4.5, *Examples — identifying and separating components of a contract and determining and allocating the consideration in the contract*. Also refer to section 1.4.3.2, *Allocating the consideration in the contract — lessees*.

Lessors would follow the guidance in ASC 842-10-15-38 to 15-40, which incorporates ASC 606's allocation guidance. Refer to section 1.4.4.2, *Allocating the consideration in the contract — lessors*.

ASC 842 provides the following examples of accounting for lease-related executory costs.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

Example 12 — Activities or Costs That Are Not Components of a Contract

Case A — Payments for Taxes and Insurance are Variable

842-10-55-141

Lessor and Lessee enter into a five-year lease of a building. The contract designates that Lessee is required to pay for the costs relating to the asset, including the real estate taxes and the insurance on the building. The real estate taxes would be owed by Lessor regardless of whether it leased the building and who the lessee is. Lessor is the named insured on the building insurance policy (that is, the insurance protects Lessor's investment in the building, and Lessor will receive the proceeds from any claim). The annual lease payments are fixed at $10,000 per year, while the annual real estate taxes and insurance premium will vary and be billed to Lessee each year.

842-10-55-142

The real estate taxes and the building insurance are not components of the contract. The contract includes a single lease component — the right to use the building. Lessee's payments of those amounts solely represent a reimbursement of Lessor's costs and do not represent payments for goods or services in addition to the right to use the building. However, because the real estate taxes and insurance premiums during the lease term are variable, those payments are variable lease payments that do not depend on an index or a rate and are excluded from the measurement of the lease liability and recognized in profit or loss in accordance with paragraph 842-20-25-5 or 842-20-25-6.

Case B — Payment for Taxes and Insurance are Fixed

842-10-55-143

Assume the same facts and circumstances as in Case A (paragraphs 842-10-55-141 through 55-142), except that the fixed annual lease payment is $13,000. There are no additional payments for real estate taxes or building insurance; however, the fixed payment is itemized in the contract (that is, $10,000 for rent, $2,000 for real estate taxes, and $1,000 for building insurance). Consistent with Case A, the taxes and insurance are not components of the contract. The contract includes a single lease component, the right to use the building. The $65,000 in payments Lessee will make over the 5-year lease term are all lease payments for the single component of the contract and, therefore, are included in the measurement of the lease liability.

Case C — Common Area Maintenance

842-10-55-144

Assume the same facts and circumstances as in Case B (paragraph 842-10-55-143), except that the lease is of space within the building, rather than for the entire building, and the fixed annual lease payment of $13,000 also covers Lessor's performance of common area maintenance activities (for example, cleaning of common areas, parking lot maintenance, and providing utilities to the building). Consistent with Case B, the taxes and insurance are not components of the contract. However, the common area maintenance is a component because Lessor's activities transfer services to Lessee. That is, Lessee receives a service from Lessor in the form of the common area maintenance activities it would otherwise have to undertake itself or pay another party to provide (for example, cleaning the lobby for its customers, removing snow from the parking lot for its employees and customers, and providing utilities). The common area maintenance is a single component in this contract rather than multiple components, because Lessor performs the activities as needed (for example, plows snow or undertakes minor repairs when and as necessary) over the same period of time.

842-10-55-145

Therefore, the contract in Case C includes two components — a lease component (that is, the right to use the building) and a nonlease component. The consideration in the contract of $65,000 is allocated between those 2 components; the amount allocated to the lease component is the lease payments in accounting for the lease.

1.4.2.2 Guarantees of performance of underlying asset

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-33

A lessor should evaluate a commitment to guarantee performance of the **underlying asset** or to effectively protect the **lessee** from obsolescence of the underlying asset in accordance with paragraphs 606-10-55-30 through 55-35 on **warranties.** If the lessor's commitment is more extensive than a typical product warranty, it might indicate that the commitment is providing a service to the lessee that should be accounted for as a nonlease component of the contract.

Entities should carefully evaluate the terms of any performance guarantees provided by the lessor and the provisions of ASC 606-10-55-30 through 55-35 to determine whether the guarantee is a non-lease component of the contract that should be separated (e.g., if the lessor's commitment is more extensive than a typical product warranty).

1.4.2.3 Practical expedient — lessees

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-37

As a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose not to separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component.

ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component. ASC 842 provides this expedient to alleviate concerns that the costs and administrative burden of allocating consideration to separate lease and non-lease components may not be justified by the benefit of more precisely reflecting the right-of-use asset and the lease liability. Furthermore, the FASB expects the practical expedient to most often be used when the non-lease components of a contract are not significant when compared to the lease components of a contract. The practical expedient does not allow lessees to account for multiple lease components of a contract (refer to section 1.4.1, *Identifying and separating lease components of a contract*) as a single lease component. Refer to chapter 4, *Lessee accounting*, for a discussion of measurement of right-of-use assets and lease liabilities.

When a lease includes a non-lease component related to the purchase of inventory, we believe an entity should separate the purchase of inventory from other lease and non-lease components, even if it has elected to apply the practical expedient to the class of underlying asset to which the lease relates. For example, if a contract contains a lease as well as non-lease components related to a service and the purchase of sheet metal to be used in the construction of inventory, we believe the purchase of the sheet metal should be accounted for as a component of inventory rather than together with the lease component as the purchase of a physical good is not a "non-lease component associated with that lease component."

Lessees that make the policy election to account for a lease component of a contract and its associated non-lease components as a single lease component allocate all of the contract consideration to the lease component. Therefore, the initial and subsequent measurement of the lease liability and right-of-use asset is greater than if the policy election was not applied, which could have an effect on a lessee's impairment analysis (refer to section 4.2.5, *Impairment of right-of-use assets after the effective date*).

1.4.3 Determining, allocating and reassessing the consideration in the contract — lessees

1.4.3.1 Determining the consideration in the contract

Excerpt from Accounting Standards Codification

Master Glossary

Consideration in the Contract

See paragraph 842-10-15-35 for what constitutes the consideration in the **contract** for **lessees** and paragraph 842-10-15-39 for what constitutes consideration in the contract for **lessors.**

Leases — Overall

Scope and Scope Exceptions

842-10-15-35

The consideration in the contract for a lessee includes all of the payments described in paragraph 842-10-30-5, as well as all of the following payments that will be made during the **lease term**:

a. Any fixed payments (for example, monthly service charges) or in substance fixed payments, less any incentives paid or payable to the lessee, other than those included in paragraph 842-10-30-5

b. Any other variable payments that depend on an index or a rate, initially measured using the index or rate at the **commencement date.**

The consideration in the contract for a lessee includes all of the payments described as lease payments in section 2.4, *Lease payments*, as well as any of the following payments made during the lease term:

- Any fixed payments (e.g., monthly service charges) or in-substance fixed payments, less any incentives paid or payable to the lessee (refer to section 2.4.1, *Fixed (including in-substance fixed) lease payments and lease incentives*), other than those included in lease payments
- Any variable payments that depend on an index or a rate (refer to section 2.4.2, *Variable lease payments that depend on an index or rate*), initially measured using the index or rate at the commencement date (refer to section 2.2, *Commencement date of the lease*)

- The payments described as lease payments in section 2.4, *Lease payments*

+

- Any other fixed payments (e.g., monthly service charges) or in-substance fixed payments made during the lease term, less any incentives paid or payable to the lessee

+

- Any other variable payments that depend on an index or a rate made during the lease term and initially measured using the index or rate at the commencement date

Consideration in the contract for a lessee

(ASC 842-10-15-35)

1.4.3.2 Allocating the consideration in the contract — lessees

Excerpt from Accounting Standards Codification

Master Glossary

Standalone Price

The price at which a customer would purchase a component of a **contract** separately.

Leases — Overall

Scope and Scope Exceptions

842-10-15-33

A **lessee** shall allocate (that is, unless the lessee makes the accounting policy election described in paragraph 842-10-15-37) the **consideration in the contract** to the separate **lease** components determined in accordance with paragraphs 842-10-15-28 through 15-31 and the nonlease components as follows:

a. The lessee shall determine the relative **standalone price** of the separate lease components and the nonlease components on the basis of their observable standalone prices. If observable standalone prices are not readily available, the lessee shall estimate the standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate if the standalone price for a component is highly variable or uncertain.

b. The lessee shall allocate the consideration in the contract on a relative standalone price basis to the separate lease components and the nonlease components of the **contract**.

Initial direct costs should be allocated to the separate lease components on the same basis as the **lease payments**.

842-10-15-34

A price is observable if it is the price that either the **lessor** or similar suppliers sell similar lease or nonlease components on a standalone basis.

Lessees that do not make an accounting policy election (by class of underlying asset) to use the practical expedient (refer to section 1.4.2.3, *Practical expedient — lessees*) to account for each separate lease component of a contract and its associated non-lease components as a single lease component are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis. Lessees are required to use observable standalone prices (i.e., prices at which a customer would purchase a component of a contract separately) when readily available. If observable standalone prices are not readily available, lessees estimate standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate when the standalone price for a component is highly variable or uncertain. Refer to section 1.4.5, *Examples — identifying and separating components of a contract and determining and allocating the consideration in the contract*, for illustrations of how a lessee determines and allocates consideration in a contract, including for arrangements that include variable payments.

For contracts that contain multiple lease components (refer to section 1.4.1, *Identifying and separating lease components of a contract*), lessees also allocate initial direct costs (refer to section 2.6, *Initial direct costs*) to the separate lease components on the same basis as the lease payments.

1.4.3.3 Reassessment — determining and allocating the consideration in the contract

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-36

A lessee shall remeasure and reallocate the consideration in the contract upon either of the following:

a. A remeasurement of the **lease liability** (for example, a remeasurement resulting from a change in the lease term or a change in the assessment of whether a lessee is or is not reasonably certain to exercise an option to purchase the **underlying asset**) (see paragraph 842-20-35-4)

b. The effective date of a contract modification that is not accounted for as a separate contract (see paragraph 842-10-25-8).

Lessees are required to remeasure and reallocate the consideration in a contract when they remeasure the lease liability, which occurs as a result of any of the following:

- A change to the lease term (e.g., a change resulting from a lessee's determination that it is reasonably certain to exercise an existing option to extend a lease that it had previously determined it was not reasonably certain to exercise)
- A change in the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset
- A change in the amount that it is probable the lessee will owe under a residual value guarantee
- A resolution of a contingency that results in some or all of the payments allocated to the lease component that were previously determined to be variable meeting the definition of lease payments (e.g., an event occurs that results in variable lease payments that were linked to the performance or use of the underlying asset becoming fixed payments for the remainder of the lease term)

Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases,* for further discussion.

Lessees are also required to remeasure and reallocate the consideration in the contract on the effective date of a contract modification (i.e., the date the lessor and lessee approve a change to the terms and conditions of the lease that results in a change in the scope of or the consideration for the lease) if the modified contract is not accounted for as a separate contract. Refer to section 4.6, *Lease modifications*.

Also refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements.*

1.4.4 Determining, allocating and reassessing the consideration in the contract — lessors

Excerpt from Accounting Standards Codification

Master Glossary

Consideration in the Contract

See paragraph 842-10-15-35 for what constitutes the consideration in the **contract** for **lessees** and paragraph 842-10-15-39 for what constitutes consideration in the contract for **lessors**.

Leases — Overall

Scope and Scope Exceptions

842-10-15-38

A **lessor** shall allocate the **consideration in the contract** to the separate **lease** components and the nonlease components using the requirements in paragraphs 606-10-32-28 through 32-41. A lessor also shall allocate any capitalized costs (for example, **initial direct costs** or **contract** costs capitalized in accordance with Subtopic 340-40 on other assets and deferred costs — contracts with customers) to the separate lease components or nonlease components to which those costs relate.

842-10-15-39

The consideration in the contract for a lessor includes all of the amounts described in paragraph 842-10-15-35 and any other variable payment amounts that would be included in the transaction price in accordance with the guidance on variable consideration in Topic 606 on revenue from contracts with customers that specifically relates to either of the following:

a. The lessor's efforts to transfer one or more goods or services that are not leases

b. An outcome from transferring one or more goods or services that are not leases.

Any variable payment amounts accounted for as consideration in the contract shall be allocated entirely to the nonlease component(s) to which the variable payment specifically relates if doing so would be consistent with the transaction price allocation objective in paragraph 606-10-32-28.

842-10-15-40

If the terms of a variable payment amount other than those in paragraph 842-10-15-35 relate to a lease component, even partially, the lessor shall recognize those payments as income in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur (for example, when the **lessee's** sales on which the amount of the variable payment depends occur).

1.4.4.1 Determining the consideration in the contract

This illustration shows the types of payments that a lessor incudes as consideration in the contract. Although similar, consideration in a contract for lessees and lessors may differ because lessors include certain other variable payments that do not relate to a lease component.

- The payments described as lease payments in section 2.4, *Lease payments*

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- Any other fixed payments (e.g., monthly service charges) or in-substance fixed payments made during the lease term, less any incentives paid or payable to the lessee

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- Any other variable payments that depend on an index or a rate made during the lease term and initially measured using the index or rate at the commencement date

Consideration in the contract for a lessee (ASC 842-10-15-35)

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- Any other variable payment amounts that would be included in the transaction price in accordance with the guidance on variable consideration in ASC 606 that specifically relate to either of the following:
  - The lessor's efforts to transfer one or more goods or services that are not leases
  - An outcome from transferring one or more goods or services that are not leases

=

Consideration in the contract for a lessor (ASC 842-10-15-39)

1.4.4.2 Allocating the consideration in the contract — lessors

When applying ASC 842, lessors are required to apply the guidance in ASC 606-10-32-28 through 32-41 to allocate the consideration in the contract to lease and non-lease components. This guidance requires lessors to allocate consideration in the contract on a relative standalone selling price basis, except when allocating certain discounts (ASC 606-10-32-36 through 32-38) and certain variable consideration (ASC 606-10-32-39 through 32-41). Using the guidance in ASC 606, lessors may ultimately attribute all or portions of the consideration in the contract to specific lease and non-lease components.

The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. When standalone selling prices are not directly observable, the lessor must estimate the standalone selling price. ASC 606-10-32-33 through 32-35 provides guidance for estimating the standalone selling price. The requirement to estimate a standalone selling price is not a new concept for lessors that previously applied the multiple-element arrangements guidance in ASC 605-25, *Multiple-Element Arrangements*, to leases accounted for under ASC 840. The guidance on estimating standalone selling price in ASC 606 is similar to

ASC 605-25. However, ASC 606 doesn't require an entity to consider a hierarchy of evidence to make this estimate. Refer to section 6.1, *Determining standalone selling prices*, of our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606)*, for an in-depth discussion of determining the standalone selling price and some possible estimation methods.

1.4.4.3 Allocating variable payments — lessors

If an arrangement includes variable payments, a lessor should carefully analyze the nature of the variable payments and the components to which they relate to determine how to allocate those amounts.

Variable payments included as consideration in the contract

Under ASC 842, certain variable payments are **included** as consideration in the contract (i.e., variable payments that depend on an index or rate and other variable payments that relate to the transfer of or the outcome from transferring one or more goods or services that are not leases). Refer to section 1.4.4.1, *Determining the consideration in the contract*. Variable payments included as consideration in the contract are allocated entirely to the non-lease component(s) to which they relate if doing so would be consistent with the transaction price allocation objective in ASC 606-10-32-28 (i.e., the variable payment would be allocated entirely to the non-lease component if doing so depicts the amount of consideration to which the lessor expects to be entitled in exchange for transferring the non-lease component).

Excerpt from Accounting Standards Codification

Revenue from Contracts with Customers — Overall

Measurement

606-10-32-28

The objective when allocating the **transaction price** is for an entity to allocate the transaction price to each **performance obligation** (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the **customer**.

If allocating the variable payments entirely to the non-lease component is not consistent with the transaction price allocation objective in ASC 606-10-32-28, the consideration in the contract is generally allocated between lease and non-lease components on a relative standalone selling price basis.

The following illustration on allocating variable payments included in the consideration in the contract is based on Example 14, *Determining the Consideration in the Contract — Variable Payments, Case B — Variable Payments That Relate Specifically to a Nonlease Component*, in ASC 842 (refer to section 1.4.5, *Examples — identifying and separating components of a contract and determining and allocating the consideration in the contract*).

Illustration 6 — Allocating the consideration in the contract: variable payments that specifically relate to the non-lease component

Lessee and Lessor enter into a five-year lease of highly specialized equipment that includes specialized maintenance services on the equipment throughout the lease term. Lessee agrees to pay:

- A fixed payment of $200,000 per year; and
- A variable payment each year that is based on the number of hours that the equipment is operating at specified performance metrics (i.e., the equipment is not malfunctioning or inoperable)

Assume Lessor properly concludes that the variable payments relate specifically to the outcome of its performance of the maintenance services (i.e., the non-lease component). Lessor evaluates the variable payments in accordance with the guidance on variable consideration in ASC 606 and estimates, using the expected value method, that it will be entitled to receive $50,000 in variable payments (subject to the constraint on variable consideration). Lessor measures the consideration in the contract at $1,050,000 ($200,000 X 5 years + $50,000 of estimated variable payments that specifically relate to the non-lease component). The standalone selling prices for the equipment and maintenance services are $1,350,000 and $200,000, respectively.

Scenario 1

Lessor concludes that allocating the variable payment of $50,000 entirely to the maintenance services would reasonably depict the amount of consideration to which it expects to be entitled in exchange for providing the equipment and maintenance services (i.e., this would result in an allocation that is consistent with the transaction price allocation objective in ASC 606-10-32-28). In this case, Lessor allocates the consideration in the contract as follows:

Component	Standalone Price	Allocation of Fixed Payment	Allocation of Variable Payment	Total Allocation
Equipment lease	$ 1,350,000	$ 870,968[(a)]	–	$ 870,968
Maintenance	200,000	129,032[(b)]	50,000	179,032
	$ 1,550,000	$ 1,000,000	$ 50,000	$ 1,050,000

(a) (1,350,000/1,550,000) X 1,000,000

(b) (200,000/1,550,000) X 1,000,000

Note: If the consideration allocated to the maintenance services is significantly higher than the standalone selling price, this may indicate that the allocation is not consistent with the allocation objective in ASC 606-10-32-28 (i.e., allocating the variable payment entirely to the non-lease component may not depict the amount of consideration to which the lessor expects to be entitled in exchange for transferring the non-lease component).

Scenario 2

Lessor concludes that allocating the variable payments entirely to the maintenance services would not result in an allocation that is consistent with the allocation objective in ASC 606-10-32-28. In this case, Lessor allocates the entire consideration in the contract of $1,050,000 between the equipment lease (i.e., lease component) and maintenance services (i.e., non-lease component) on a relative standalone selling price basis as follows:

Component	Standalone Price	Allocation of Fixed Payment	Allocation of Variable Payment	Total Allocation
Equipment lease	$ 1,350,000	$ 870,968[(a)]	$ 43,548[(c)]	$ 914,516
Maintenance	200,000	129,032[(b)]	6,452[(d)]	135,484
	$ 1,550,000	$ 1,000,000	$ 50,000	$ 1,050,000

(a) (1,350,000/1,550,000) X 1,000,000

(b) (200,000/1,550,000) X1,000,000

(c) (1,350,000/1,550,000) X 50,000

(d) (200,000/1,550,000) X 50,000

Variable payments not included as consideration in the contract

Variable payments that do not depend on an index or rate (e.g., performance- or usage-based payments) that relate to the lease component, even partially, are **excluded** from the consideration in the contract. For example, ASC 842-10-55-152 states that if the quality and condition of the underlying leased asset substantively affects whether a lessor receives potential variable payments, such variable payments are not solely related to the non-lease component (i.e., the potential variable payments are related to the lease component, even partially) and are excluded from the consideration in the contract. However, determining whether variable payments relate to the lease component, even partially, may require significant judgment in many cases.

If the terms of a variable payment amount other than those in ASC 842-10-15-35 (refer to section 1.4.3.1, *Determining the consideration in the contract*) relate to the lease component, even partially, lessors recognize those payments as income in profit or loss in the period when the changes in facts and circumstances on which the variable payments are based occur (i.e., when and if the variable payments are earned) and allocate that income between lease and non-lease components on the same basis as the initial allocation of the consideration in the contract or on the same basis as the most recent reallocation if the contract was previously modified (ASC 842-10-15-40 and 842-10-55-152). In such circumstances, revenue is recognized for the non-lease component only when the associated lease-related revenue is earned.

Illustration 7 — Allocating the consideration in the contract: variable payments that relate to the lease component even partially

Entity A (lessee) and Entity B (lessor) enter into a three-year lease of retail space in a mall that includes common area maintenance throughout the lease term. Entity A agrees to pay a fixed payment of $100,000 per year and variable payments based on a percentage of sales. Entity B concludes that variable payments relate, at least partially, to the lease component and, therefore, Entity B measures the consideration in the contract at $300,000, which excludes the variable payments. Entity B allocates the consideration in the contract between the lease and maintenance services on the basis of relative standalone selling prices of each component, which, for purposes of this example, are $350,000 and $50,000.

Component	Standalone Price	Allocation	Calculation
Retail lease	$ 350,000	$ 262,500	($350,000/400,000) X 300,000
Maintenance	50,000	37,500	($50,000/400,000) X 300,000
	$ 400,000	$ 300,000	

Entity B subsequently recognizes income related to the variable payments based on a percentage of sales when they are earned and allocates that income between the lease and maintenance services on the same basis as the initial allocation of consideration in the contract or on the same basis as the most recent reallocation if the contract was previously modified.

1.4.4.4 Initial direct costs or contract costs

A lessor allocates any capitalized costs (e.g., initial direct costs or contract costs capitalized in accordance with ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers,* to the separate lease components or non-lease components to which those costs relate.

1.4.4.5 Reassessment — determining and allocating the consideration in the contract

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-41

A lessor shall remeasure and reallocate the remaining consideration in the contract when there is a contract modification that is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.

842-10-15-42

If the consideration in the contract changes, a lessor shall allocate those changes in accordance with the requirements in paragraphs 606-10-32-42 through 32-45.

Lessors will remeasure and reallocate the remaining consideration in the contract upon a contract modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that is not accounted for as a separate contract. Refer to section 5.6, *Lease modifications*.

Lessors will apply the guidance in ASC 606-10-32-42 through 32-45 to allocate changes in the consideration in the contract that are not the result of a modification (e.g., the consideration in the contract changes if a lessor concludes in applying ASC 606 that there is a change in the amount it will receive for variable payments related to services that are not leases). That guidance generally requires lessors to allocate the subsequent changes between lease and non-lease components on the same basis as the initial allocation of the consideration in the contract (or on the same basis as the most recent reallocation if the contract was previously modified). Refer to section 6.5, *Changes in transaction price after contract inception*, of our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606),* for a discussion of changes in transaction prices after contract inception. Although not considered a change in the consideration in the contract, lessors recognize changes to index- and rate-based variable payments in profit or loss in the period of the change and allocate those changes between lease and non-lease components on the same basis as the initial allocation (or most re-allocation) of consideration in the contract.

Refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements*.

1.4.5 Examples — identifying and separating components of a contract and determining and allocating the consideration in the contract

ASC 842 provides the following examples to illustrate how lessees and lessors identify and separate lease and non-lease components of a contract and determine and allocate the consideration in the contract.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementations Guidance and Illustrations

Example 11 — Allocation of Consideration to Lease and Nonlease Components of a Contract

Case A — Allocation of Consideration in the Contract

842-10-55-132

Lessor leases a bulldozer, a truck, and a crane to Lessee to be used in Lessee's construction operations for three years. Lessor also agrees to maintain each piece of equipment throughout the lease term. The total consideration in the contract is $600,000, payable in $200,000 annual installments.

842-10-55-133

Lessee and Lessor both conclude that the leases of the bulldozer, the truck, and the crane are each separate lease components because both of the criteria in paragraph 842-10-15-28 are met. That is:

a. The criterion in paragraph 842-10-15-28(a) is met because Lessee can benefit from each of the three pieces of equipment on its own or together with other readily available resources (for example, Lessee could readily lease or purchase an alternative truck or crane to use with the bulldozer).

b. The criterion in paragraph 842-10-15-28(b) is met because, despite the fact that Lessee is leasing all three machines for one purpose (that is, to engage in construction operations), the machines are not highly dependent on or highly interrelated with each other. The machines are not, in effect, inputs to a combined single item for which Lessee is contracting. Lessor can fulfill each of its obligations to lease one of the underlying assets independently of its fulfillment of the other lease obligations, and Lessee's ability to derive benefit from the lease of each piece of equipment is not significantly affected by its decision to lease or not lease the other equipment from Lessor.

842-10-55-134

In accordance with paragraph 842-10-15-31, Lessee and Lessor will account for the nonlease maintenance services components separate from the three separate lease components (unless Lessee elects the practical expedient — see Case B [paragraphs 842-10-55-138 through 55-140]). In accordance with the identifying performance obligations guidance in paragraphs 606-10-25-19 through 25-22, Lessor further concludes that its maintenance services for each piece of leased equipment are distinct and therefore separate performance obligations, resulting in the conclusion that there are three separate lease components and three separate nonlease components (that is, three maintenance service performance obligations).

842-10-55-135

Lessor allocates the consideration in the contract to the separate lease components and nonlease components by applying the guidance in paragraphs 606-10-32-28 through 32-41. The consideration allocated to each separate lease component constitutes the lease payments for purposes of Lessor's accounting for those components.

842-10-55-136

Lessee allocates the consideration in the contract to the separate lease and nonlease components. Several suppliers provide maintenance services that relate to similar equipment such that there are observable standalone prices for the maintenance services for each piece of leased equipment. In addition, even though Lessor, who is the manufacturer of the equipment, requires that all leases of its equipment include maintenance services, Lessee is able to establish observable standalone prices for the three lease components on the basis of the price other lessors lease similar equipment on a standalone basis. The standalone prices for the separate lease and nonlease components are as follows.

	Lease	Maintenance
Bulldozer	$ 200,000	$ 50,000
Truck	120,000	20,000
Crane	240,000	70,000
	$ 560,000	$ 140,000

842-10-55-137

Lessee first allocates the consideration in the contract ($600,000) to the lease and nonlease components on a relative basis, utilizing the observable standalone prices determined in paragraph 842-10-55-136. Lessee then accounts for each separate lease component in accordance with

Subtopic 842-20, treating the allocated consideration as the lease payments for each lease component. The nonlease components are accounted for by Lessee in accordance with other Topics. The allocation of the consideration to the lease and nonlease components is as follows.

	Lease	Maintenance
Bulldozer	$ 171,429	$ 42,857
Truck	102,857	17,143
Crane	205,714	60,000
	$ 480,000	$ 120,000

The following example from ASC 842 assumes the same facts as Case A above except that the lessee has made an accounting policy election to use the practical expedient to not separate non-lease components from their associated lease components.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementations Guidance and Illustrations

Example 11 — Allocation of Consideration to Lease and Nonlease Components of a Contract

Case B — Lessee Elects Practical Expedient to Not Separate Lease from Nonlease Components

842-10-55-138

Assume the same facts and circumstances as in Case A (paragraphs 842-10-55-132 through 55-137), except that Lessee has made an accounting policy election to use the practical expedient to not separate nonlease from lease components for its leased construction equipment. Consequently, Lessee does not separate the maintenance services from the related lease components but, instead, accounts for the contract as containing only three lease components.

842-10-55-139

Because Lessor regularly leases each piece of equipment bundled together with maintenance services on a standalone basis, there are observable standalone prices for each of the three combined components, each of which includes the lease and the maintenance services. Because each of the three separate lease components includes the lease of the equipment and the related maintenance services, the observable standalone price for each component in this scenario is greater than the observable standalone price for each separate lease component that does not include the maintenance services in Case A.

842-10-55-140

Lessee allocates the consideration in the contract ($600,000) to the three separate lease components on a relative basis utilizing the observable standalone selling price of each separate lease component (inclusive of maintenance services) and then accounts for each separate lease component in accordance with the guidance in Subtopic 842-20, treating the allocated consideration as the lease payments for each separate lease component. The standalone prices for each of the three combined lease components is as follows.

	Standalone Price	Relative Standalone Price
Bulldozer	$ 230,000	$ 215,625
Truck	130,000	121,875
Crane	280,000	262,500
	$ 640,000	$ 600,000

ASC 842 provides the following examples to illustrate how lessees and lessors identify and separate lease and non-lease components of a contract and determine and allocate the consideration in the contract when there are variable payments that relate to the lease component and the non-lease component.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementations Guidance and Illustrations

Example 14 — Determining the Consideration in the Contract — Variable Payments

Case A — Variable Payments That Relate to the Lease Component and the Nonlease Component

842-10-55-150

Lessee and Lessor enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the three-year lease term. Lessee will pay Lessor $100,000 per year plus an additional $7,000 each year that the equipment is operating a minimum number of hours at a specified level of productivity (that is, the equipment is not malfunctioning or inoperable). The potential $7,000 payment each year is variable because the payment depends on the equipment operating a minimum number of hours at a specified level of productivity. The lease is an operating lease.

842-10-55-151

In accordance with paragraph 842-10-15-35, variable payments other than those that depend on an index or a rate are not accounted for as consideration in the contract by Lessee. Therefore, the consideration in the contract to be allocated by Lessee to the equipment lease and the maintenance services at lease commencement includes only the fixed payments of $100,000 each year (or $300,000 in total). Lessee allocates the consideration in the contract to the equipment lease and the maintenance services on the basis of the standalone prices of each, which, for purposes of this example, are $285,000 and $45,000, respectively.

	Standalone Price	Relative Standalone Price
Lease	$ 285,000	$ 259,091
Maintenance	45,000	40,909
	$ 330,000	$ 300,000

Each $100,000 annual fixed payment and each variable payment are allocated to the equipment lease and the maintenance services on the same basis as the initial allocation of the consideration in the contract (that is, 86.4 percent to the equipment lease and 13.6 percent to the maintenance services). Therefore, annual lease expense, excluding variable expense, is $86,364. Lessee recognizes the expense related to the variable payments in accordance with paragraphs 842-20-25-6 and 842-20-55-1 through 55-2.

842-10-55-152

In accordance with paragraphs 842-10-15-39 through 15-40, Lessor also concludes that the potential variable payments should not be accounted for as consideration in the contract. That is because the potential variable payment each year is not solely related to performance of the nonlease maintenance services; the quality and condition of the underlying asset also substantively affect whether Lessor will earn those amounts. Therefore, Lessor's allocation of the consideration in the contract ($300,000) in this Example is the same as Lessee. Lessor, in the same manner as Lessee, also will recognize the income related to the variable payments and allocate that income between the lease and nonlease maintenance services (on the same basis as the initial allocation of the consideration in the contract), when and if earned.

The following example assumes the same facts as Case A above except that the variable payments relate specifically to a non-lease component.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementations Guidance and Illustrations

Example 14 — Determining the Consideration in the Contract — Variable Payments

Case B — Variable Payments That Relate Specifically to a Nonlease Component

842-10-55-153

Assume the same facts and circumstances as in Case A (paragraphs 842-10-55-150 through 55-152), except in this scenario the maintenance services are highly specialized and no entity would expect the equipment to meet the performance metrics without the specialized maintenance services.

842-10-55-154

Lessee would account for the potential variable payments consistent with Case A. The rationale for this accounting also is consistent with that in Case A.

842-10-55-155

In contrast to Case A, Lessor concludes that the variable payments relate specifically to an outcome from Lessor's performance of its maintenance services. Therefore, Lessor evaluates the variable payments in accordance with the variable consideration guidance in paragraphs 606-10-32-5 through 32-13. If Lessor estimates, using the most likely amount method, that it will be entitled to receive the $21,000 in variable payments and that it is probable that including that amount in the transaction price for the maintenance services would not result in a significant revenue reversal when the uncertainty of the performance bonus is resolved, the $21,000 would be included in the consideration in the contract. Because allocating the $21,000 entirely to the maintenance services would not result in an allocation that is consistent with the allocation objective in paragraph 606-10-32-28 (that is, it would result in allocating $61,909 to the maintenance services and the remainder to the equipment lease, which would not reasonably depict the consideration to which Lessor expects to be entitled for each component), the entire consideration in the contract of $321,000 is allocated on a relative standalone price basis as follows.

	Standalone Price	Relative Standalone Price
Lease	$ 285,000	$ 277,227
Maintenance	45,000	43,773
	$ 330,000	$ 321,000

842-10-55-156

The $277,227 allocated to the equipment lease is the lease payment in accounting for the lease in accordance with Subtopic 842-30. Lessor will recognize the consideration in the contract allocated to the maintenance services in accordance with the guidance on the satisfaction of performance obligations in paragraphs 606-10-25-23 through 25-37. If the consideration in the contract changes (for example, because Lessor no longer estimates that it will receive the full $21,000 in potential variable payments), Lessor will allocate the change in the transaction price on the same basis as was initially done.

The following example assumes the same facts as Case B above except that the variable payments relate specifically to a non-lease component.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementations Guidance and Illustrations

Example 14 — Determining the Consideration in the Contract — Variable Payments

Case C — Allocating Variable Payments Entirely to a Nonlease Component

842-10-55-157

Assume the same facts and circumstances as in Case B (paragraphs 842-10-55-153 through 55-156), except that in this scenario all of the following apply:

a. The potential variable payments are $14,000 per year ($42,000 in total), and the annual fixed payments are $93,000 per year ($279,000 in total).

b. While Lessor's estimate of the variable payments to which it will be entitled is $42,000, Lessor concludes that it is not probable that including the full $42,000 in potential variable payments in the consideration in the contract will not result in a significant revenue reversal (that is, the entity applies the constraint on variable consideration in paragraph 606-10-32-11). Lessor concludes that only $28,000 is probable of not resulting in a significant revenue reversal. Therefore, the consideration in the contract is initially $307,000 ($279,000 + $28,000).

842-10-55-158

In contrast to Case B, Lessor concludes that allocating the variable payments entirely to the maintenance services and the fixed payments entirely to the equipment lease is consistent with the allocation objective in paragraph 606-10-32-28. This is because $42,000 (Lessor considers its estimate of the variable payments to which it expects to be entitled exclusive of the constraint on variable consideration in Topic 606 on revenue recognition) and $279,000 approximate the standalone price of the maintenance services ($45,000) and the equipment lease ($285,000), respectively. Because the variable payments are allocated entirely to the maintenance services, if the consideration in the contract changes (for example, because Lessor concludes it is now probable that it will earn the full $42,000 in variable payments), that change is allocated entirely to the maintenance services component in the contract.

1.5 Contract combinations

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-25-19

An entity shall combine two or more **contracts**, at least one of which is or contains a **lease**, entered into at or near the same time with the same counterparty (or related parties) and consider the contracts as a single transaction if any of the following criteria are met:

a. The contracts are negotiated as a package with the same commercial objective(s).

b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

c. The rights to use **underlying assets** conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component in accordance with paragraph 842-10-15-28.

ASC 842 requires that two or more contracts entered into at or near the same time with the same counterparty (or related party) be considered a single contract if at least one of the contracts is or contains a lease and any one of the following criteria is met:

- The contracts are negotiated as a package with the same commercial objective(s).
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
- The rights to use the underlying assets conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component (refer to section 1.4.1, *Identifying and separating lease components of a contract*).

The FASB indicated in the Basis for Conclusions (BC 165) that it developed these criteria to address concerns that separately accounting for multiple contracts may not result in a faithful representation of the combined transaction.

1.6 Lease broker

The difficulty in accounting for lease broker transactions is often determining whether the broker transaction is in substance a lease. In certain leasing transactions, a lease broker acts as an intermediary between the lessor and the lessee. The lease broker fee arrangement can be a relatively simple one where a lump-sum cash payment is paid to the broker at closing (when all or substantially all of the services were rendered, and the broker has no future service commitments or obligations associated with the lease). In certain more complex leasing transactions, lease brokers often assume additional risks, offer additional services and sometimes receive additional benefits and compensation in various forms. Lease broker participation in the terms of the lease may be so extensive that the broker appears to be a lessor or a lessee and not merely an intermediary. As a result, what is intended to be a lease broker transaction may in certain cases be considered a lease. Alternatively, a lease broker may merely serve as an intermediary in substance.

1.7 Acquisition of lease residual values

The following issues related to accounting for the purchase of lease interests or residual values are discussed in ASC 360, *Property, Plant, and Equipment*.

Excerpt from Accounting Standards Codification

Leases — Overall

Derecognition

842-30-40-4

For guidance on the acquisition of the residual value of an **underlying asset** by a third party, see paragraph 360-10-25-2.

Property, Plant, and Equipment — Overall

Recognition

360-10-25-2

This Section provides guidance on how a third-party entity shall account for the following:

a. The acquisition from a lessor of the unconditional right to own and possess, at the end of the lease term, an asset subject to a lease

b. The acquisition of the right to receive all, or a portion, of the proceeds from the sale of a leased asset at the end of the lease term.

360-10-25-3

At the date the rights in the preceding paragraph are acquired, both transactions involve a right to receive, at the end of the lease term, all, or a portion, of any future benefit to be derived from the leased asset and shall be accounted for as the acquisition of an asset. Both transactions are referred to as the acquisition of an interest in the residual value of a leased asset.

360-10-25-4

An interest in the residual value of a leased asset shall be recorded as an asset at the date the right is acquired.

Initial Measurement

360-10-30-3

An interest in the residual value of a leased asset recognized under paragraph 360-10-25-4 shall be measured initially at the amount of cash disbursed, the fair value of other consideration given, and the present value of liabilities assumed.

360-10-30-4

The fair value of the interest in the residual value of the leased asset at the date of the agreement shall be used to measure its cost if that fair value is more clearly evident than the fair value of assets surrendered, services rendered, or liabilities assumed.

Subsequent Measurement

360-10-35-13

The following paragraph provides guidance on how an entity acquiring an interest in the residual value of a leased asset shall account for that asset during the lease term.

360-10-35-14

An entity acquiring an interest in the residual value of any leased asset, irrespective of the classification of the related lease by the lessor, shall not recognize increases to the asset's estimated value over the remaining term of the related lease, and the asset shall be reported at no more than its acquisition cost until sale or disposition. If it is subsequently determined that the fair value of the residual value of a leased asset has declined below the carrying amount of the acquired interest and that decline is other than temporary, the asset shall be written down to fair value, and the amount of the write-down shall be recognized as a loss. That fair value becomes the asset's new carrying amount, and the asset shall not be increased for any subsequent increase in its fair value before its sale or disposition.

The acquisition of the unconditional right to own and possess, at the end of the lease term, an asset subject to a lease or the right to receive all, or a portion, of the proceeds from the sale of a leased asset at the end of the lease are both transactions involving a right to receive all, or a portion, of any future benefit to be derived from the leased asset and should be accounted for as the acquisition of an asset. For the remainder of this section, both transactions are referred to as the acquisition of an interest in the residual value of a leased asset.

An interest in the residual value of a leased asset should be recorded as an asset at the amount of cash disbursed, the fair value of other consideration given and the present value of liabilities assumed at the date the right is acquired. The fair value of the interest in the residual value of the leased asset at the date of the agreement should be used to measure its cost if that fair value is more clearly evident than the fair value of assets surrendered, services rendered or liabilities assumed.

An enterprise acquiring an interest in the residual value of any leased asset, irrespective of the classification of the related lease by the lessor, should not recognize increases to the asset's estimated value over the remaining term of the related lease, and the asset should be reported at no more than its acquisition cost until sale or disposition. If it is subsequently determined that the fair value of the residual value of a leased asset has declined below the carrying amount of the acquired interest and that decline is other than temporary, the asset should be written down to fair value, and the amount of the write-down should be recognized as a loss. That fair value becomes the asset's new carrying amount, and the asset should not be increased for any subsequent increase in its fair value prior to its sale or disposition.

An interest in the residual value of a leased asset acquired by a lease broker for cash, liabilities assumed and the fair value of other consideration given, including services rendered, should be accounted for under this guidance.

1.8 Service concession arrangements

Excerpt from Accounting Standards Codification

Service Concession Arrangements — Overall

Overview and Background

General

853-10-05-1

A service concession arrangement is an arrangement between a grantor and an operating entity for which the terms provide that the operating entity will operate the grantor's infrastructure (for example, airports, roads, bridges, tunnels, prisons, and hospitals) for a specified period of time. The operating entity may also maintain the infrastructure. The infrastructure already may exist or may be constructed by the operating entity during the period of the service concession arrangement. If the infrastructure already exists, the operating entity may be required to provide significant upgrades as part of the arrangement. Service concession arrangements can take many different forms.

853-10-05-2

In a typical service concession arrangement, an operating entity operates and maintains for a period of time the infrastructure of the grantor that will be used to provide a public service. In exchange, the operating entity may receive payments from the grantor to perform those services. Those payments may be paid as the services are performed or over an extended period of time. Additionally, the operating entity may be given a right to charge the public (the third-party users) to use the infrastructure. The arrangement also may contain an unconditional guarantee from the grantor under which the grantor provides a guaranteed minimum payment if the fees collected from the third-party users do not reach a specified minimum threshold. This Topic provides guidance for reporting entities when they enter into a service concession arrangement with a public sector grantor who controls or has the ability to modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide them, and at what price (which could be set within a specified range). The grantor also controls, through ownership, beneficial entitlement, or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement.

A service concession arrangement is an arrangement between a grantor and an operating entity that operates the grantor's infrastructure for a specified period of time. Such arrangements may take various forms. A service concession arrangement within the scope of ASC 853 involves a public-sector entity grantor contracting with an operating entity to provide a public service, and the arrangement meets two additional criteria described in ASC 853-10-15-3 as discussed below. A public-sector entity grantor may be a governmental body (e.g., a municipal government, a state government) or another entity to which a governmental body has delegated responsibility for providing a public service (e.g., a regional airport authority, a municipal transportation authority). Under such arrangements, the operating entity generally operates and maintains the public-sector entity's infrastructure (e.g., a highway, bridge, parking facility, power plant, hospital) that fulfills a public service for a period of time, in exchange for consideration (e.g., payments from the grantor, the right to charge third-party users of the assets). The operating entity may also construct the public-sector entity's infrastructure or upgrade the existing infrastructure.

We believe service concession arrangements within the scope of ASC 853 exist in the US but may be more prevalent in other jurisdictions, particularly in the energy and construction sectors (e.g., entities involved with assets such as power plants or bridges). However, all entities should evaluate each arrangement with a public-sector entity to determine whether the arrangement is in the scope of this guidance. Additionally, entities with equity method investees should also consider the accounting effects of their investees' service concession arrangements, if any.

Excerpt from Accounting Standards Codification

Service Concession Arrangements — Overall

Scope and Scope Exceptions

General

853-10-15-2

The guidance in this Topic applies to the accounting by operating entities of a service concession arrangement under which a public-sector entity grantor enters into a contract with an operating entity to operate the grantor's infrastructure. The operating entity also may provide the construction, upgrading, or maintenance services of the grantor's infrastructure.

The guidance in ASC 853 applies only to the operating entity in a service concession arrangement that involves a public-sector entity grantor (grantor), which has the responsibility to provide a public service and meets the following two conditions:

- The grantor controls or has the ability to modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide them and at what price.
- The grantor controls, through ownership, beneficial entitlement or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement.

Public service

A feature of a service concession arrangement is that an operating entity provides a public service on behalf of a governmental entity. However, ASC 853 does not provide a framework for determining whether an arrangement between a grantor and an operating entity provides a public service or is a normal supplier-customer arrangement between two unrelated parties.

In some circumstances, it may be clear that the operating entity is providing a public service on behalf of a governmental entity (e.g., operating a highway used by the general public). However, judgment may be required when determining the substance of the arrangement.

ASC 853 also does not provide a framework for evaluating whether the grantor controls or has the ability to modify or approve the public services that must be provided, to whom they must be provided and at what price. To be in the scope of ASC 853, we believe the grantor should have the substantive ability to control, modify or approve:

- The public services that the operator must provide,
- To whom those public services must be provided, and
- At what price those public services must be provided.

All three conditions must be met. Therefore, the terms and conditions of each arrangement, including the rights of the operating entity and grantor, should be evaluated carefully. For example, even though the operating entity may have certain managerial or day-to-day decision-making abilities in providing the required services (e.g., constructing, operating and maintaining a toll road), the grantor may retain the unilateral ability to control, modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide them, and at what price.

Importantly, a grantor need only have the ability to control, modify **or** (*emphasis added*) approve each of the conditions above. For example, a grantor may not control each condition in a contract where such conditions are agreed to up front (i.e., agreed to by both parties to the contract). However, the grantor may have to approve any changes, indicating the approval criteria would be met.

When assessing whether the grantor controls or has the ability to set, modify or approve the price of the service provided, the arrangement need not establish a specific price. As described in ASC 853-10-05-2, the price in a service concession arrangement "could be set within a specified range." Such arrangements should be evaluated to determine if the grantor set or approved the initially established price range and if it can also modify or must approve any subsequent price changes outside that range.

Control of the residual interest

The contractual terms of the arrangement will generally specify whether the grantor or the operating entity controls through ownership (or other means) any residual interest in the infrastructure at the end of the term of the arrangement. We believe control of the residual interest is generally evidenced within the contractual arrangements (e.g., an automatic transfer; a substantive option allowing the government to purchase the asset; circumstances when the governmental entity can determine how the asset will be disposed of or transferred at the end of the arrangement).

Accounting for a service concession arrangement

For service concession arrangements that are in the scope of ASC 853, the operating entity should not account for the arrangement as a lease (i.e., in accordance with ASC 842) and should not recognize the infrastructure as property, plant and equipment (i.e., in accordance with ASC 360). Instead, the operating entity should refer to other US GAAP (e.g., ASC 605, ASC 606 following the adoption of ASC 606) to account for the various aspects of a service concession arrangement. The FASB did not specify which aspects of US GAAP should be applied to service concession arrangements within the scope of ASC 853, except to say that service concession arrangements in the scope of both ASC 853 and ASC 980, *Regulated Operations*, should be accounted for using ASC 980 instead of ASC 853. Refer to section 1.8.1, *Service concession arrangements in regulated operations*, for additional information about service concession arrangements that may also be within the scope of ASC 980.

We believe operating entities will generally follow the revenue recognition guidance when accounting for service concession arrangements within the scope of ASC 853. This accounting may be similar to other non-lease service and management contracts where a party manages property or equipment on behalf of the owner. Arrangements not in the scope of ASC 853 should first be evaluated by the operating entity using the criteria in ASC 842 to determine whether lease accounting is appropriate.

The following example is provided to assist with the application of the service concession arrangements scope guidance in ASC 853-10-15-1 through 15-3:

Illustration 8 — Accounting for a service concession arrangement

Assume the following facts:

- Company Q (Company Q or operating entity) enters into an arrangement with the State X Department of Transportation (referred to as the DOT), State X's governmental entity responsible for its public highways.
- Under the terms of the arrangement, Company Q will be required to perform the following services: construct, operate and maintain the DOT's toll highway for a period of 20 years. The arrangement does not contain any renewal periods.
- The DOT will control any residual interest in the highway at the end of the 20-year contractual period.
- The arrangement requires Company Q to operate the toll highway by allowing the public to access and travel upon the constructed highway (i.e., a public service) in exchange for a toll that will be collected from each vehicle. The arrangement does not provide Company Q with any rights to unilaterally change the services that it must provide with the highway (e.g., roadway maintenance, emergency access and services, rest area concessions) or to whom it must provide the services.
- The arrangement initially sets the toll within a specified range, determined by the DOT, of $0.50 to $1.00 per vehicle. Future changes to the toll amount (i.e., price changes outside the specified range) require the DOT's approval.

Evaluation:

The arrangement is a service concession arrangement. The arrangement involves an operating entity (Company Q) contracting with a public-sector entity grantor (the DOT) to provide a public service, and the following two conditions are met:

- The DOT controls or has the ability to modify or approve the services that the operating entity must provide with the toll highway, to whom it must provide them and at what price.
- The DOT controls, through ownership, beneficial entitlement or otherwise, any residual interest in the toll highway at the end of the term of the arrangement.

Because the arrangement meets both criteria above, it is in the scope of ASC 853. Therefore, Company Q should not account for the service concession arrangement as a lease in accordance with ASC 842. Additionally, Company Q should not recognize the highway as its property, plant and equipment in accordance with ASC 360. Instead, Company Q should refer to other US GAAP to account for the aspects of the arrangement (e.g., revenue recognition guidance to account for tolls collected).

1.8.1 Service concession arrangements in regulated operations

Excerpt from Accounting Standards Codification

Service Concession Arrangements — Overall

Scope and Scope Exceptions

General

853-10-15-4

A service concession arrangement that meets the scope criteria in Topic 980 on regulated operations shall apply the guidance in that Topic and not follow the guidance in this Topic.

A common characteristic between regulated operations and service concession arrangements is that the grantor (i.e., the regulator in the case of regulated operations) determines the price that can be charged for the service. However, in regulated operations, the operating entity often controls the residual interest in the infrastructure (i.e., the infrastructure is often owned by the operating entity). Therefore, such arrangements in regulated operations generally would not be in the scope of ASC 853. In circumstances when the arrangement would otherwise be in the scope of both ASC 853 and ASC 980 (e.g., an arrangement with an operating entity where the grantor is a state-owned utility that retains control over any residual interest in the infrastructure), the FASB specified that the service concession arrangement should be accounted for using the guidance in ASC 980 (i.e., the guidance in ASC 853 should not be applied to such arrangements). See ASC 980 for additional information about determining whether an arrangement is in the scope of that standard and for guidance about the recognition and measurement of such arrangements.

2 Key concepts

Lessees and lessors generally apply the same key concepts for purposes of identifying, classifying, recognizing and measuring lease contracts.

2.1 Inception of a contract

Excerpt from Accounting Standards Codification

Leases — Overall

Scope and Scope Exceptions

842-10-15-2

At inception of a **contract**, an entity shall determine whether that contract is or contains a **lease**.

ASC 842-10-15-2 requires customers and suppliers to determine, at contract inception, whether a contract is a lease or contains a lease. Entities should consider other US GAAP to determine how to account for and disclose the existence of rights or obligations created between the inception of a contract that is or contains a lease and the commencement date of the lease (e.g., disclosures required by ASC 440, *Commitments*, ASC 460, *Guarantees*).

2.2 Commencement date of the lease

Excerpt from Accounting Standards Codification

Master Glossary

Commencement Date of the Lease (Commencement Date)

The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**. See paragraphs 842-10-55-19 through 55-21 for implementation guidance on the commencement date.

Underlying Asset

An asset that is the subject of a **lease** for which a right to use that asset has been conveyed to a **lessee**. The underlying asset could be a physically distinct portion of a single asset.

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-19

In some **lease** arrangements, the **lessor** may make the **underlying asset** available for use by the **lessee** (for example, the lessee may take possession of or be given control over the use of the underlying asset) before it begins operations or makes **lease payments** under the terms of the lease. During this period, the lessee has the right to use the underlying asset and does so for the purpose of constructing a lessee asset (for example, leasehold improvements).

842-10-55-20

The **contract** may require the lessee to make lease payments only after construction is completed and the lessee begins operations. Alternatively, some contracts require the lessee to make lease payments when it takes possession of or is given control over the use of the underlying asset. The timing of when lease payments begin under the contract does not affect the **commencement date** of the lease.

The commencement date is the date on which the lessor makes an underlying asset (i.e., the property, plant or equipment that is subject to the lease) available for use by the lessee. In some cases, the commencement date of the lease may be before the date stipulated in the lease agreement (e.g., the date rent becomes due and payable). This often occurs when the leased space is modified by the lessee prior to commencing operations in the leased space (e.g., during the period a lessee uses the leased space to construct its own leasehold improvements). In making the assessment of lease commencement, it will often be necessary to distinguish lessee versus lessor assets (refer to section 4.7.1, *Which party owns the improvements*).

If a lessee takes possession of, or is given control over, the use of the underlying asset before it begins operations or making lease payments under the terms of the lease, the lease term has commenced even if the lessee is not required to pay rent or the lease arrangement states the lease commencement date is a later date. As a result, the straight-line rent computation for operating leases must include the deemed rent holiday period (refer to section 4.2.2, *Subsequent measurement,* for a discussion of the subsequent measurement of an operating lease by a lessee and section 5.4.1, *Time pattern of use of property in an operating lease*, for a discussion of recognition of revenue for an operating lease by a lessor). The timing of when lease payments begin under the contract does not affect the commencement date of the lease. For example, a lessee (except lessees applying the short-term lease exception discussed in section 4.1.1, *Short-term leases*) initially recognizes a lease liability and related right-of-use asset on the commencement date, and a lessor (for direct financing and most sales-type leases) initially recognizes its net investment in the lease on the commencement date.

Illustration 9 — Determining the lease commencement date

Assume that Entity A leases office space from Entity B, and both parties execute the lease on 1 December 20X6. Entity B makes the space available for use by Entity A on 1 February 20X7 so that Entity A can begin to construct leasehold improvements. On 1 June 20X7, following completion of construction of the leasehold improvements, Entity A begins to use the office space for its operations and makes its first rental payment to Entity B.

Analysis: The lease commencement date is 1 February 20X7, the date on which Entity B made the underlying asset available for use by Entity A. On the commencement date (i.e., 1 February 20X7), the lessee would generally recognize a right-of-use asset and a lease liability (refer to section 4, *Lessee accounting*) and the lessor (for direct financing and most sales-type leases) recognizes its net investment in the lease.

2.2.1 Lease commencement date for master lease agreements

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-17

Under a master **lease** agreement, the **lessee** may gain control over the use of additional **underlying assets** during the term of the agreement. If the agreement specifies a minimum number of units or dollar value of equipment, the lessee obtaining control over the use of those additional underlying assets is not a **lease modification**. Rather, the entity (whether a lessee or a **lessor**) applies the guidance in paragraphs 842-10-15-28 through 15-42 when identifying the separate lease components and allocating the **consideration in the contract** to those components. Paragraph 842-10-55-22 explains that a master lease agreement may, therefore, result in multiple **commencement dates**.

842-10-55-22

There may be multiple **commencement dates** resulting from a master **lease** agreement. That is because a master lease agreement may cover a significant number of **underlying assets**, each of which are made available for use by the **lessee** on different dates. Although a master lease agreement may specify that the lessee must take a minimum number of units or dollar value of equipment, there will be multiple commencement dates unless all of the underlying assets subject to that minimum are made available for use by the lessee on the same date.

A master lease agreement is a lease under which a lessee may gain control over the use of additional underlying assets during the term of the agreement. In certain cases, a master lease agreement specifies minimum and maximum equipment dollars or quantities that can be required to be leased. If the agreement specifies a minimum number of units or dollar value of equipment, the lessee obtaining control over the use of those additional underlying assets is not a lease modification.

There will be multiple commencement dates resulting from a master lease agreement unless all of the underlying assets are made available for use by the lessee on the same date (refer to section 1.4.1, *Identifying and separating lease components of a contract*, for discussion of when multiple assets may be accounted for as a single lease component). Entities would determine the commencement date for each underlying asset subject to a master lease agreement based on the date each underlying asset is made available for use by a lessee (refer to section 2.2, *Commencement date of the lease*).

2.3 Lease term and purchase options

2.3.1 Lease term

Excerpt from Accounting Standards Codification

Master Glossary

Lease Term

The noncancellable period for which a **lessee** has the right to use an **underlying asset**, together with all of the following:

a. Periods covered by an option to extend the **lease** if the lessee is reasonably certain to exercise that option

b. Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option

c. Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the **lessor**.

Leases — Overall

Initial Measurement

842-10-30-1

An entity shall determine the **lease term** as the noncancellable period of the **lease**, together with all of the following:

a. Periods covered by an option to extend the lease if the **lessee** is reasonably certain to exercise that option

b. Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option

c. Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the **lessor**.

842-10-30-2

At the **commencement date**, an entity shall include the periods described in paragraph 842-10-30-1 in the lease term having considered all relevant factors that create an economic incentive for the lessee (that is, **contract**-based, asset-based, entity-based, and market-based factors). Those factors shall be considered together, and the existence of any one factor does not necessarily signify that a lessee is reasonably certain to exercise or not to exercise an option.

Implementation Guidance and Illustrations

842-10-55-25

The lease term begins at the **commencement date** and includes any rent-free periods provided to the lessee by the lessor.

842-10-55-26

At the **commencement date**, an entity assesses whether the **lessee** is reasonably certain to exercise or not to exercise an option by considering all economic factors relevant to that assessment—contract-based, asset-based, market-based, and entity-based factors. An entity's assessment often will require the consideration of a combination of those factors because they are interrelated. Examples of economic factors to consider include, but are not limited to, any of the following:

a. Contractual terms and conditions for the optional periods compared with current market rates, such as:
   1. The amount of **lease payments** in any optional period
   2. The amount of any **variable lease payments** or other contingent payments, such as payments under termination penalties and **residual value guarantees**
   3. The terms and conditions of any options that are exercisable after initial optional periods (for example, the terms and conditions of a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).

b. Significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the **lease** or to purchase the **underlying asset** becomes exercisable.

c. Costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.

d. The importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset.

The lease term begins at the lease commencement date and is determined on that date based on the noncancelable term of the lease, together with all of the following:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain **not** to exercise that option
- Periods covered by an option to extend (or not terminate) the lease in which the exercise of the option is controlled by the lessor

The FASB indicated in the Basis for Conclusions (BC 195) that the phrase "reasonably certain," which is used in International Accounting Standard 17 and is generally interpreted as a high threshold, has the same meaning as the phrase "reasonably assured" that is used in ASC 840. Therefore, the FASB does not anticipate a change in practice.

Refer to section 2.3.5.2, *The effect of a sublease on the lease term*, for discussion of how a sublease is considered in evaluating the term of a head lease.

2.3.2 Purchase options

Excerpt from Accounting Standards Codification

Leases — Overall

Initial Measurement

842-10-30-3

At the commencement date, an entity shall assess an option to purchase the **underlying asset** on the same basis as an option to extend or not to terminate a lease, as described in paragraph 842-10-30-2.

Purchase options should be assessed in the same way as options to extend the lease term or terminate the lease. The FASB indicated in the Basis for Conclusions (BC 218) that an option to purchase an underlying asset is economically similar to an option to extend the lease term for the remaining economic life of the underlying asset. When a lease contains a purchase option and the lessee is reasonably certain to exercise that option, the lease is classified as a finance lease by a lessee and a sales-type lease by a lessor. Refer to section 3.1, *Criteria for lease classification — lessees*, or section 3.2, *Criteria for lease classification — lessors*.

2.3.3 Cancellable leases

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-23

An entity should determine the noncancellable period of a **lease** when determining the **lease term**. When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a contract and determine the period for which the **contract** is enforceable. A lease is no longer enforceable when both the **lessee** and the **lessor** each have the right to terminate the lease without permission from the other party with no more than an insignificant **penalty**.

842-10-55-24

If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term, as described in paragraph 842-10-30-1. If only a lessor has the right to terminate a lease, the noncancellable period of the lease includes the period covered by the option to terminate the lease.

ASC 842 applies to contracts that are referred to as "cancellable," "month-to-month," "at-will," "evergreen," "perpetual" or "rolling" if they create enforceable rights and obligations. An arrangement is not enforceable if both the lessee and the lessor each have the right to terminate the lease without permission from the other party and with no more than an insignificant penalty.

Any noncancelable periods (by the lessee and the lessor) in contracts that meet the definition of a lease are considered part of the lease term. If only a lessor has the right to terminate a lease, the period covered by the option to terminate the lease is included in the noncancelable period of the lease. The likelihood of the lessor exercising the termination option is not considered in evaluating the potential impact on the lease term. If only a lessee has the right to terminate a lease, that right is a termination option that is considered when determining the lease term.

Illustration 10 — Cancellable leases

Scenario A

A lease has an initial noncancelable period of one year and an extension for an additional year if both the lessee and the lessor agree. There is no penalty if the lessee and the lessor do not agree to extend the term.

Analysis: The initial one-year noncancelable period meets the definition of a contract because it creates enforceable rights and obligations. However, the one-year extension period does not meet the definition of a contract because both the lessee and the lessor could unilaterally elect to not extend the arrangement without penalty.

Scenario B

A lease has an initial period of five years but can be terminated at the end of the third year at the option of the lessor. The lessee's consent is not required for the termination option to be exercised.

Analysis: The initial five-year noncancelable period meets the definition of a contract because it creates enforceable rights and obligations that can only be terminated by the lessor.

2.3.4 Penalty

Excerpt from Accounting Standards Codification

Master Glossary

Penalty

Any requirement that is imposed or can be imposed on the **lessee** by the **lease** agreement or by factors outside the lease agreement to do any of the following:

a. Disburse cash

b. Incur or assume a liability

c. Perform services

d. Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider in determining whether an economic detriment may be incurred include, but are not limited to, all of the following:

   1. The uniqueness of purpose or location of the **underlying asset**
   2. The availability of a comparable replacement asset
   3. The relative importance or significance of the underlying asset to the continuation of the lessee's line of business or service to its customers
   4. The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the underlying asset
   5. Adverse tax consequences
   6. The ability or willingness of the lessee to bear the cost associated with relocation or replacement of the underlying asset at market rental rates or to tolerate other parties using the underlying asset.

A penalty is any requirement that is imposed or can be imposed on the lessee by the lease agreement or factors outside the lease agreement to distribute cash, incur or assume a liability, perform services, surrender or transfer an asset (or rights to an asset), to forgo an economic benefit or suffer an economic detriment.

A penalty may affect the assessment of lease term (refer to section 2.3.1, *Lease term*), purchase options and lease payments. As described in section 2.3.5.1, *Renewal penalty*, a penalty may be sufficiently large to make the exercise of a renewal option reasonably certain at lease commencement. Similarly, the existence of a penalty can cause the exercise of a purchase option to be reasonably certain. In instances where a penalty is not sufficiently large, in and of itself, to make a renewal or purchase option reasonably certain of exercise at lease commencement, the penalty (if payable to or on behalf of the lessor) is included in lease payments. For example, if a lease includes a penalty payable to the lessor for failure to renew, and the lessee determines that the penalty and other factors indicate that the renewal of the lease is not reasonably certain at commencement of the lease, the penalty should be included as a lease payment.

It is important to note that a penalty is not solely a payment to a lessor but may be a payment to a third party or a loss of future earnings by the lessee. For example, if a lessee leases equipment that is used to generate operating income and alternative equipment is not available, the loss of the ability to generate operating income might represent a penalty associated with terminating the lease. In addition, if a lessee can generate operating income by subleasing an underlying asset, the loss of the ability to generate sublease income might also represent a penalty associated with terminating the lease (refer to section 2.3.5.2, *The effect of a sublease on the lease term*). However, only penalties payable to or on behalf of the lessor are potentially lease payments (refer to section 2.4, *Lease payments,* for a discussion of items included in lease payments).

2.3.5 Evaluating lease term and purchase options

When evaluating whether a lessee is reasonably certain to exercise an option to renew the lease, not terminate the lease or to purchase the underlying asset, lessees and lessors are required to assess all relevant factors that create an economic incentive for the lessee to exercise lease renewal, termination or purchase options (i.e., contract-, asset-, entity- and market-based factors), including:

- The existence of a purchase option or lease renewal option and its pricing (e.g., fixed rates, discounted rates, "bargain" rates)
- The existence of a termination option, the amount of payments for termination or nonrenewal and the pricing of the continuing lease
- Contingent amounts due under residual value guarantees and other variable lease payments
- Costs of returning the asset in a contractually specified condition or to a contractually specified location
- Significant customization (e.g., leasehold improvements), installation costs or relocation costs
- The importance of the leased asset to the lessee's operations, considering the potential business disruptions from not having the leased asset and the availability of a replacement asset
- A sublease term that extends beyond the noncancelable period of the head lease (e.g., a head lease that has a noncancelable term of five years with a two-year renewal option, and the sublease term is for seven years)

The longer the period from commencement of the lease (refer to section 2.2, *Commencement date of the lease*) to the exercise date of an option, the more difficult it will be, in certain cases, to determine whether the exercise of the option is reasonably certain. The difficulty arises from several factors. For example, a lessee's estimates of its future needs for the leased asset become less precise the further into the future the forecast goes. Also, the future fair value of certain assets, such as those involving technology, is more difficult to predict than the future fair value of a relatively stable asset, such as a fully leased commercial office building located in a prime area.

The further into the future the option date is, the lower the option price must be in relation to the estimated future fair value to conclude that the lessee is reasonably certain to exercise the option simply based on option pricing. The difference between the option price and the estimated future fair value of an asset that is subject to significant changes in value also should be greater than would be the case for an asset with a relatively stable value.

An artificially short lease term (e.g., a lease of a corporate headquarters, distribution facility, manufacturing plant or other key property with a four-year lease term) may effectively create a significant economic incentive for the lessee to exercise a purchase or renewal option. This may be evidenced by the significance of the underlying asset to the lessee's continuing operations and whether, absent the option, the lessee would have entered into such a lease.

Similarly, the significance of the underlying asset to the lessee's operations may create a significant economic disincentive that affects a lessee's decisions about whether it is reasonably certain to exercise a purchase or renewal option. For example, a company that leases a specialized facility (e.g., manufacturing plant, distribution facility, corporate headquarters) and doesn't exercise a purchase or renewal option would face a significant economic penalty if an alternative facility is not readily available. This would potentially have an adverse effect on the company while it searched for a replacement asset.

Illustration 11 — Determining the lease term

Scenario A

Assume that Entity P enters into a lease for equipment that includes a noncancelable term of four years and a two-year fixed-price renewal option with future lease payments that are intended to approximate market rates at lease inception. There are no termination penalties or other factors indicating that Entity P is reasonably certain to exercise the renewal option.

Analysis: At the lease commencement date, the lease term is four years.

Scenario B

Assume that Entity Q enters into a lease for a building that includes a noncancelable term of four years and a two-year, fixed-price renewal option with future lease payments that are intended to approximate market rates at lease inception. Before it takes possession of the building, Entity Q pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of four years, and that value can only be realized through continued occupancy of the leased property.

Analysis: At lease commencement, Entity Q determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial noncancelable period. At lease commencement, Entity Q concludes that the lease term is six years.

2.3.5.1 Renewal penalty

When a penalty for failure to renew a lease at the end of a lease term (prior to renewal term) is so significant that it is reasonably certain at the commencement date (refer to section 2.2, *Commencement date of the lease*) that the lease will be renewed, the renewal period is included in the lease term for purposes of determining a lease's classification.

The cancellation penalty must be sufficiently large to represent a significant economic deterrent to cancellation. Determining whether this is the case requires judgment about the particular circumstances. Other factors also should be considered, such as the expected availability of other assets to serve the lessee's needs, the practicality of surrendering the leased property and the attractiveness of the ongoing rental price.

2.3.5.2 The effect of a sublease on the lease term

In situations where a lessee grants (or intends to grant) a sublessee an initial lease term or renewal rights extending beyond the initial term of the lessee's head lease arrangement, the head lessee would consider any penalty (refer to section 2.3.4, *Penalty*) created by failure to renew the head lease as well as all other contract, asset and market-based factors that could potentially impact the head lease in evaluating whether is it reasonably certain to exercise options to extend or terminate the lease or purchase the underlying asset, which includes entering into a sublease (refer to section 2.3.5, *Evaluating lease term and purchase options*, and section 2.3.6, *Reassessment of the lease term and purchase options*).

When the lease term (including a renewal provision that the sublessee is reasonably certain to exercise) on the sublease extends longer than the lease term on the head lease, the lessee would revise its head lease term by assuming it is reasonably certain to exercise the renewal option on the head lease to be at least as long as the term on the sublease. If the lease term (including a renewal provision that the lessee is reasonably certain to exercise) on the sublease is shorter than the lease term on the head lease, the lessee may, after considering any penalties and all other contract, asset and market-based factors, conclude that the renewal provision on the head lease is not reasonably certain of exercise. That is, the existence of the renewal provision in the sublease, in and of itself, does not automatically result in the lessee assuming the exercise of the renewal options in the head lease are reasonably certain of exercise. The FASB staff, through a FASB Technical Inquiry, agreed with this view.

Illustration 12 — Evaluating a lessee's head lease term when a sublease exists

Assume Entity A leases land (the head lease) for an initial five-year term followed by four successive five-year renewal options. Entity A immediately constructs a radio tower on the land and enters into a lease (as sublessor) with Radio Station B for an initial term of 10 years followed by three successive five-year renewals at Radio Station B's option. Entity A concludes Radio Station B is reasonably certain to exercise the first of its five-year renewal options based on consideration of all contract, asset and market-based factors, resulting in a total lease term on the sublease of 15 years.

Analysis: The lease term used by Entity A in its accounting for the head lease would be at least 15 years (i.e., the noncancelable term of the sublease plus the five-year renewal period that Entity A has concluded Radio Station B is reasonably certain to exercise). If Radio Station B exercises its extension options beyond the 15-year lease term, Entity A would reassess the lease term consistent with the guidance in paragraph 842-10-55-28.

2.3.5.3 Guarantee of residual value at a point in time prior to expiration

Certain lease agreements enable a lessee to terminate the lease early, but such a termination results in the lessee guaranteeing the residual value of the underlying asset at the date of early termination. However, if the lease runs through to its full term, the lessee does not guarantee the leased asset's residual value. In such lease agreements, an assessment of the guaranteed residual value is required to determine whether it provides a significant incentive for the lessee to continue the lease for the full term. In certain cases, the guarantee of a residual value at a point in time prior to the end of the lease term may be considered an option to terminate the lease for purposes of determining lease term and lease payments (refer to section 2.4, *Lease payments*).

Illustration 13 — Guarantee of residual value upon early termination

Assume a lessee guarantees to a lessor that if the lessee terminates a five-year lease at the end of three years, the residual value of the underlying asset at the end of three years will not be less than $3,000.

Analysis: The lessee and lessor would evaluate the $3,000 residual value guarantee, in light of other factors, to determine whether it serves as a penalty such that the lessee is reasonably certain to not exercise its termination option due to the existence of the guarantee. If the lessee is reasonably certain to not exercise its termination option, the lease term would be five years.

Refer to section 2.4.6, *Amounts it is probable that a lessee will owe under residual value guarantees — lessees only*, for further discussion of evaluating residual value guarantees.

2.3.5.4 Fiscal funding clause

Excerpt from Accounting Standards Codification

Fiscal Funding Clause

A provision by which the lease is cancellable if the legislature or other funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the lease agreement.

Leases — Overall

Lease Term and Purchase Options

Fiscal Funding Clauses

842-10-55-27

The existence of a **fiscal funding clause** in a **lease** agreement requires an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If it is more than **remote** that the fiscal funding clause will be exercised, the **lease term** should include only those periods for which funding is reasonably certain.

A fiscal funding clause is commonly found in a lease agreement in which the lessee is a governmental unit. A fiscal funding clause generally provides that the lease is cancelable if the legislature or other funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the lease agreement.

The existence of a fiscal funding clause in a lease agreement would necessitate an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If the likelihood of exercise of the fiscal funding clause is assessed as being remote (i.e., the chance of occurring is slight), a lease agreement containing such a clause would be considered a noncancelable lease. If the chance of exercise is assessed as being more than remote, the lease term should include only those periods for which the funding is reasonably certain. Refer to section 2.3.3, *Cancellable leases*.

2.3.6 Reassessment of the lease term and purchase options

2.3.6.1 Lessees

Excerpt from Accounting Standards Codification

Leases — Overall

Subsequent Measurement

842-10-35-1

A **lessee** shall reassess the **lease term** or a lessee option to purchase the **underlying asset** only if and at the point in time that any of the following occurs:

a. There is a significant event or a significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the **lease** or to purchase the underlying asset.

b. There is an event that is written into the **contract** that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease.

c. The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so.

d. The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.

Implementation Guidance and Illustrations

842-10-55-28

Examples of significant events or significant changes in circumstances that a **lessee** should consider in accordance with paragraph 842-10-35-1 include, but are not limited to, the following:

a. Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable

b. Making significant modifications or customizations to the **underlying asset**

c. Making a business decision that is directly relevant to the lessee's ability to exercise or not to exercise an option (for example, extending the **lease** of a complementary asset or disposing of an alternative asset)

d. Subleasing the underlying asset for a period beyond the exercise date of the option.

842-10-55-29

A change in market-based factors (such as market rates to lease or purchase a comparable asset) should not, in isolation, trigger reassessment of the **lease term** or a lessee option to purchase the underlying asset.

After lease commencement (refer to section 2.2, *Commencement date of the lease*), ASC 842 requires lessees to monitor leases for significant changes that could trigger a change in the lease term. Lessees are required to reassess the lease term (i.e., the likelihood of exercising a renewal or termination option) or whether it is reasonably certain that they will exercise an option to purchase the underlying asset at the point in time when any of the following occurs:

Event	Description
Significant event or change in circumstance	▸ There is a significant event or significant change in circumstances **within the lessee's control** that directly affects whether the lessee is reasonably certain to (1) extend the lease, (2) not terminate the lease or (3) purchase the underlying asset.
Contractual event	▸ There is an event that is written into the contract that obliges the lessee to exercise or not to exercise an option to extend or terminate the lease.
Option exercised	▸ The lessee elects to exercise an option even though it had previously determined that it was not reasonably certain to do so.
Option not exercised	▸ The lessee elects not to exercise an option even though it had previously determined that it was reasonably certain to do so.

Examples of significant events or significant changes in circumstances **within the lessee's control** include:

- Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable
- Making significant modifications or customizations to the underlying asset
- Making a business decision that is directly relevant to the lessee's ability to exercise or not exercise an option (e.g., extending the lease of a complementary asset or disposing of an alternative asset)
- Subleasing the underlying asset for a period beyond the exercise date of the option

Changes in market-based factors (e.g., a change in market rates to lease or purchase a comparable asset) are not within the lessee's control, and they therefore don't trigger a reassessment by themselves.

ASC 842-10-25-1 requires a lessee to reassess lease classification when there is a change in its assessment of either the lease term or whether it is reasonably certain to exercise an option to purchase the underlying asset. Refer to section 3.5, *Reassessment of lease classification*.

Additionally, if there is a change in a lessee's assessment of either the lease term or whether it is reasonably certain to exercise an option to purchase the underlying asset, a lessee should remeasure the lease liability, using revised inputs (e.g., discount rate and its allocation of contract consideration, discussed in section 2.5, *Discount rates,* and section 1.4.3.2, *Allocating the consideration in the contract — lessees,* respectively) at the reassessment date, and adjust the right-of-use asset. However, if the right-of-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss. Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*.

Refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements.*

2.3.6.2 Lessors

Excerpt from Accounting Standards Codification

Leases — Overall

Subsequent Measurement

842-10-35-3

A **lessor** shall not reassess the lease term or a lessee option to purchase the underlying asset unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset, the lessor shall account for the exercise of that option in the same manner as a **lease modification**.

A lessor does not reassess the lease term or a lessee's option to purchase the underlying asset unless the lease is modified (i.e., the terms and conditions of the contract are changed in a way that results in a change in the scope of the lease or the consideration) and the modified lease is not accounted for as a separate contract. Additionally, ASC 842-10-35-3 requires a lessor to account for a lessee's exercise of an option to extend or terminate the lease or purchase the underlying asset in the same manner as a lease modification. Refer to section 5.6, *Lease modifications*.

We believe that the exercise of an option to extend or terminate the lease or purchase the underlying asset should be accounted for in the same manner as a lease modification only when the exercise of the option is inconsistent with the lessor's assumption about whether the lessee will exercise the option. For example, if a lessor included an optional period to extend the lease in the lease term because it concluded that the lessee is reasonably certain to exercise that option, we do not believe that the exercise of the option should be accounted for as a lease modification.

Refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements*.

2.4 Lease payments

Excerpt from Accounting Standards Codification

Master Glossary

Lease Payments

See paragraph 842-10-30-5 for what constitutes lease payments from the perspective of a **lessee** and a **lessor**.

Variable Lease Payments

Payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** that vary because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

Probable (second definition)

The future event or events are likely to occur.

Residual Value Guarantee

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.

Leases — Overall

Initial Measurement

842-10-30-5

At the **commencement date**, the **lease payments** shall consist of the following payments relating to the use of the **underlying asset** during the **lease term**:

a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the **lessee** (see paragraphs 842-10-55-30 through 55-31).

b. **Variable lease payments** that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.

c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).

d. Payments for **penalties** for terminating the **lease** if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.

e. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the **fair value** of the underlying asset for purposes of applying paragraph 842-10-25-2(d).

f. For a lessee only, amounts **probable** of being owed by the lessee under **residual value guarantees** (see paragraphs 842-10-55-34 through 55-36).

842-10-30-6

Lease payments do not include any of the following:

a. Variable lease payments other than those in paragraph 842-10-30-5(b)

b. Any guarantee by the lessee of the **lessor's** debt

c. Amounts allocated to nonlease components in accordance with paragraphs 842-10-15-33 through 15-42.

Lease payments are payments, made by a lessee to a lessor, relating to the right to use an underlying asset during the lease term and include the following amounts:

Payment type	Description
Fixed payment	‣ Fixed (including in-substance fixed) payments, less any lease incentives paid or payable to the lessee (refer to section 2.4.1, *Fixed (including in-substance fixed) lease payments and lease incentives*)
Variable lease payment based on an index or rate	‣ Variable lease payments that depend on an index or a rate (e.g., the Consumer Price Index (CPI), a market interest rate) (refer to section 2.4.2, *Variable lease payments that depend on an index or rate*)
Purchase option	‣ The exercise price of a purchase option if the lessee is reasonably certain to exercise that purchase option (refer to section 2.4.3, *The exercise price of a purchase option*)
Penalty	‣ Payments for penalties for terminating a lease, if the lease term reflects the lessee exercising an option to terminate the lease (refer to section 2.4.4, *Payments for penalties for terminating a lease*)
Fee	‣ Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction (refer to section 2.4.5, *Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction*)
Residual value guarantee	‣ Amounts it is probable the lessee will owe under residual value guarantees (lessees only) (refer to section 2.4.6, *Amounts it is probable that a lessee will owe under residual value guarantees — lessees only*)

Lease payments do not include consideration in the contract allocated to the non-lease components of a contract. However, lease payments include amounts that would otherwise be allocable to the non-lease components of a contract when the lessee makes an accounting policy election to account for the lease and non-lease components as a single lease component. Refer to section 1.4, *Identifying and separating lease and non-lease components of a contract and allocating contract consideration*.

ASC 842 does not specifically address noncash lease payments (e.g., equity shares or stock options of the lessee provided to the lessor, estimated costs to dismantle and remove a leased asset at the end of the lease term imposed by the lease agreement as opposed to an asset retirement obligation (refer to section 2.4.8, *Lessee's obligations for asset retirement obligations (AROs)*)). We believe that unless a form of consideration is specifically excluded, noncash lease payments should be included in lease payments at their fair value.

ASC 842-10-30-6 does explicitly note that lessee's guarantees of lessor's debt are excluded from lease payments (refer to section 2.4.10 *Amounts not included in lease payments*).

Similarly, a provision that requires lessee indemnifications for preexisting environmental contamination or environmental contamination caused by the lessee during its use of the underlying asset over the term of the lease does not affect classification of the lease. Therefore, non-cash payments in the form of such indemnities are excluded from lease payments but only for purposes of lease classification (refer to section 3.4.8, *Lessee indemnifications for environmental contamination*).

2.4.1 Fixed (including in-substance fixed) lease payments and lease incentives

2.4.1.1 In-substance fixed lease payments

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-31

Lease payments include in substance fixed lease payments. In substance fixed payments are payments that may, in form, appear to contain variability but are, in effect, unavoidable. In substance fixed payments for a **lessee** or a **lessor** may include, for example, any of the following:

a. Payments that do not create genuine variability (such as those that result from clauses that do not have economic substance)

b. The lower of the payments to be made when a lessee has a choice about which set of payments it makes, although it must make at least one set of payments.

Some lease agreements include payments that are described as variable or may appear to contain variability but are in-substance fixed payments because the contract terms require the payment of a fixed amount that is unavoidable (e.g., a lease that requires a lessee to pay percentage rent equal to 1% of its sales, subject to a minimum sales figure to be used). Such payments are included in the lease payments at lease commencement and thus used to measure entities' lease assets and lease liabilities.

Certain lease agreements include lease payments that increase based on a multiple of a change in an index (e.g., the Consumer Price Index) with a cap. Questions arise as to whether this feature should be viewed as variable lease payments, a derivative or included as in-substance fixed lease payments at the capped amount. An example would be a lease of a retirement community where lease payments increase each year by the lesser of 3% or three times the annual increase in the Consumer Price Index. As discussed in ASC 842-10-30-5 (refer to section 2.4.2, *Variable lease payments that depend on an index or rate*), lease payments that depend on an existing index, such as the CPI, should be included in lease payments based on the index at lease commencement, and any increases or decreases in lease payments that result from subsequent changes in the index should be reflected as they occur. However, the function of an index multiplier and a cap serves to significantly modify the arrangement from one in which the lease payments simply vary based on an index rate. Often, the combination of the multiplier and cap is specifically designed to make sure the cap is always reached.

We believe that lessees and lessors should evaluate provisions in lease arrangements that require an adjustment to lease payments based on a multiple of an index and a cap and determine whether these provisions represent genuine variability or whether these provisions are in-substance fixed lease payments. If the contingent rent feature does not create genuine variability (i.e., the increase in the index coupled with the multiplier and cap are designed such that the cap will be reached each year), the capped payments should be considered lease payments. This accounting, which applies to both lessors and lessees, affects lease payments not only for purposes of the lease classification test but also the lessee measurement of the right-of-use asset and lessor and lessee accounting for straight-line rent (subject to collectibility) under an operating lease. If the lessee or lessor determines that the index multiplier and cap do not represent in-substance fixed lease payments, the lessee or lessor would apply the embedded derivative guidance of ASC 815-15 and would likely conclude that inflation-indexed rentals that are subject to a leverage factor (e.g., three times the change in CPI) do not qualify for the clearly and closely related exception and, as a result, the portion of the rent attributed to the inflation index would be separated from the host contract (the lease) and accounted for as a derivative. The initial fair value of such a derivative would be treated as a day-one lease payment with subsequent changes in fair value accounted for under the applicable guidance in ASC 815, *Derivatives and Hedging*. Subsequent changes in the fair value of the derivative would be recognized in income at each reporting period.

The following example illustrates the accounting for in-substance fixed lease payments:

Illustration 14 — In-substance lease payments

Company A leases a building for five years with a fair value of $100 from Lessor B. The lease agreement provides that the lease payments start at $10 annually. The annual adjustment is based on three times the annual increase in the CPI, but the aggregate annual adjustment is limited to 3%.

Analysis: Company A concludes that in substance, it has agreed, at the commencement date of the lease, to pay Lessor B additional lease payments in the amount of 3% per year. As a result, the 3% increase represents an in-substance fixed lease payment that would be included in the measurement of the right-of-use asset.

The following would be the straight-line rent calculation for both the lessee and lessor:

Year	Lease payments	Straight-line rental revenue/expense[1]
1	$10.00	$ 10.62
2	$10.30 ($10.00 x 1.03)	$ 10.62
3	$10.61 ($10.30 x 1.03)	$ 10.62
4	$10.93 ($10.61 x 1.03)	$ 10.62
5	$11.26 ($10.93 x 1.03)	$ 10.62

[1] If the multiplier of the CPI were considered a derivative instead of an in-substance lease payment (at the capped amount), the day-one fair value of the derivative would be included as a lease payment for purposes of determining straight-line rent (as well as assessing lease classification). Subsequent changes in the fair value of the derivative would be recognized in income at each reporting period.

2.4.1.2 Lease incentives

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-30

Lease incentives include both of the following:

a. Payments made to or on behalf of the **lessee**

b. Losses incurred by the **lessor** as a result of assuming a lessee's preexisting lease with a third party. In that circumstance, the lessor and the lessee should independently estimate any loss attributable to that assumption. For example, the lessee's estimate of the lease incentive could be based on a comparison of the new lease with the market rental rate available for similar **underlying assets** or the market rental rate from the same lessor without the lease assumption. The lessor should estimate any loss on the basis of the total remaining costs reduced by the expected benefits from the **sublease** of use of the assumed underlying asset.

A lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving expenses) or the assumption by the lessor of the lessee's preexisting lease with a third party.

Lessee

For lessees, lease incentives that are paid or payable to the lessee are deducted from lease payments and affect the lease classification test and reduce the initial measurement of a lessee's right-of-use asset. Lease incentives that are payable to the lessee at lease commencement reduce a lessee's lease liability.

ASC 842 does not specifically address the recognition of lease incentives by a lessee that are neither paid nor payable at lease commencement. For example, we believe the following approaches to recognition would be acceptable:

1. If a lease specifies a maximum level of reimbursement and the lessee is reasonably certain to incur costs equal to or exceeding this level, the amount would be deemed payable by the lessor at the commencement date and included in the measurement of the consideration in the contract at commencement (and thus a reduction in the right-of-use asset).
2. Once a lessee has incurred costs and the amounts qualify for reimbursement by the lessor, the lessee would reduce the right-of-use asset by the costs incurred. The reduction to the right-of-use asset would be recognized prospectively over the remainder of the lease term as a reduction to lease expense.
3. Similar to the approach above, a lessee would recognize the reduction to the right-of-use asset as reimbursable costs are incurred and would recognize a cumulative catch-up adjustment to expense, as if the incentive were paid or payable at the lease commencement date.

Illustration 15 — Accounting for lease incentives not paid or payable at commencement

Entity A leases retail space to Entity B for a term of 10 years and provides an incentive allowance to reimburse Entity B for the cost of leasehold improvements up to $1 million. Entity B is required to provide proof of payment of qualified expenditures to receive the incentive from Entity A. At lease commencement, Entity B has incurred $100,000 of reimbursable costs associated with design of the leasehold improvements and has submitted a request for payment to Entity A. Entity B has contracted for and is reasonably certain it will incur costs in excess of the maximum allowance by the end of the first year of the lease term. The lease is classified as an operating lease.

Analysis: Entity B would apply any of the following three approaches:

- Approach 1: At lease commencement, Entity B records a receivable from the lessor of $1,000,000 with an offsetting reduction to its right-of-use asset as the lease specifies a maximum allowance, and Entity B expects to incur costs to fully utilize the allowance. Entity B recognizes the allowance in income on a straight-line basis over the 10-year lease term ($1,000,000 over 10 years or $100,000 annually).
- Approach 2: At lease commencement, Entity B records a receivable from the lessor for $100,000 with an offsetting reduction to its right-of-use asset. The $100,000 is amortized over the 10-year lease term (i.e., $10,000 annually). When Entity B incurs the remaining reimbursable costs (for simplicity, assume it occurs at a single point in time at the end of year 1), it records a receivable from the lessor for $900,000 with an offsetting reduction to its right-of-use asset. The aggregate remaining incentive of $990,000 ($900,000 plus $90,000 unamortized from year 1) is amortized over the remaining lease term at that that time ($110,000 in years 2 through 9).

- Approach 3: At lease commencement, Entity B records a receivable from the lessor for $100,000 with an offsetting reduction to its right-of-use asset. The $100,000 is amortized over the 10-year lease term (i.e., $10,000 annually). When Entity B incurs the remaining reimbursable costs (for simplicity, assume it occurs at a single point in time at the end of year 1), it records a receivable from the lessor for $900,000 with an offsetting reduction to its right-of-use asset. Unlike Approach 1, Entity B would recognize an additional $90,000 in amortization expense in year 1 as a cumulative adjustment as though the full amount of the incentive was recognized at lease commencement (i.e., $1 million / 10 years = $100,000 less the $10,000 already expensed) and recognizes the remaining aggregate incentive of $900,000 over the remaining nine years of the lease term, resulting in a total annual reductions of $100,000 in years 2 through 10.

Refer to section 4.2.1.2, *Right-of-use assets*, for accounting for operating leases or section 4.3.1.2, *Right-of-use assets*, for accounting for finance leases.

Lessor

For lessors, lease incentives that are paid or payable to the lessee also are deducted from lease payments and affect the lease classification test. Lease incentives that are payable to the lessee at commencement reduce the initial measurement of the lessor's net investment in the lease for sales-type and direct financing leases. However, if lease incentives have been paid to the lessee prior to the commencement date, we believe that they affect the calculation of selling profit or loss for sales-type and direct financing leases (refer to section 5.1.3, *Selling profit or selling loss*). For operating leases, lessors should defer the cost of any lease incentives paid or payable to the lessee and recognize that cost as a reduction to lease income over the lease term (refer to section 5.4.2, *Lease incentives in an operating lease*).

ASC 842 does not specifically address the recognition of lease incentives by lessors that are neither paid nor payable at lease commencement. We believe a lessor should initially recognize its contingent obligation at lease commencement, if probable (similar to the threshold used to recognize variable lease payments for lessees), and amortize the incentive as a reduction to revenue over the lease term. If the lessor later determines that the incentive will not be paid, the lessor would derecognize the liability and associated unamortized incentive and either recognize a cumulative catch-up adjustment to revenue to reverse the previously recognized amortization or recognize the adjustment prospectively over the remaining lease term.

2.4.2 Variable lease payments that depend on an index or rate

Variable lease payments that depend on an index or a rate are included in the lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). The FASB indicated in the Basis for Conclusions (BC 211) that despite the measurement uncertainty associated with changes to index- or rate-based payments, the payments meet the definition of an asset (lessor) and a liability (lessee) because they are unavoidable. Lessees and lessors recognize changes to index- and rate-based variable lease payments in profit or loss in the period of the change (i.e., similar to other variable lease payments). Common examples of indexes and rates are:

- Consumer Price Index (CPI)
- London interbank offered rate (LIBOR)
- Prime interest rate
- Treasury rates (with or without a spread)
- Payments that depend on market rental rates

ASC 842-10-35-4(b) requires a lessee to remeasure lease payments when a contingency upon which some or all of the lease payments that will be paid over the remainder of the lease term is resolved (refer to section 2.4.11.1, *Lessees*). However, we believe that guidance is applicable only to variable lease payments not based on an index or rate. That is, it does not apply to variable payments based on an index or rate. For example, assume that a lessee enters into a five-year lease agreement with a fixed lease payment in year one that is then adjusted at the beginning of years two through five based on the increase in CPI. In this case, we believe the entity would not remeasure its lease payments at the beginning of each year and instead would recognize the effect of future increases in CPI in expense in each year.

2.4.3 The exercise price of a purchase option

If the lessee is reasonably certain to exercise a purchase option, the exercise price is included as a lease payment. That is, entities consider the exercise price of asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options (refer to section 2.3.5, *Evaluating lease term and purchase options*).

2.4.4 Payments for penalties for terminating a lease

If it is reasonably certain that the lessee will not terminate a lease, the lease term is determined assuming that the termination option would not be exercised, and any termination penalty is excluded from the lease payments. Otherwise, the lease termination penalty is included as a lease payment, and the lease term is determined accordingly. The determination of whether to include lease termination penalties as lease payments is similar to the evaluation of lease renewal options.

2.4.5 Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction

Fees paid by a lessee to the owners of a special-purpose entity for structuring a transaction are included as lease payments. However, such fees are excluded from the fair value of the underlying asset for purposes of the lease classification test. Refer to section 3.4.6, *Fair value of the underlying asset*.

2.4.6 Amounts it is probable that a lessee will owe under residual value guarantees — lessees only

ASC 842 requires a lessee to include the amount it is probable it will owe to a lessor under a residual value guarantee as lease payments.

A lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least a specified amount. Such guarantees are enforceable obligations that the lessee has assumed by entering into the lease. Uncertainty related to the amount that a lessee will pay under a guarantee of a lessor's residual value affects the measurement of the obligation rather than the existence of an obligation.

A lessee is required to remeasure and reallocate the remaining consideration in the contract and remeasure finance and operating lease liabilities when it changes its assessment of the amount it is probable that it will owe under a residual value guarantee. Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*.

Illustration 16 — Residual value guarantee included in lease payments

Lessee R enters into a lease and guarantees that Lessor S will realize $15,000 from selling the asset to another party at the end of the lease. At lease commencement, based on Lessee R's estimate of the residual value of the underlying asset, Lessee R determines that it is probable that it will owe $6,000 at the end of the lease.

Analysis: In accordance with ASC 842-10-25-2, Lessee R and Lessor S will include the full guaranteed residual value of $15,000 for purposes of evaluating lease classification (refer to section 3.1, *Criteria for lease classification — lessees*, and section 3.2, *Criteria for lease classification — lessors*).

Because it is probable that Entity R will owe the lessor $6,000 under the residual value guarantee, Entity R includes that amount as a lease payment.

Refer to section 5.1.1, *Net investment in the lease,* for discussion of accounting for residual value guarantees by lessors in sales-type or direct financing leases.

2.4.6.1 Third-party insurance that guarantees the asset's residual value

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-36

A residual value guarantee obtained by the lessee from an unrelated third party for the benefit of the lessor should not be used to reduce the amount of the lessee's lease payments under paragraph 842-10-30-5(f) except to the extent that the lessor explicitly releases the lessee from obligation, including the secondary obligation, which is if the guarantor defaults, a residual value deficiency must be made up. Amounts paid in consideration for a guarantee by an unrelated third party are executory costs and are not included in the lessee's lease payments.

Lessees may guarantee the residual value to the lessor and obtain an offsetting guarantee from an unrelated third party (e.g., an insurance company). A third-party guarantee can be used as a basis to reduce the lessee's lease payments (refer to section 2.4, *Lease payments) only* when (and to the extent) the lessor explicitly releases the lessee from the residual value guarantee (including any secondary obligation if the guarantor defaults). Amounts paid to the unrelated third party as consideration for the guarantee are executory costs and are not included in the lessee's lease payments.

2.4.6.2 Requirement for lessee to purchase the underlying asset

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-35

If the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease term, the stated purchase price is included in lease payments. That amount is, in effect, a guaranteed residual value that the lessee is obligated to pay on the basis of circumstances outside its control.

A lease may contain a provision granting the lessor the right to require the lessee to purchase the underlying asset by the end of the lease term. In these cases, the amount of the stated put option would be included in lease payments as it is, in effect, a residual value guarantee that the lessee is required to pay.

2.4.7 Payments made by a lessee prior to the beginning of the lease term

Payments made prior to lease commencement (refer to section 2.2, *Commencement date of the lease*) are considered lease payments (refer to section 2.4, *Lease payments) and* included in the lease classification test (refer to section 3.1, *Criteria for lease classification — lessees*, and section 3.2, *Criteria for lease classification — lessors*) and are included in the initial measurement of the right-of-use asset (refer to section 4.2.1.2, *Right-of-use assets*, for measurement of operating leases or section 4.3.1.2, *Right-of-use assets*, for measurement of finance leases).

2.4.8 Lessee's obligations for asset retirement obligations (AROs)

Excerpt from Accounting Standards Codification

Leases — Overall

Initial Measurement

842-10-30-7

Paragraph 410-20-15-3(e) addresses the scope application of Subtopic 410-20 on asset retirement obligations to obligations of a lessee in connection with a lease (see paragraph 842-10-55-37).

Implementation Guidance and Illustrations

842-10-55-37

Obligations imposed by a lease agreement to return an underlying asset to its original condition if it has been modified by the lessee (for example, a requirement to remove a lessee-installed leasehold improvement) generally would not meet the definition of lease payments or variable lease payments and would be accounted for in accordance with Subtopic 410-20 on asset retirement and environmental obligations. In contrast, costs to dismantle and remove an underlying asset at the end of the lease term that are imposed by the lease agreement generally would be considered lease payments or variable lease payments.

Asset Retirement and Environmental Obligations — Asset Retirement Obligations

Scope and Scope Exceptions

410-20-15-3

The guidance in this Subtopic does not apply to the following transactions and activities:

e. Obligations of a lessee in connection with an underlying asset, whether imposed by a lease or by a party other than the lessor, that meet the definition of either lease payments or variable lease payments in Subtopic 842-10. Those obligations shall be accounted for by the lessee in accordance with the requirements of Subtopic 842-10. However, if obligations of a lessee in connection with an underlying asset, whether imposed by a lease or by a party other than the lessor, meet the provisions in paragraph 410-20-15-2 but do not meet the definition of either lease payments or variable lease payments in Subtopic 842-10, those obligations shall be accounted for by the lessee in accordance with the requirements of this Subtopic.

It is important to remember that the requirements of ASC 410-20, *Asset Retirement Obligations*, may apply not only to long-lived assets owned by the entity but also to improvements made to leased assets. The following is a discussion of the lessee's obligations for asset retirement obligations.

Distinguishing an asset retirement obligation (ARO) from lease payments and variable lease payments

The provisions of ASC 410-20 do not apply to obligations of a lessee in connection with leased property, whether imposed by a lease agreement or by a party other than the lessor, that meet the definition of either lease payments or variable lease payments. Instead, obligations that are considered either lease payments or variable lease payments should be accounted for in accordance with ASC 842. However, obligations imposed by a lease agreement that meet the definition of an ARO and do not meet the definition of lease payments or variable lease payments are accounted for by the lessee in accordance with the requirements of ASC 410-20. It should be noted that ASC 842 does not apply to leases to explore or exploit natural resources; thus, any retirement obligations imposed by these types of agreements always are within the scope of ASC 410-20.

The estimated costs imposed by a lease that requires a lessee to dismantle and remove a lessor's asset at the end of the lease term are recognized as a component of lease payments. Because the estimated removal costs are included in lease payments (refer to section 2.4, *Lease payments*), these removal costs will be included in the measurement of the lease liability and right-of-use asset, and the related expense will be recognized over the lease term.

Variable lease payments are defined as payments made by a lessee to a lessor for the right to use an underlying asset that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time (refer to section 2.10, *Amounts not included in lease payments*). Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours or sales volume during the lease term, are variable lease payments and, accordingly, are excluded from lease payments in their entirety. Increases or decreases in payments that result from variable lease payments are included in income as accruable.

Obligations imposed by a lease agreement to return a leased asset to its original condition (if it has been modified by the lessee by the installation of leasehold improvements, such as a building constructed on leased land) generally do not meet the definition of a lease payment or a variable lease payment and, therefore, should be accounted for by the lessee as an ARO. Said another way, if an improvement to leased property has been recognized as an asset on the lessee's balance sheet (leasehold improvements), any obligation to remove that lessee-owned improvement on expiration of the lease should generally be accounted for as an ARO. For example, assume a lessee that leases retail space and installs its own improvements (e.g., customized buildout) has an obligation under the lease to remove the improvements at the expiration of the lease. The obligation to remove the leasehold improvements does not arise solely because of the lease but instead is a direct result of the lessee's decision to modify the leased space. Such costs would be excluded from lease payments and variable lease payments. We believe the lessee's estimate of its ARO at lease commencement would be included in the measurement of the leasehold improvement to which it relates. Refer to our Financial reporting developments publication, *Asset Retirement Obligations*, for further discussion of the accounting for an ARO.

In certain circumstances, it may be difficult to determine whether improvements are assets of the lessee or the lessor. In many cases, the conclusion, which can affect the determination as to whether removal costs should be accounted for under the provisions for accounting for leases (ASC 842) or the provision for AROs (ASC 410-20), will be facts and circumstances based. Guidance to assist in determining whether improvements should be considered assets of the lessee or the lessor can be found in ASC 842-40-55-5. Sections 4.7.1, *Which party owns the improvements,* and 7.7, *Lessee involvement in asset construction ('build-to-suit' transactions),* also discuss factors to consider in making this determination.

The following illustrations demonstrate the concepts discussed above.

Illustration 17 — Obligation as a result of lease contract

Land with cellular tower

Entity A (lessee) leases vacant land from Entity B (lessor). Entity A has the right but not the obligation to construct a cellular tower on the property. If Entity A constructs the cellular tower on the property, it is obligated to return the land to its original condition at the end of the lease term. In this case, it is the construction of the cellular tower that imposes the liability on Entity A, not the lease of the land. If Entity A does not construct the cellular tower, it has no obligation under the lease. If it does construct the cellular tower, the tower would be recognized as a leasehold improvement, and the obligation to remove the tower would be an ARO.

Alternatively, if Entity A leases land and an existing cellular tower from Entity B and is required to demolish and remove the cellular tower at the end of the lease term, Entity A has assumed a direct obligation related to the leased asset that arises upon entering into the lease rather than an obligation created by a future action. As a result, the estimated demolition and removal costs should be included in lease payments. By including the dismantling obligation in lease payments, the obligation will be included in the measurement of the lease liability and right-of-use asset, and the related expense will be recognized over the lease term. At the end of the lease term, a liability exists that would be reduced by the payments made to demolish and remove the cellular tower.

Lease of office space

A lessee leases office space with preexisting improvements (e.g., interior walls, carpeting) and is contractually obligated to remove these preexisting improvements upon expiration of the lease. Because the original condition of the underlying asset included the improvements and the lessee is leasing the space and improvements, the estimated removal obligation should be included in lease payments.

Alternatively, if the lessee pays to build out the space to configure it to its needs (e.g., interior walls and carpeting accounted for by the lessee as leasehold improvements) and is required to remove the improvements on expiration of the lease, it should account for the removal obligation as an ARO. The lessee is obligated to remove an asset that it constructed and recorded as an asset (i.e., a leasehold improvement).

If the lessee leases office space with both preexisting improvements (i.e., lessor assets) and additional lessee-owned leasehold improvements, estimated costs to remove the improvements should be split between the preexisting improvements and the lessee improvements. Estimated costs to remove the preexisting improvements should be included in lease payments. The contractual obligation associated with the removal of the leasehold improvements constructed and accounted for by the lessee should be accounted for as an ARO.

Illustration 18 — Obligation as a result of a legal obligation

Entity A (lessor) owns a gas station that it leases to Entity B (lessee). The property includes preexisting underground fuel storage tanks.

Scenario 1

If the lease agreement requires Entity B to remove the underground storage tanks at the end of the lease term, the estimated cost of removal would be included in the lease payments by Entity B and would have no effect on the requirement for Entity A to recognize an ARO under ASC 410-20 for its legal obligation to remove the storage tanks.

Scenario 2

At the inception of the lease, there is no legal requirement for removal of the underground storage tanks. However, the lease requires that if such a legal requirement is enacted during the lease term, Entity B is required to remove the underground storage tanks at the end of the lease.

Entity B would have to consider the facts and circumstances to determine whether to account for the estimated costs of removal of the underground storage tanks as a lease payment or variable lease payment. We believe, if the enactment of a law requiring removal of the underground storage tanks during the lease term was judged to be probable at inception of the lease, the removal costs would be included in the lease payments and accounted for under the general provisions for accounting for leases under ASC 842. However, if the enactment of such a law was not judged to be probable at lease commencement, the estimated removal costs would be accounted for as a variable lease payment. If a legal requirement to remove the underground storage tanks was enacted during the lease term or it was determined that the enactment of such law was probable, Entity B would accrue the estimated costs of removal.

As noted above, an obligation to return an underlying asset (i.e., the leased asset) to its original condition (if it has been modified by the lessee by the installation of leasehold improvements) is an ARO that should be accounted for under ASC 410-20. In certain cases, settlement of the obligation may be planned prior to the end of the lease term. However, a plan to voluntarily settle an ARO obligation prior to the end of the lease term does not affect the requirement to record an ARO liability when leasehold improvements are made.

Illustration 19 — Settlement of ARO prior to the end of the lease term

A retailer signs a 10-year lease for space in a shopping mall. The lease terms include a requirement for the lessee to return the space to its original condition at the end of the lease. At commencement of the lease, the retailer modifies the space by constructing various leasehold improvements (e.g., merchandise displays, shelving to stock merchandise, flooring, checkout counters). The retailer estimates that the useful life of the improvements is five years, at which time they will all be replaced.

The obligating event to remove these leasehold improvements occurs when they are made, regardless of whether settlement is planned at the end of the lease term or at an earlier point in time. The asset retirement cost should be amortized over the five-year estimated useful life of the improvements, and the obligation should be accreted using the credit-adjusted risk-free rate over the same five-year term. If the retailer replaces the original leasehold improvements after five years, a settlement of the original ARO obligation should be recognized, and a new ARO obligation should be recorded related to any newly constructed leasehold improvements.

See our Financial reporting developments publication, *Asset retirement obligations*, for further discussion on the accounting for asset retirement obligations, including further discussion regarding the effect of applying the provisions of ASC 820, *Fair Value Measurement*, to the measurement of asset retirement obligations.

2.4.9 Tax indemnifications in lease agreements

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-55-38

Some leases contain indemnification clauses that indemnify lessors on an after-tax basis for certain tax benefits that the lessor may lose if a change in the tax law precludes realization of those tax benefits. Although the indemnification payments may appear to meet the definition of variable lease payments, those payments are not of the nature normally expected to arise under variable lease payment provisions.

842-10-55-39

Because of the close association of the indemnification payments to specific aspects of the tax law, any payments should be accounted for in a manner that recognizes the tax law association. The lease classification should not be changed.

842-10-55-40

Paragraph 842-30-55-16 discusses a lessor's accounting for guarantee payments received.

Implementation Guidance and Illustrations

Guarantee Payments Received

842-30-55-16

Indemnification payments related to tax effects other than the investment tax credit should be reflected by the **lessor** in income consistent with the classification of the **lease**. That is, the payments should be accounted for as an adjustment of the lessor's **net investment in the lease** if the lease is a **sales-type lease** or a **direct financing lease** or recognized ratably over the **lease term** if the lease is an **operating lease**.

Indemnities for changes in tax laws

Some leases contain indemnification clauses that indemnify lessors, on an after-tax basis, for certain tax benefits a lessor may lose because of a change in tax law. Although the indemnification payments may appear to meet the definition of variable lease payments, such payments are not of the nature normally expected to arise under variable lease payment provisions. Further, due to the close association of the payments to specific aspects of the tax law, the payments should be accounted for in a manner that recognizes the tax law association. The lease classification should not be changed.

Lessors

Indemnification payments received by lessors should be reflected in income consistent with the classification of the lease. That is, the payments should be accounted for as an adjustment to the lessor's net investment in the lease if a direct financing or sales-type lease or recognized ratably over the lease term if an operating lease. The lease classification is not affected by indemnification clauses or indemnification payments received by the lessor.

Lessees

A lessee's indemnification of the lessor for any adverse tax consequences that may arise from a change in the tax laws is generally subject to the provisions for guarantees under ASC 460. These types of indemnifications are not considered to be guarantees of the lessee's own future performance because only a legislative body can change the tax laws, and the lessee therefore has no control over whether payments will be required under that indemnification. In addition, while ASC 460-10-15-7(c) provides a scope exception for contracts that have the characteristics of a guarantee or indemnification, but are accounted for as variable lease payments, because ASC 842-10-55-38 indicates that indemnification payments should not be accounted for as variable lease payments, the scope exception does not apply. Therefore, to the extent a general indemnity requires additional payments to the lessor due to adverse changes in the tax law, regulations or ruling, the indemnification would generally be subject to ASC 460.

Illustration 20 — Accounting for indemnity for changes in tax laws

Assume a lessor in an operating lease is a foreign entity that is not subject to tax withholding requirements and the lessor requires the lessee to indemnify the lessor for any future change in the tax law, which would require the lessee to withhold income taxes from payments to the lessor. This may occur if the lessor's taxing authority enters into or modifies its tax treaty with the US. The effect of this indemnification would be to increase the lessee's payments for the leased property for the required withholding tax (which would be remitted directly to the IRS).

Analysis: This arrangement meets the criteria of ASC 460-10-15-4(c), and therefore, the indemnity is subject to the recognition and measurement provisions of ASC 460. Therefore, the lessee should record a liability for the guarantee based on its fair value, and the related expense should be recognized over the operating lease term.

As noted above, tax indemnities do not affect the lease classification. That is, the fair value of the guarantee and the related expense should not be included in the lease classification test per ASC 842-10-25-3(b)(1) (refer to section 3.2, *Criteria for lease classification — lessors*).

General indemnity for increase in taxes

Many leases include a general indemnification that the lessee will directly pay (or reimburse the lessor) either the entire amount due or a pro rata share of any increases in all sales, use or property taxes. As noted in section 1.4.2.1, *Executory costs*, the payment of taxes by a lessee is not considered a separate (i.e., non-lease) component of a contract. Entities should evaluate whether lease payments made for taxes are fixed (or in-substance fixed) lease payments or variable lease payments (refer to section 2.4, *Lease payments*). These types of arrangements are generally not viewed as indemnifications under ASC 460.

Indemnities for adverse tax consequences that result from actions of the lessee

Many leases require the lessee to indemnify the lessor for any adverse tax consequences that may arise from acts, omissions and misrepresentations of the lessee. These types of indemnifications are generally related to the anticipated use of the underlying asset and level of taxation (or deductibility) related to that intended use. We believe these indemnities would be outside the scope of ASC 460 as they represent a guarantee of an entity's own performance.

2.4.10 Amounts not included in lease payments

Excerpt from Accounting Standards Codification

Leases — Overall

Initial Measurement

842-10-30-6

Lease payments do not include any of the following:

a. Variable lease payments other than those in paragraph 842-10-30-5(b)

b. Any guarantee by the lessee of the **lessor's** debt

c. Amounts allocated to nonlease components in accordance with paragraphs 842-10-15-33 through 15-42.

Variable lease payments that do not depend on an index or rate

Variable lease payments that do not depend on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset (e.g., the number of hours flown, the number of units produced), are not included as lease payments. Entities should carefully evaluate the provisions of variable lease payments so that the payments are not in-substance fixed payments (refer to section 2.4.1.1, *In-substance fixed lease payments*). Lessees are required to remeasure lease payments when a contingency is resolved that results in some or all of the lease payments that were previously determined to be variable meeting the definition of lease payments (refer to section 2.4.11, *Subsequent remeasurement of lease payments*).

A lessee's guarantee of a lessor's debt

Lease payments do not include any guarantee by the lessee of the lessor's debt (which is generally accounted for under ASC 460, *Guarantees*). However, we believe if the lessor's debt is recourse only to the leased asset either because the debt is non-recourse or the lessor has no significant assets other than the property under lease, a guarantee by the lessee of the lessor's debt is tantamount to guaranteeing the underlying asset's residual value. The same would be true for a non-recourse loan made by the lessee to the lessor. Accordingly, the probable shortfall between the outstanding debt balance and the value of the residual asset at the end of the lease term should be included in lease payments. In addition, the presence of a lessee's guarantee of the lessor's debt may affect the evaluation of both lease term and lease payments (e.g., the evaluation of whether a purchase option is reasonably certain to be exercised).

While "any guarantee by the lessee of the lessor's debt" is excluded from lease payments, a guarantee of a lessor's debt would still need to be accounted for under ASC 460, *Guarantees*.

Amounts allocated to non-lease components

Lease payments do not include payments allocated to the non-lease components of a contract. However, lease payments include amounts that would otherwise be allocable to the non-lease components of a contract when the lessee makes an accounting policy election to account for the lease and non-lease components as a single lease component (this election is not available to lessors). Refer to sections 1.4.3.2, *Allocating the consideration in the contract — lessees*, and 1.4.4.2, *Allocating the consideration in the contract — lessors*, for lessees and lessors, respectively.

2.4.11 Subsequent remeasurement of lease payments

2.4.11.1 Lessees

Excerpt from Accounting Standards Codification

Leases — Overall

Subsequent Measurement

842-10-35-4

A **lessee** shall remeasure the **lease payments** if any of the following occur:

a. The **lease** is modified, and that modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8.

b. A contingency upon which some or all of the **variable lease payments** that will be paid over the remainder of the **lease term** are based is resolved such that those payments now meet the definition of lease payments. For example, an event occurs that results in variable lease payments that were linked to the performance or use of the **underlying asset** becoming fixed payments for the remainder of the lease term.

c. There is a change in any of the following:

   1. The lease term, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments on the basis of the revised lease term.

   2. The assessment of whether the lessee is reasonably certain to exercise or not to exercise an option to purchase the underlying asset, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments to reflect the change in the assessment of the purchase option.

   3. Amounts **probable** of being owed by the lessee under **residual value guarantees**. A lessee shall determine the revised lease payments to reflect the change in amounts probable of being owed by the lessee under residual value guarantees.

842-10-35-5

When a lessee remeasures the lease payments in accordance with paragraph 842-10-35-4, variable lease payments that depend on an index or a rate shall be measured using the index or rate at the remeasurement date.

ASC 842 requires lessees to remeasure lease payments when there is a lease modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that is not accounted for as a separate contract. Refer to the section 4.5, *Lease modifications*.

Lessees are also required to remeasure lease payments if any of the following occur:

Title	Description of Remeasurement Event	Reference
Resolution of contingency fixing previously variable lease payments	A resolution of a contingency that results in some or all of the lease payments that were previously determined to be variable meeting the definition of lease payments (e.g., an event occurs that results in variable lease payments that were linked to the performance or use of the underlying asset becoming fixed payments for the remainder of the lease term)	2.4.1, *Fixed (including in-substance fixed) lease payments and lease incentives*
	We believe this provision does not apply to variable payments based on an index or rate	2.4.2, *Variable payments that depend on an index or rate*
Lease term	A change in the lease term	2.3.1, *Lease term*
Exercise of options	A change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset	2.3.2, *Purchase options*
Residual value guarantee	A change in the amounts it is probable that the lessee will owe under residual value guarantees	2.4.6, *Amounts it is probable that a lessee will owe under residual value guarantees — lessees only*

When lease payments are remeasured for any of the reasons discussed above, lessees will also remeasure variable lease payments that depend on an index or rate using the index or rate at the remeasurement date and remeasure and reallocate the remaining consideration in the contract (refer to section 1.4.3.2, *Allocating the consideration in the contract — lessees*).

Lessees remeasure the lease liability upon a remeasurement event, with a corresponding adjustment to the right-of-use asset. However, if the right-of-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss. Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*.

Refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements*.

2.4.11.2 Lessors

Excerpt from Accounting Standards Codification

Leases — Overall

Subsequent Measurement

842-10-35-6

A **lessor** shall not remeasure the lease payments unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.

Lessors remeasure the lease payments only upon a modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that is not accounted for as a separate contract. Refer to section 5.6, *Lease modifications*.

Refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements*.

2.5 Discount rates

Excerpt from Accounting Standards Codification

Master Glossary

Discount Rate for the Lease

For a **lessee**, the discount rate for the **lease** is the **rate implicit in the lease** unless that rate cannot be readily determined. In that case, the lessee is required to use its **incremental borrowing rate**.

For a **lessor**, the discount rate for the lease is the rate implicit in the lease.

Rate Implicit in the Lease

The rate of interest that, at a given date, causes the aggregate present value of (a) the **lease payments** and (b) the amount that a **lessor** expects to derive from the **underlying asset** following the end of the **lease term** to equal the sum of (1) the **fair value** of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred **initial direct costs** of the lessor.

Incremental Borrowing Rate

The rate of interest that a **lessee** would have to pay to borrow on a collateralized basis over a similar term an amount equal to the **lease payments** in a similar economic environment.

Leases — Lessee

Initial Measurement

842-20-30-2

The **discount rate for the lease** initially used to determine the present value of the **lease payments** for a **lessee** is calculated on the basis of information available at the **commencement date**.

842-20-30-3

A lessee should use the **rate implicit in the lease** whenever that rate is readily determinable. If the rate implicit in the lease is not readily determinable, a lessee uses its **incremental borrowing rate**. A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable with that of the **lease term**, as an accounting policy election for all leases.

Leases — Overall

Recognition

842-10-25-4

A lessor shall assess the criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1) using the **rate implicit in the lease**. For purposes of assessing the criterion in paragraph 842-10-25-2(d), a lessor shall assume that no **initial direct costs** will be deferred if, at the commencement date, the fair value of the underlying asset is different from its carrying amount.

Discount rates are used to determine the present value of the lease payments, which are used to determine lease classification (refer to section 3.3, *Discount rates used to determine lease classification*) and to measure a lessor's net investment in the lease for sales-type and direct financing leases and a lessee's lease liability.

For a lessee, the discount rate for the lease is the "rate implicit in the lease" and, if that rate cannot be readily determined, its incremental borrowing rate. For a lessor, the discount rate for the lease is the rate implicit in the lease. The rate implicit in the lease is similar to the current definition in US GAAP and reflects the nature and specific terms of the lease. The discount rate should not be less than zero.

2.5.1 Lessors

Lessors use the rate implicit in the lease that causes the following:

The present value of lease payments made by the lessee for the right to use the underlying asset	+	The present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term	=	The fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor	+	Any deferred initial direct costs of the lessor (varies — see below)

Initial direct costs — classification

The following table summarizes the discount rates used to determine lease classification by lessors.

	At lease commencement, the fair value of the underlying asset does not equal its carrying value	At lease commencement, the fair value of the underlying asset is equal to its carrying value
Sales-type lease classification test (as described in ASC 842-10-25-2(d))	Rate implicit in the lease, assuming that no initial direct costs of the lessor will be deferred (i.e., exclude initial direct costs from the calculation of the rate implicit in the lease)	Rate implicit in the lease (including initial direct costs of the lessor in the calculation of the rate)
Direct financing lease classification test (as described in ASC 842-10-25-3(b)(1))	Rate implicit in the lease (including initial direct costs of the lessor in the calculation of the rate)	Rate implicit in the lease (including initial direct costs of the lessor in the calculation of the rate)

When a lessor is performing the sale-type lease classification test, ASC 842-10-25-4 clarifies that the lessor should assume that no initial direct costs will be deferred when determining the rate implicit in the lease if, at lease commencement, the fair value of the asset does not equal its carrying value. That is, a lessor would exclude initial direct costs from the calculation of the rate implicit in the lease if the underlying asset's fair value differs from its carrying value. The direct financing lease classification test described in ASC 842-10-25-3(b)(1) does not include a similar exception. As a result, the calculation of the rate implicit in the lease for purposes of applying the direct financing lease classification test will always include the lessor's initial direct costs.

Initial direct costs — initial recognition and measurement

For purposes of the initial recognition and measurement of a direct financing lease or a sales-type lease, if the fair value of the underlying asset equals its carrying amount at lease commencement, any initial direct costs are deferred and included in the computation of the rate implicit in the lease and, therefore, the net investment in the lease (refer to sections 5.2.1, *Initial recognition and measurement*, and 5.3.1, *Initial recognition and measurement*, for sales-type and direct financing leases, respectively). The rate that was used in the sales-type lease classification test can differ from the rate used in the direct financing lease classification test and to initially measure the net investment in the lease because of the lease classification guidance above.

2.5.2 Lessees

Excerpt from Accounting Standards Codification

Leases — Lessee

Initial Measurement

842-20-30-3

A lessee should use the **rate implicit in the lease** whenever that rate is readily determinable. If the rate implicit in the lease is not readily determinable, a lessee uses its **incremental borrowing rate**. A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable with that of the **lease term**, as an accounting policy election for all leases.

Lessees are required to use the rate implicit in the lease as described above if that rate can be readily determined. We believe that lessees often will not know the amount of the lessor's initial direct costs and, therefore, will be unable to determine the rate implicit in the lease. When the lessee cannot readily determine that rate, the lessee uses its incremental borrowing rate. The lessee's incremental borrowing rate is the rate of interest that the lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment. When an entity identifies a borrowing with a "similar term," we believe the entity should evaluate the term relative to the lease term determined at the lease commencement date (i.e., any options not deemed reasonably certain of exercise at lease commencement, such as termination or extension options, would not be considered in the term of the debt). Also, we believe the incremental borrowing rate should not be adjusted to consider renewal options not included in the lease term.

Non-PBE accounting policy election

A lessee that is not a public business entity (PBE) is permitted to make an accounting policy election to use the risk-free rate (e.g., in the US, the rate of a zero coupon US Treasury instrument) for the initial and subsequent measurement of lease liabilities. The risk-free rate is determined using a period comparable with the lease term. If a lessee makes this election, it must apply this policy to all leases and disclose it in the notes to the financial statements. The risk-free rate should not be less than zero.

The rate implicit in the lease is not necessarily the rate stated in the contract. In addition, the rate implicit in the lease reflects the lessor's initial direct costs for certain leases (as discussed above) and estimates of residual value. Therefore, lessees will often not know the rate implicit in the lease.

While using a risk-free rate might reduce complexity for eligible lessees, it would increase the likelihood that the present value of the lease payments and any residual value guaranteed by the lessee would equal or exceed substantially all of the fair value of the leased asset, potentially resulting in the lease being classified as a finance lease. Additionally, the use of a lower rate would increase the initial measurement of a lessee's lease liability and right-of-use asset. This might dissuade some lessees that aren't PBEs from making a policy election to use a risk-free rate.

2.5.2.1 Lessee unable to obtain financing

If the lessee's financial condition is such that third parties generally would be unwilling to provide debt financing, the incremental borrowing rate of the lessee might not be readily determinable. In these rare cases, the lessee should use the interest rate for the lowest grade of debt currently available in the marketplace as its incremental borrowing rate.

2.5.2.2 Subsidiaries' incremental borrowing rate

The FASB indicated in the Basis for Conclusions (BC 201) that it might be appropriate in some cases for a subsidiary to use its parent's incremental borrowing rate as the discount rate. For instance, if a subsidiary does not have a separate treasury function and the group's funding is managed centrally at the group level, the lease negotiation may result in the parent entity providing a guarantee of the lease. In this circumstance, use of the parent's incremental borrowing rate would be appropriate.

2.5.3 Reassessment of the discount rate

2.5.3.1 Lessors

Lessors reassess the discount rate, for purposes of lease classification, upon a modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or consideration for the lease) that is not accounted for as a separate contract. The discount rate that is used to account for the modified lease depends on the classification of the lease before and after the lease modification.

Lessors use a revised discount rate to account for the modified lease upon any of the following:

- A modification (as described above) to an operating lease that is not accounted for as a separate contract, if the modified lease is classified as either a direct financing or a sales-type lease
- A modification (as described above) to a direct financing lease that is not accounted for as a separate contract, if the modified lease is classified as either a direct financing or a sales-type lease
- A modification (as described above) to a sales-type lease that is not accounted for as a separate contract, if the modified lease is classified as either a direct financing or a sales-type lease

Refer to section 5.6, *Lease modifications*. Also refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements*.

2.5.3.2 Lessees

Lessees reassess the discount rate upon a change to the lease term or a change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset if the discount rate for the lease liability (e.g., the lessee's incremental borrowing rate) does not already reflect the lessee's option in the lease to extend or terminate the lease or to purchase the underlying asset. That is, in such cases, a change in the discount rate is only required if the lessee had not accounted for the optionality in the contract when determining the discount rate previously. The reassessment is based on the remaining lease term and lease payments.

Lessees are also required to reassess the discount rate upon a modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that is not accounted for as a separate contract. Refer to section 4.6, *Lease modifications*.

If a reassessment of the discount rate results in a change to the discount rate, lessees should remeasure the lease liability using the revised discount rate at the reassessment date and adjust the right-of-use asset. However, if the right-of-use asset is reduced to zero, a lessee should recognize any remaining amount in profit or loss.

Refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements*.

2.6 Initial direct costs

Excerpt from Accounting Standards Codification

Master Glossary

Initial Direct Costs

Incremental costs of a **lease** that would not have been incurred if the lease had not been obtained.

Leases — Overall

Initial Measurement

842-10-30-9

Initial direct costs for a **lessee** or a **lessor** may include, for example, either of the following:

a. Commissions

b. Payments made to an existing tenant to incentivize that tenant to terminate its **lease**.

842-10-30-10

Costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained, such as fixed employee salaries, are not initial direct costs. The following items are examples of costs that are not initial direct costs:

a. General overheads, including, for example, depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time

b. Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities

c. Costs related to activities that occur before the lease is obtained, such as costs of obtaining tax or legal advice, negotiating lease terms and conditions, or evaluating a prospective lessee's financial condition.

Under ASC 842, initial direct costs are incremental costs that would not have been incurred if the lease had not been obtained (e.g., commissions, payments made to an existing tenant to incentivize that tenant to terminate its lease). Lessees and lessors apply the same definition of initial direct costs. ASC 842's guidance on initial direct costs is consistent with the concept of incremental costs of obtaining a contract in the new revenue recognition standard.

ASC 842-10-15-33 requires lessees to allocate initial direct costs to the separate lease components of a contract on the same basis as the lease payments (i.e., on a relative standalone price basis). Refer to section 1.4.3.2, *Allocating the consideration in the contract — lessees*.

ASC 842-10-15-38 also requires lessors to allocate any capitalized costs (e.g., initial direct costs, contract costs that are capitalizable in accordance with ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*) to the separate lease and non-lease components to which the costs relate. Refer to section 1.4.4.2, *Allocating the consideration in the contract — lessors*.

The following table summarizes how lessees and lessors account for initial direct costs (i.e., incremental costs of a lease that would not have been incurred if the lease had not been obtained) that are capitalized at the date the lease is obtained (which may be before lease commencement) and allocate them to the lease components of the contract.

	Lease classification	Accounting for capitalized initial direct costs (IDCs)
Lessees	Operating lease	Include IDCs in the initial and subsequent measurement of the right-of-use asset. Refer to section 4.2.1.2, *Right-of-use assets*, or 4.3.1.2, *Right-of-use assets*, for the initial measurement of operating and finance leases, respectively, and section 4.2.2.2, *Right-of-use assets*, or 4.3.2.2, *Right-of-use assets*, for the subsequent measurement of operating and finance leases, respectively.
	Finance lease	
Lessors*	Sales-type lease if the fair value of the underlying asset is different from its carrying amount at lease commencement	Expense IDCs at lease commencement. Refer to section 5.2.1, *Initial recognition and measurement*.
	Sales-type lease if the fair value equals the carrying value of the underlying asset at lease commencement	Include IDCs in the initial and subsequent measurement of the net investment in the lease. Refer to sections 5.2.1, *Initial recognition and measurement*, and 5.3.1, *Initial recognition and measurement*, for sales-type and direct financing leases, respectively.
	Direct financing lease	
	Operating lease	Recognize IDCs as an expense over the lease term on the same basis as lease income. Refer to section 5.4, *Operating leases*.

* As discussed in section 2.5.1, *Lessors*, for purposes of performing the sales-type lease classification test only, a lessor assumes that no initial direct costs will be deferred (i.e., initial direct costs are excluded from the calculation of the rate implicit in the lease) if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. Refer to section 3.3, *Discount rates used to determine lease classification,* for further discussion.

ASC 842 includes the following example of the accounting for initial direct costs.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-240

Lessee and Lessor enter into an operating lease. The following costs are incurred in connection with the lease:

Travel costs related to lease proposal	$ 7,000
External legal fees	22,000
Allocation of employee costs for time negotiating lease terms and conditions	6,000
Commissions to brokers	10,000
Total costs incurred by Lessor	$ 45,000
External legal fees	$ 15,000
Allocation of employee costs for time negotiating leases terms and conditions	7,000
Payments made to existing tenant to obtain the lease	20,000
Total costs incurred by Lessee	$ 42,000

842-10-55-241

Lessor capitalizes initial direct costs of $10,000, which it recognizes ratably over the lease term, consistent with its recognition of lease income. The $10,000 in broker commissions is an initial direct cost because that cost was incurred only as a direct result of obtaining the lease (that is, only as a direct result of the lease being executed). None of the other costs incurred by Lessor meet the definition of initial direct costs because they would have been incurred even if the lease had not been executed. For example, the employee salaries are paid regardless of whether the lease is obtained, and Lessor would be required to pay its attorneys for negotiating and drafting the lease even if Lessee did not execute the lease.

842-10-55-242

Lessee includes $20,000 of initial direct costs in the initial measurement of the right-of-use asset. Lessee amortizes those costs ratably over the lease term as part of its total lease cost. Throughout the lease term, any unamortized amounts from the original $20,000 are included in the measurement of the right-of-use asset. The $20,000 payment to the existing tenant is an initial direct cost because that cost is only incurred upon obtaining the lease; it would not have been owed if the lease had not been executed. None of the other costs incurred by Lessee meet the definition of initial direct costs because they would have been incurred even if the lease had not been executed (for example, the employee salaries are paid regardless of whether the lease is obtained, and Lessee would be required to pay its attorneys for negotiating and drafting the lease even if the lease was not executed).

2.6.1 Initial direct costs in a lease modification

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-25-10

An entity shall account for **initial direct costs**, lease incentives, and any other payments made to or by the entity in connection with a modification to a lease in the same manner as those items would be accounted for in connection with a new lease.

Lessees and lessors account for costs incurred in a lease modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that meet the definition of initial direct costs in the same manner as those items are accounted for in connection with a new lease.

A lessee's initial direct costs in a lease modification are included in the measurement of the new right-of-use asset (i.e., for a modification that is accounted for as a separate contract) or the adjustment to the right-of-use asset (i.e., for a modification that is not accounted for as a separate contract).

A lessor accounts for initial direct costs in a lease modification based on the classification of the new lease as follows:

- For sales-type leases if, at the commencement date, the fair value of the underlying asset is different from its carrying amount, expense initial direct costs allocated to the lease component on the effective date of the modification
- For sales-type leases if, at the commencement date, the fair value of the underlying asset equals its carrying amount, and direct financing leases, initial direct costs allocated to the lease component are included in the measurement of the new net investment in the lease (i.e., for a modification that is accounted for as a separate contract) or the adjustment to the net investment in the lease (i.e., for a modification that is not accounted for as a separate contract)

- For operating leases, capitalize and expense initial direct costs allocated to the lease component over the lease term on the same basis as lease income for those costs allocated to the lease component

Refer to sections 4.6, *Lease modifications,* and 5.6, *Lease modifications*.

2.7 Economic life

Excerpt from Accounting Standards Codification

Leases — Overall

Master Glossary

Economic Life

Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.

ASC 842 defines the economic life of an asset as either:

- The period over which an asset is expected to be economically usable by one or more users
- The number of production or similar units expected to be obtained from the asset by one or more users

This definition of economic life, while not the same as the definition in ASC 840, is not expected to significantly change economic life estimates.

We believe that "economically usable" means that the asset is or is expected to be viable from an economic perspective. In addition, we believe that "one or more users" means the existing lessee plus any successor lessees or owners.

2.8 Fair value

Excerpt from Accounting Standards Codification

Leases — Overall

Master Glossary

Fair Value (second definition)

The price that would be received to sell an asset or paid to transfer a liability in an **orderly transaction** between **market participants** at the measurement date.

Orderly Transaction

A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not **related parties**, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms

b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary

c. They are able to enter into a transaction for the asset or liability

d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Lessees and lessors determine the fair value of the underlying asset in a lease arrangement for purposes of lease classification and measurement under ASC 842 using the definition of fair value in ASC 820, *Fair Value Measurement*. That is, the fair value of the underlying asset in a lease arrangement is the price that would be received to sell the asset in an orderly transaction between market participants at the measurement date. ASC 820 provides a framework for measuring fair value and requires certain disclosures.

While ASC 842 does not specifically prohibit lessees from recognizing a right-of-use asset that exceeds the fair value of the underlying asset, we believe that lessees should challenge the inputs and assumptions used to measure the right-of-use asset if the carrying amount of the right-of-use asset would exceed the fair value of the underlying asset. Inputs and assumptions that could be challenged include the identification of lease and non-lease components, the allocation of consideration in the contract to those components and the discount rate used.

2.9 Variable lease payments

Excerpt from Accounting Standards Codification

Master Glossary

Variable lease payments

Payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** that vary because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

Common examples of variable lease payments include:

- Payments that depend on a percentage of sales of a lessee
- Payments that increase based upon an index such as CPI (including payments that depend on market rental rates)

2.9.1 Lessee accounting for variable lease payments

Excerpt from Accounting Standards Codification

Leases — Lessee

Implementation Guidance and Illustrations

842-20-55-1

A **lessee** should recognize costs from **variable lease payments** (in annual periods as well as in interim periods) before the achievement of the specified target that triggers the variable lease payments, provided the achievement of that target is considered **probable**.

842-20-55-2

Variable lease costs recognized in accordance with paragraph 842-20-55-1 should be reversed at such time that it is probable that the specified target will not be met.

Master Glossary

Probable (second definition)

The future event or events are likely to occur.

Some rental agreements provide for fixed lease payments plus variable lease payments based on the lessee's operations. Often, the specified targets are not achieved until the later months of either the lessor's or lessee's fiscal year. This may occur despite the fact that achievement of the targets is considered probable at some earlier point in the year. A lessee should recognize costs for variable lease payments (in annual periods as well as in interim periods) before the achievement of the specified target that triggers the variable lease payments if the achievement of that target is considered probable. Previously recognized variable lease expense should be reversed into income if it becomes probable that the specified target will not be met. Probable in this context means the future event or events that will trigger the payment are likely to occur. This is the same threshold of probability that is used in ASC 450, *Contingencies*, with respect to the recognition of liabilities.

Illustration 21 — Lessee accounting for variable lease payments

A rental agreement requires an additional payment of $1,000 if machine hours exceed 10,000 hours.

Analysis: The $1,000 annual payment should be accrued before the achievement of the specified target that triggers the variable lease payments if the achievement of that target, annual machine hours in excess of 10,000 hours, is considered probable.

Refer to sections 4.2.3, *Expense recognition*, and 4.3.3, *Expense recognition*, for further discussion of recognition of variable lease payments by lessees in operating and finance leases, respectively.

2.9.2 Lessor accounting for variable lease payments

Excerpt from Accounting Standards Codification

Leases — Lessor

Recognition

Sales-Type Leases

842-30-25-2

After the commencement date, a lessor shall recognize all of the following:

a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a)

b. **Variable lease payments** that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur

c. Impairment of the net investment in the lease (as described in paragraph 842-30-35-3).

Pending Content:

Transition Date: *(P) December 16, 2019; (N) December 16, 2020* Transition Guidance: 326-10-65-1

Editor's note: The content of paragraph 842-30-25-2 will change upon the adoption of ASU 2016-13

After the commencement date, a lessor shall recognize all of the following:

a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a)

b. **Variable lease payments** that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur

c. Credit losses on the net investment in the lease (as described in paragraph 842-30-35-3).

Direct Financing Leases

842-30-25-9

After the commencement date, a lessor shall recognize all of the following:

a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a)

b. **Variable lease payments** that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur

c. Impairment of the net investment in the lease (as described in paragraph 842-30-35-3).

Pending Content:

Transition Date: *(P) December 16, 2019; (N) December 16, 2020* Transition Guidance: 326-10-65-1

Editor's note: The content of paragraph 842-30-25-9 will change upon the adoption of ASU 2016-13

After the commencement date, a lessor shall recognize all of the following:

a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a)

b. **Variable lease payments** that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur

c. Credit losses on the net investment in the lease (as described in paragraph 842-30-35-3).

Operating Leases

842-30-25-11

After the commencement date, a lessor shall recognize all of the following:

a. The **lease payments** as income in profit or loss over the **lease term** on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the **underlying asset**, subject to paragraph 842-30-25-12.

b. **Variable lease payments** as income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur

c. Initial direct costs as an expense over the lease term on the same basis as lease income (as described in (a)).

A lessor should recognize income for variable lease payments in the period when changes in facts and circumstances on which the variable lease payments are based occur. This applies to both interim and annual periods and applies regardless of lease classification (i.e., applies to sales-type, direct financing and operating leases). For example, if a lessor receives contingent rent if the lessee's sales exceed $2,000,000 during the year, the lessor cannot recognize the variable lease payments until sales exceed this amount, regardless of probability. Consequently, it would be inappropriate to anticipate changes in the factors on which variable lease payments are based and recognize rental income prior to the occurrence of the change in factors on which variable lease payments are based. Refer to sections 5.2.2, *Subsequent measurement*, 5.3.2, *Subsequent measurement*, and 5.4, *Operating leases*, for further discussion of accounting for variable lease payments by a lessor for sales-type, direct financing and operating leases, respectively.

2.9.3 Embedded derivatives in variable lease payments

Derivative versus variable lease payments

Arrangements with variable lease payments may also contain embedded derivatives that must be evaluated pursuant to the "clearly and closely related" criteria of ASC 815-15. If the embedded derivative is not considered to be "clearly and closely related" to the host contract (i.e., the lease agreement), ASC 815-15 requires that the embedded derivative(s) be bifurcated and accounted for separately from the host contract. The following examples illustrate the application of the "clearly and closely related" analysis to variable lease payments:

- Inflation-indexed rentals (e.g., rentals that vary based on increases in the CPI) are considered to be clearly and closely related and would not be separated from the host contract unless a significant leverage factor is involved (e.g., rent payments escalate at twice the rate of an increase in the CPI).
- Variable lease payments based on sales volume of the lessee would not result in separation of the variable lease payment-related embedded derivative from the host contract. ASC 815-10-15-59 provides an exception from the application of ASC 815 to non-exchange-traded contracts with an underlying that is a specified volume of sales by one of the parties to the contract.
- Variable lease payments based on a variable interest rate are generally considered to be clearly and closely related. Consequently, lease contracts that include variable lease payments based on changes in, for example, the prime rate or the LIBOR rate would not typically result in a separation of the variable lease payment-rental-related embedded derivative from the host contract, unless, for example, the rental formula permits a significant leverage factor.

Refer to section 2.4.1.1, *In-substance fixed lease payments,* for a discussion of whether certain payments are lease payments, variable lease payments or derivatives and section 2.9.4, *Embedded foreign currency derivatives in operating leases,* for a discussion of embedded foreign currency derivatives in operating leases. Our Financial reporting developments publication, *Derivatives and hedging*, provides additional information and guidance about subsequent accounting for embedded derivatives in lease arrangements that are accounted for separately pursuant to ASC 815-15.

2.9.4 Embedded foreign currency derivatives

Excerpt from Accounting Standards Codification

Derivatives and Hedging

Overview and Background

815-15-15-5

Unsettled foreign currency transactions, including **financial instruments**, shall not be considered to contain embedded foreign currency derivatives under this Subtopic if the transactions meet all of the following criteria:

a. They are monetary items.

b. They have their principal payments, interest payments, or both denominated in a foreign currency.

c. They are subject to the requirement in Subtopic 830-20 to recognize any foreign currency transaction gain or loss in earnings.

815-15-15-10

An embedded foreign currency derivative shall not be separated from the host contract and considered a derivative instrument under paragraph 815-15-25-1 if all of the following criteria are met:

a. The host contract is not a financial instrument.

b. The host contract requires payment(s) denominated in any of the following currencies:

   1. The functional currency of any substantial party to that contract

   2. The currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions)

   3. The local currency of any substantial party to the contract

   4. The currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary (as discussed in paragraph 830-10-45-11).

c. Other aspects of the embedded foreign currency derivative are clearly and closely related to the host contract.

The evaluation of whether a contract qualifies for the scope exception in this paragraph shall be performed only at inception of the contract.

Finance leases denominated in a nonfunctional currency are governed by the provisions of ASC 830, *Foreign Currency Matters*, and would not be subject to the embedded derivatives provisions of ASC 815-15 as the finance lease liability meets all of the criteria in ASC 815-15-15-5. While operating leases denominated in foreign currencies meet the criteria in ASC 815-15-15-5(a) and (c), it is unclear whether payments on an operating lease could be viewed as principal and interest payments (ASC 815-15-15-5(b)). We believe that, consistent with other monetary items that are remeasured under ASC 830, bifurcation of the foreign currency embedded derivative in an operating lease denominated in a nonfunctional currency would not be required.

2.10 Other matters related to residual value guarantees

2.10.1 Residual value guarantees as derivatives

ASC 842-10-15-43 addresses the interaction between ASC 842 and ASC 815, *Derivatives and Hedging*.

Excerpt from Accounting Standards Codification

Leases — Overall

Other Considerations

842-10-15-43

Paragraph 815-10-15-79 explains that **leases** that are within the scope of this Topic are not derivative instruments subject to Subtopic 815-10 on derivatives and hedging although a derivative instrument embedded in a lease may be subject to the requirements of Section 815-15-25. Paragraph 815-10-15-80 explains that **residual value guarantees** that are subject to the guidance in this Topic are not subject to the guidance in Subtopic 815-10. Paragraph 815-10-15-81 requires that a third-party residual value guarantor consider the guidance in Subtopic 815-10 for all residual value guarantees that it provides to determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in that Subtopic.

Derivatives — Overall

Scope and Scope Exceptions

815-10-15-80

Residual value guarantees that are subject to the requirements of Topic 842 on leases are not subject to the requirements of this Subtopic.

815-10-15-81

A third-party residual value guarantor shall consider the guidance in this Subtopic for all residual value guarantees that it provides to determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in this Subtopic. The guarantees described in paragraph 842-10-15-43 for which the exceptions of paragraphs 460-10-15-7(b) and 460-10-25-1(a) do not apply are subject to the initial recognition, initial measurement, and disclosure requirements of Topic 460.

Leases are not considered derivatives and are not subject to the accounting for derivative instruments under ASC 815-10. However, a lease may contain an embedded derivative, which could be subject to the requirements of ASC 815-15-25.

Residual value guarantees that are subject to the requirements of the lease accounting literature are not subject to the requirements for derivative instruments under ASC 815. This "exception" only applies to residual value guarantees within the scope of the leasing literature (ASC 815-10-15-80). A residual value guarantee obtained by a lessor or provided by a lessee at a point in time after the commencement date of the lease (refer to section 2.2, *Commencement date of the lease*) would not be subject to ASC 842 and thus would potentially be subject to derivative accounting under ASC 815 if the guarantee is not in the scope of ASC 460 and met the definition of a derivative (and did not qualify for any of the scope exceptions therein).

2.10.2 Residual value guarantee of deficiency that is attributable to damage, extraordinary wear and tear or excessive usage

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-34

A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to variable lease payments in that the amount is not determinable at the commencement date. Such a provision does not constitute a lessee guarantee of the residual value.

Lease provisions often require the lessee to make up a residual value deficiency attributed to damage, extraordinary wear and tear, or excessive usage (e.g., excessive mileage on a leased vehicle). These lease provisions do not constitute a guarantee of residual value by the lessee but are similar to variable lease payments in that the amount is not determinable at the commencement date of the lease. Thus, they are not included in lease payments (refer to section 2.4, *Lease payments*) but instead would be accounted for like variable lease payments (refer to section 2.9.1, *Lessee accounting for variable lease payments*, and section 2.9.2, *Lessor accounting for variable lease payments*).

2.10.3 Residual value guarantee of a group of assets — lessees

In certain master lease agreements covering a group of assets, the lessee guarantees the residual value of the group of assets being leased as opposed to the residual value of each individual asset in the group. Although other methods of allocation might be appropriate, allocating the amount it is probable a lessee will owe under the residual value guarantee among all of the leased assets on a pro rata basis in relation to the expected residual value at the end of the lease term of each asset would be appropriate if the lease term is coterminous. For instance, if the amount probable of being owed under a group residual value guarantee is $180 and the total expected residual values of all of the leased assets as of the end of the master lease term is $300, the residual value guarantee would be allocated to each asset based on 60% of each leased asset's expected residual value.

2.10.4 Residual value guarantee of a group of assets — lessors

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-9

Lessors may obtain **residual value guarantees** for a portfolio of **underlying assets** for which settlement is not solely based on the residual value of the individual underlying assets. In such cases, the lessor is economically assured of receiving a minimum residual value for a portfolio of assets that are subject to separate **leases** but not for each individual asset. Accordingly, when an asset has a residual value in excess of the "guaranteed" amount, that excess is offset against shortfalls in residual value that exist in other assets in the portfolio.

842-10-55-10

Residual value guarantees of a portfolio of underlying assets preclude a lessor from determining the amount of the guaranteed residual value of any individual underlying asset within the portfolio. Consequently, no such amounts should be considered when evaluating the lease classification criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1).

In some cases, the residual value insurance may be for a portfolio of assets rather than individual assets within the lease portfolio. Accordingly, when an asset has a residual value below the guaranteed amount, such a deficiency could be offset by assets that have residual values in excess of their guaranteed value. Paragraphs 842-10-55-9 through 55-10 address a lessor's accounting for residual value guarantees for a portfolio of underlying assets and state that residual value guarantees of a portfolio of leased assets preclude a lessor from determining the amount of the guaranteed residual value of any individual leased asset within the portfolio at lease inception, due to the netting of the residual value gains and losses. Therefore, no amounts should be included when evaluating the lease classification criteria. Refer to section 3.2, *Criteria for lease classification — lessors*, for further discussion of consideration of residual value guarantees in evaluating lease classification.

2.10.5 Lessee guarantee of lessor's return

Certain lease agreements include a provision that on early termination of a lease by a lessee, the lessee is required to make payments to the lessor, or a lender to the lessor, to guarantee a stated return on the leased property. Any termination payments that could be required to be made would be considered a termination penalty that would be used to determine the lease term (refer to section 2.3, *Lease term and purchase options*) and might have to be included in lease payments. An obligation to only make up any shortfall on the lessor's return in the event of early termination also would be an early termination penalty that would be used to determine the lease term and might be included in lease payments (under the assumption that the lessee would be responsible for the full shortfall, regardless of the likelihood of that assumption).

2.10.6 Third-party guarantee of lease payments or residual value

Excerpt from Accounting Standards Codification

Guarantees — Overall

460-10-25-1

The following types of guarantees are not subject to the recognition provisions of the Subsection:

e. A guarantee by an original lessee that has become secondarily liable under a new lease that relieved the original lessee from being the primary obligor (that is, principal debtor) under the original lease, as discussed in paragraph 842-20-40-3. This exception shall not be applied by analogy to other secondary obligations.

For lessors, in addition to lessee guarantees of residual value (primary or secondary), the amount of any guarantee of the residual value or rental payments beyond the lease term (refer to section 2.3, *Lease term and purchase options)* by a third party unrelated to the lessee or lessor is considered when determining the classification of a direct financing lease (i.e., when determining whether the lease is a direct financing lease but not a sales-type lease). As noted in section 2.4.6.1, *Third-party insurance that guarantees the asset's residual value*, a lessee excludes third-party residual value guarantees from lease payments for purposes of determining lease classification, only if the lessor has released the lessee from primary and secondary liability. As a result, the purchase of a third-party guarantee often results in lessors obtaining direct financing lease treatment when the lease would otherwise be classified as an operating lease (refer to section 3.2, *Criteria for lease classification — lessors*).

In considering residual value guarantees, it is important to understand the contract's terms prior to including the amount of the guaranteed residual value for purposes of determining the lessor's lease classification. In many cases, the guarantee will contain provisions that result in the exclusion of the guarantee for purposes of the lessor's lease classification. Some of these provisions are described below.

Exclusion provisions

In some cases, third-party residual value insurance contracts contain exclusion provisions that the contract does not represent a guarantee of the lessor's residual value (that is, the residual value guarantee is only effective in limited circumstances). Many of the customary exclusion provisions, such as excess wear and tear or damages (which are typically the lessee's responsibility), would be acceptable and not preclude consideration of the guaranteed residual value for lease classification purposes (i.e., whether the lease is a direct financing lease). However, exclusion provisions that substantially curtail the lessor's ability to receive a payment from the guarantor on disposition of the leased asset at the end of the lease term (refer to section 2.3, *Lease term and purchase options*) would prevent the lessor from considering the guaranteed residual value. For example, a requirement that the lessee return the leased asset to "like-new" condition at the end of the lease would not represent an effective guarantee of the asset's residual value. Likewise, a requirement that the leased asset be returned to a location that is economically unfeasible based on the anticipated location of the leased asset and transportation costs to the specified location at the end of the lease term, or other requirements that severely restrict the lessor's ability to dispose of the asset at or near market value at the end of the lease term, should be carefully evaluated.

Self-insurance and premiums based on loss experience — lessors

The residual value guarantee must be from a third party unrelated to the lessor. If the guarantee is from a related party, the residual value is <u>not</u> guaranteed and should be excluded from the evaluation of lease classification. In addition, if the lessor participates in the loss experience, whether directly or indirectly, as would be the case with many retrospective policies (that is, the lessor's premium is adjusted at the end of the coverage period based on actual loss experience, or subsequent premiums are adjusted based on prior policy period losses), the residual values are <u>not</u> guaranteed and should be excluded from the lessor's evaluation of lease classification.

As further discussed in section 2.10.1, *Residual value guarantees as derivatives*, residual value guarantees that are subject to lease accounting literature (i.e., ASC 842) by lessees and lessors are excluded from the scope of ASC 815, *Derivatives and Hedging*.

3 Lease classification

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-25-2

A lessee shall classify a lease as a **finance lease** and a **lessor** shall classify a lease as a **sales-type lease** when the lease meets any of the following criteria at lease commencement:

a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

c. The lease term is for the major part of the remaining **economic life** of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.

d. The present value of the sum of the **lease payments** and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the **fair value** of the underlying asset.

e. 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.

842-10-25-3

When none of the criteria in paragraph 842-10-25-2 are met:

a. A lessee shall classify the lease as an **operating lease**.

b. A lessor shall classify the lease as either a **direct financing lease** or an operating lease. A lessor shall classify the lease as an operating lease unless both of the following criteria are met, in which case the lessor shall classify the lease as a direct financing lease:

    1. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.

    2. It is **probable** that the lessor will collect the lease payments plus any amount necessary to satisfy a **residual value guarantee**.

842-10-25-4

A lessor shall assess the criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1) using the **rate implicit in the lease**. For purposes of assessing the criterion in paragraph 842-10-25-2(d), a lessor shall assume that no **initial direct costs** will be deferred if, at the commencement date, the fair value of the underlying asset is different from its carrying amount.

Under ASC 842, lessees and lessors classify leases at the lease commencement date (except when the lessee elects the short-term lease exception discussed in section 4.1.1, *Short-term leases*). Lessees classify leases as either finance leases or operating leases. Lessors classify leases as sales-type leases, direct financing leases or operating leases. Lease classification determines how and when a lessee and a lessor recognize lease expense and income, respectively, and what assets and liabilities they record. The criteria used for lease classification are discussed in detail below. The lease classification criteria are applied to all leases other than short-term leases, including those with related parties (refer to section 9.1, *Related party leasing transactions,* for further discussion of considerations associated with related party leases).

3.1 Criteria for lease classification — lessees

At lease commencement, a lessee classifies a lease as a finance lease if the lease meets **any one** of the following criteria:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term (refer to section 3.4.1, *Transfer of ownership*).
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise (refer to section 2.3.5, *Evaluating lease term and purchase options*).
- The lease term (refer to section 2.3.1, *Lease term*) is for a major part of the remaining economic life (refer to section 2.7, *Economic life*) of the underlying asset. This criterion is not applicable for leases that commence at or near the end of the underlying asset's economic life (refer to section 3.4.3, *Evaluating 'major part,' 'substantially all' and 'at or near the end'*).
- The present value of the sum of the lease payments (refer to section 2.4, *Lease payments*) and any residual value guaranteed by the lessee[3] (refer to section 3.4.5, *Residual value guarantees included in the lease classification test*) that is not already included in the lease payments equals or exceeds substantially all of the fair value (refer to section 2.8, *Fair value*) of the underlying asset (refer to section 3.4.3, *Evaluating 'major part,' 'substantially all' and 'at or near the end'*).
- 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 (refer to section 3.4.7, *Alternative use criterion*).
- Neither of the following forms of consideration affect lease classification: (1) indemnifications for environmental contamination (refer to section 3.4.8, *Lessee indemnifications for environmental contamination*) nor (2) a lessee's guarantee of a lessor's debt (refer to section 2.4.10, *Amounts not included in lease payments*).

A lessee classifies a lease as an operating lease when it does not meet any one of these criteria.

3.2 Criteria for lease classification — lessors

At lease commencement, a lessor classifies a lease as a sales-type lease if the lease meets **any one** of the criteria in section 3.1, *Criteria for lease classification — lessees*.

If none of the criteria in section 3.1, *Criteria for lease classification — lessees*, are met, a lessor classifies a lease as a direct financing lease when the lease meets **both** of the following criteria:

- The present value of the sum of lease payments and any residual value guaranteed by the lessee and **any other third party unrelated to the lessor** equals or exceeds substantially all the fair value of the underlying asset.

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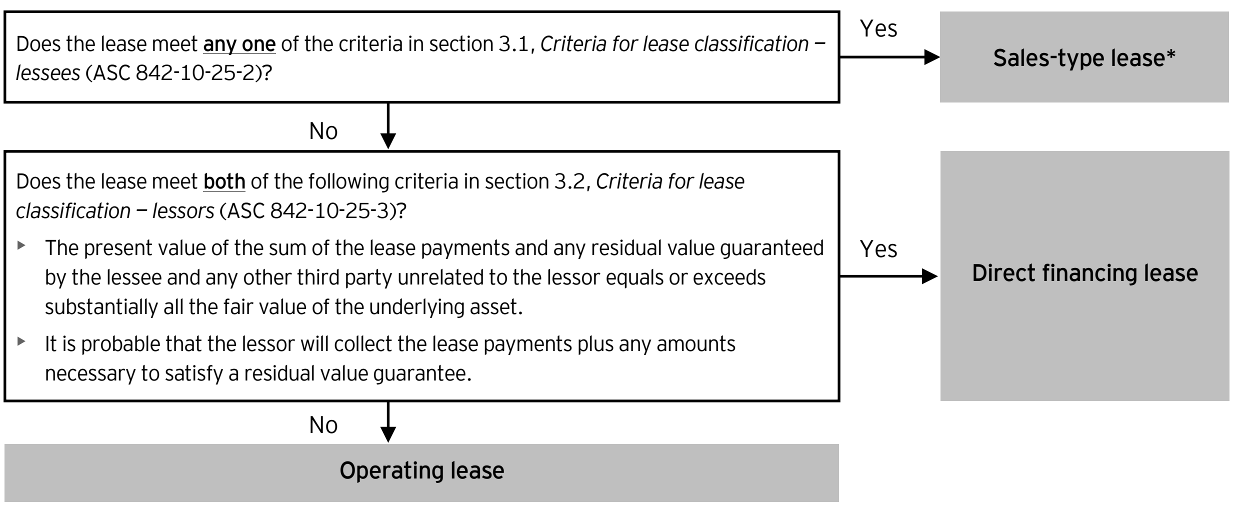
[3] As discussed in section 2.10.3, *Residual value guarantee of a group of assets — lessees*, for classification purposes, a lessee should carefully evaluate a residual value guarantee on a portfolio of underlying assets when determining the guarantee to include as a lease payment.

- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.
- Neither of the following forms of consideration affect lease classification: (1) indemnifications for environmental contamination (refer to section 3.4.8, *Lessee indemnifications for environmental contamination*) nor (2) a lessee's guarantee of a lessor's debt (refer to section 2.4.10, *Amounts not included in lease payments*).
- For lessors, all leases not classified as sales-type leases or direct financing leases are classified as operating leases.

A key difference between the sales-type lease and direct financing lease classification tests is the treatment of residual value guarantees provided by unrelated third parties other than the lessee. Those third-party guarantees are excluded from the evaluation of the "substantially all" criterion in the sales-type lease test. However, they are included in the evaluation in the direct financing lease test. In addition, the evaluation of the collectibility of lease payments and residual value guarantees affects direct financing lease classification, whereas it does not affect sales-type lease classification. However, the evaluation of collectibility does affect sales-type lease recognition and measurement.

The lease classification test is designed so that a direct financing lease involves a residual value guarantee from an unrelated third party other than the lessee that is sufficient to satisfy the "substantially all" criterion. Although such a residual value guarantee from an unrelated third party other than the lessee can exist in a sales-type or an operating lease, a lease without a residual value guarantee from an unrelated third party other than the lessee must be classified as either a sales-type or an operating lease.

The decision tree below summarizes the evaluation of lease classification for lessors under ASC 842.



* ASC 842 does not require lessors to assess the collectibility of lease payments and any residual value guarantee provided by the lessee in the sales-type lease classification test. However, lessors are required to assess the collectibility of lease payments and any residual value guarantee provided by the lessee to determine the recognition and initial measurement of sales-type leases. Refer to section 5.2, *Sales-type leases*, on the accounting for sales-type leases.

3.2.1 Evaluating collectibility

Collectibility refers to the lessee's ability and intent to pay substantially all of the lease payments and any guaranteed residual value. A lessor should assess a lessee's ability to pay based on the lessee's financial capacity and its intention to pay, considering all relevant facts and circumstances, including past experiences with that lessee or similar lessees. Collectibility determinations must be made on a lease-by-lease basis and can affect the classification of a lease between a direct financing or operating lease (refer to section 3.2, *Criteria for lease classification — lessors)* and the recognition and measurement of income on a sales-type and operating lease. Refer to section 5.2.1.2, *Collectibility is not probable at lease commencement*, for a discussion of the accounting for sales-type leases when collectibility is not probable and section 5.4, *Operating leases,* for considerations related to operating leases when collectibility is not probable.

3.3 Discount rates used to determine lease classification

Discount rates are used to determine the present value of the lease payments an entity will use to evaluate the "substantially all" criterion in the finance lease classification test for lessees and the sales-type and direct financing lease classification tests for lessors.

3.3.1 Lessees

For lessees, the discount rate used to evaluate the "substantially all" criterion is the "rate implicit in the lease" or the lessee's incremental borrowing rate, if the rate implicit in the lease cannot be readily determined. Refer to section 2.5, *Discount rates*.

3.3.2 Lessors

Sales-type lease classification test

The discount rate used to evaluate the "substantially all" criterion in the sales-type lease classification test (as described in ASC 842-10-25-2(d)) is the rate implicit in the lease (refer to section 2.5, *Discount rates*). However, a lessor assumes that none of its initial direct costs (refer to section 2.6, *Initial direct costs*) will be deferred (i.e., initial direct costs are excluded from the calculation of the rate implicit in the lease) if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. If the fair value of the underlying asset is the same as its carrying amount at lease commencement, a lessor includes initial direct costs in the calculation of the rate implicit in the lease.

Direct financing lease classification test

The discount rate used to evaluate the "substantially all" criterion in the direct financing lease classification test (as described in ASC 842-10-25-3(b)(1)) is the rate implicit in the lease (refer to section 2.5, *Discount rates*).

The following table summarizes the discount rates used to determine lease classification by lessors.

	At lease commencement, the fair value of the underlying asset does not equal its carrying value	At lease commencement, the fair value of the underlying asset is equal to its carrying value
Sales-type lease classification test (as described in ASC 842-10-25-2(d))	Rate implicit in the lease, assuming that no initial direct costs of the lessor will be deferred (i.e., exclude initial direct costs from the calculation of the rate implicit in the lease)	Rate implicit in the lease (including initial direct costs of the lessor in the calculation of the rate)
Direct financing lease classification test (as described in ASC 842-10-25-3(b)(1))	Rate implicit in the lease (including initial direct costs of the lessor in the calculation of the rate)	Rate implicit in the lease (including initial direct costs of the lessor in the calculation of the rate)

3.4 Lease classification considerations

3.4.1 Transfer of ownership

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-4

The criterion in paragraph 842-10-25-2(a) is met in **leases** that provide, upon the **lessee's** performance in accordance with the terms of the lease, that the **lessor** should execute and deliver to the lessee such documents (including, if applicable, a bill of sale) as may be required to release the **underlying asset** from the lease and to transfer ownership to the lessee.

842-10-55-5

The criterion in paragraph 842-10-25-2(a) also is met in situations in which the lease requires the payment by the lessee of a nominal amount (for example, the minimum fee required by the statutory regulation to transfer ownership) in connection with the transfer of ownership.

842-10-55-6

A provision in a lease that ownership of the underlying asset is not transferred to the lessee if the lessee elects not to pay the specified fee (whether nominal or otherwise) to complete the transfer is an option to purchase the underlying asset. Such a provision does not satisfy the transfer-of-ownership criterion in paragraph 842-10-25-2(a).

A lease is classified as a finance lease by a lessee and a sales-type lease by a lessor if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term (e.g., through the transfer of title). This includes the transfer of ownership of the underlying asset to the lessee at or shortly after the end of the lease term in exchange for no additional consideration or the payment of a nominal amount (e.g., the minimum fee required by statutory regulation to transfer ownership). A provision in a lease agreement that ownership of the underlying asset does not transfer if the lessee elects not to pay a specified fee (nominal or otherwise) to complete the transfer is a purchase option and not an automatic transfer of ownership (refer to section 2.3.2, *Purchase options*).

3.4.2 Evaluating purchase options

A lease is classified as a finance lease by a lessee and a sales-type lease by a lessor if the lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise. Purchase options should be assessed in the same way as options to extend the lease term or terminate the lease. Factors that could create an economic incentive for the lessee to exercise the purchase option might include a bargain purchase option (e.g., a fixed-price purchase option priced significantly below the expected fair value of the leased property) or contractual or economic penalties. Refer to section 2.3.5, *Evaluating lease term and purchase options*.

3.4.3 Evaluating 'major part,' 'substantially all' and 'at or near the end'

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-2

When determining **lease** classification, one reasonable approach to assessing the criteria in paragraphs 842-10-25-2(c) through (d) and 842-10-25-3(b)(1) would be to conclude:

a. Seventy-five percent or more of the remaining **economic life** of the **underlying asset** is a major part of the remaining economic life of that underlying asset.

b. A commencement date that falls at or near the end of the economic life of the underlying asset refers to a commencement date that falls within the last 25 percent of the total economic life of the underlying asset.

c. Ninety percent or more of the **fair value** of the underlying asset amounts to substantially all the fair value of the underlying asset.

The terms "major part," "substantially all" and "at or near the end" are not defined in ASC 842. However, ASC 842 includes implementation guidance that states that one reasonable approach to lease classification is to conclude that 75% or greater is a "major part" of the remaining economic life (refer to section 2.7, *Economic life*) *of* an underlying asset (refer to section 2.2, *Commencement date of the lease*), 90% or greater is "substantially all" the fair value (refer to section 2.8, *Fair value*) of the underlying asset and a commencement date that falls within the last 25% of the total economic life of the underlying asset is "at or near the end" of the total economic life of the underlying asset (refer to section 2.7, *Economic life*). We believe an entity should establish accounting policies for the thresholds it uses to determine lease classification, have a reasonable basis for those policies if they differ from the "reasonable approach" articulated in the standard and apply those policies consistently. Policies that differ from the "reasonable approach" discussed in ASC 842 may be challenged.

3.4.4 Lease component that contains the right to use more than one underlying asset

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-25-5

If a single lease component contains the right to use more than one underlying asset (see paragraphs 842-10-15-28 through 15-29), an entity shall consider the remaining economic life of the predominant asset in the lease component for purposes of applying the criterion in paragraph 842-10-25-2(c).

If a single lease component contains the right to use more than one underlying asset, the remaining economic life of the predominant asset is used to determine lease classification. Refer to section 1.4.1, *Identifying and separating lease components of a contract*, for further discussion of assessing whether a lease contains multiple lease components.

3.4.5 Residual value guarantees included in the lease classification test

A lessee is required to include the full amount of a residual value guarantee (excluding certain portfolio-based residual value guarantees — refer to section 2.10.3, *Residual value guarantees of a group of assets — lessees*) it provides to a lessor (i.e., its maximum obligation) in its evaluation of the "substantially all" criterion of the lease classification test (i.e., in its evaluation of ASC 842-10-25-2(d)). A lessor is also required to include the full amount of such a residual value guarantee provided by a lessee in its evaluation of whether a lease is a sales-type lease (excluding certain portfolio-based residual value guarantees — refer to section 2.10.4, *Residual value guarantees of a group of assets — lessors*). However, if a lease does not qualify as a sales-type lease, a lessor includes the full amounts of such residual value guarantees provided by both lessees and any other third party unrelated to the lessor in its evaluation of the "substantially all" criterion of the lease classification test to determine whether a lease is a direct financing lease (i.e., in its evaluation of ASC 842-10-25-3(b)(1)).

Residual value guarantees are treated differently when determining lease payments (i.e., for purposes of recognizing the lease rather than classifying it). A lessee includes the amount that it is probable it will owe to the lessor under a residual value guarantee as a lease payment when classifying a lease. A lessee is required to remeasure and reallocate the remaining consideration in the contract and remeasure finance and operating lease liabilities when it changes its assessment of the amount it is probable that it will owe under such a residual value guarantee. Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*. Lessors exclude residual guarantees from lease payments. Refer to section 2.4, *Lease payments*. Lessors would account for receipt of payment under a residual value guarantee in income when it is earned.

Note that ASC 842-10-55-9 through 10 excludes, for lease classification purposes only, portfolio-based residual value guarantees from lease payments for lessors (refer to section 2.10.4, *Residual value guarantee of a group of assets — lessors*).

3.4.6 Fair value of the underlying asset

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-3

In some cases, it may not be practicable for an entity to determine the fair value of an underlying asset. In the context of this Topic, practicable means that a reasonable estimate of fair value can be made without undue cost or effort. It is a dynamic concept; what is practicable for one entity may not be practicable for another, what is practicable in one period may not be practicable in another, and what is practicable for one underlying asset (or class of underlying asset) may not be practicable for another. In those cases in which it is not practicable for an entity to determine the fair value of an underlying asset, lease classification should be determined without consideration of the criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1).

In some cases, it may not be practicable for an entity to determine the fair value (refer to section 2.8, *Fair value*) of an underlying asset. This may be the case when the underlying asset is part of a larger asset (e.g., one floor in a multi-floor office building, one store in a shopping center). If a reasonable estimate of fair value cannot be made without undue cost or effort, lessees and lessors will not evaluate the "substantially all" classification criterion described in sections 3.1, *Criteria for lease classification — lessees*, and 3.2, *Criteria for lease classification — lessors*. Instead, lease classification will be based on the remaining classification criteria described in section 3.1, *Criteria for lease classification — lessees*.

If a lessor classifies the lease as a sales-type lease for other reasons such as the length of the lease term compared with the remaining economic life of the asset (e.g., if a lessee leases a floor in a multi-floor building for a term of 35 years and the building has a remaining useful life of 40 years), the lessor will still be required to estimate fair value for purposes of initial recognition and measurement of the sales-type lease (e.g., to determine the residual value as well as the amount of the underlying asset to derecognize).

Fees paid by a lessee to the owners of a special-purpose entity for structuring a transaction are included as lease payments (refer to section 2.4, *Lease payments*). However, such fees are excluded from the fair value of the underlying asset for purposes of the lease classification test.

3.4.6.1 Effect of investment tax credits

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-8

When evaluating the **lease** classification criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1), the **fair value** of the **underlying asset** should exclude any related investment tax credit retained by the **lessor** and expected to be realized by the lessor.

When an entity calculates the fair value of an underlying asset to evaluate the "substantially all" classification criterion in the lease classification tests discussed in sections 3.1, *Criteria for lease classification — lessees*, and 3.2, *Criteria for lease classification — lessors*, the fair value of the underlying asset is reduced by any related investment tax credits retained by the lessor and expected to be realized by the lessor.

3.4.7 Alternative use criterion

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-7

In assessing whether an **underlying asset** has an alternative use to the **lessor** at the end of the **lease term** in accordance with paragraph 842-10-25-2(e), an entity should consider the effects of contractual restrictions and practical limitations on the lessor's ability to readily direct that asset for another use (for example, selling it or leasing it to an entity other than the **lessee**). A contractual restriction on a lessor's ability to direct an underlying asset for another use must be substantive for the asset not to have an alternative use to the lessor. A contractual restriction is substantive if it is enforceable. A practical limitation on a lessor's ability to direct an underlying asset for another use exists if the lessor would incur significant economic losses to direct the underlying asset for another use. A significant economic loss could arise because the lessor either would incur significant costs to rework the asset or would only be able to sell or re-lease the asset at a significant loss. For example, a lessor may be practically limited from redirecting assets that either have design specifications that are unique to the lessee or that are located in remote areas. The possibility of the **contract** with the customer being terminated is not a relevant consideration in assessing whether the lessor would be able to readily direct the underlying asset for another use.

A lease is classified as a finance lease by a lessee and a sales-type lease by a lessor if 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. The FASB indicated in the Basis for Conclusions (BC 71(e)) that lessors generally would lease specialized assets that have no alternative use to them at the end of the lease term under terms that would transfer substantially all the benefits (and risks) of the asset to the lessee. That is, when this criterion is met, it is likely that one of the other criteria described in section 3.1, *Criteria for lease classification — lessees*, will also be met. An exception could be when a significant amount of anticipated lease payments are in the form of variable lease payments that do not depend on an index or rate.

When assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term, lessees and lessors should consider the effects of substantive contractual restrictions and practical limitations on the lessor's ability to readily direct that asset for another use (e.g., sell it, re-lease it). A practical limitation exists if the lessor would incur significant economic losses to repurpose the underlying asset for another use (e.g., if the lessor either would incur significant costs to rework the asset or would only be able to sell or re-lease the asset at a significant loss).

3.4.8 Lessee indemnifications for environmental contamination

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-15

A provision that requires **lessee** indemnification for environmental contamination, whether for environmental contamination caused by the lessee during its use of the **underlying asset** over the **lease term** or for preexisting environmental contamination, should not affect the classification of the **lease**.

A provision that requires lessee indemnifications for preexisting environmental contamination or environmental contamination caused by the lessee during its use of the underlying asset over the term of the lease does not affect classification of the lease. Indemnities for preexisting environmental contamination are accounted for under ASC 460, whereas indemnities for contamination caused by the lessee during the lease term are excluded from the requirements of ASC 460 as they represent a guarantee of the lessee's own performance. Contamination caused by the lessee during the lease term and related obligations are accounted for under ASC 410-30, *Environmental obligations*.

3.4.9 Leases of government-owned facilities

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-13

Because of special provisions normally present in **leases** involving terminal space and other airport facilities owned by a governmental unit or authority, the **economic life** of such facilities for purposes of classifying a lease is essentially indeterminate. Likewise, it may not be practicable to determine the **fair value** of the **underlying asset**. If it is impracticable to determine the fair value of the underlying asset and such leases also do not provide for a transfer of ownership or a purchase option that the **lessee** is reasonably certain to exercise, they should be classified as **operating leases**. This guidance also applies to leases of other facilities owned by a governmental unit or authority in which the rights of the parties are essentially the same as in a lease of airport facilities. Examples of such leases may be those involving facilities at ports and bus terminals. The guidance in this paragraph is intended to apply to leases only if all of the following conditions are met:

a. The underlying asset is owned by a governmental unit or authority.

b. The underlying asset is part of a larger facility, such as an airport, operated by or on behalf of the **lessor**.

c. The underlying asset is a permanent structure or a part of a permanent structure, such as a building, that normally could not be moved to a new location.

d. The lessor, or in some circumstances a higher governmental authority, has the explicit right under the lease agreement or existing statutes or regulations applicable to the underlying asset to terminate the lease at any time during the **lease term**, such as by closing the facility containing the underlying asset or by taking possession of the facility.

e. The lease neither transfers ownership of the underlying asset to the lessee nor allows the lessee to purchase or otherwise acquire ownership of the underlying asset.

f. The underlying asset or equivalent property in the same service area cannot be purchased nor can such property be leased from a nongovernmental unit or authority. An equivalent asset in the same service area is property that would allow continuation of essentially the same service or activity as afforded by the underlying asset without any appreciable difference in economic results to the lessee.

842-10-55-14

Leases of underlying assets not meeting all of the conditions in paragraph 842-10-55-13 are subject to the same criteria for classifying leases under this Subtopic that are applicable to leases not involving government-owned property.

Arrangements for the use of property owned by a governmental unit may meet the definition of a service concession arrangement that is within the scope of ASC 853, *Service Concession Arrangements*, (refer to section 1.8, *Service concession arrangements*). If the arrangement is not within the scope of ASC 853 and is a lease (or contains a lease), the lease is classified as an operating lease when it meets all of the criteria in ASC 842-10-55-13.

3.4.10 Classification of subleases

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-25-6

When classifying a **sublease**, an entity shall classify the sublease with reference to the underlying asset (for example, the item of property, plant, or equipment that is the subject of the lease) rather than with reference to the **right-of-use asset**.

Lessees often enter into arrangements to sublease a leased asset to a third party while the original lease contract is in effect. In these arrangements, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a head lease, the original lessee is often referred to as a sublessor and the ultimate lessee is often referred to as the sublessee.

Under ASC 842, a sublessor assesses sublease classification independently of the classification assessment that it makes as the lessee of the same asset. A sublessor considers the lease classification criteria for lessors, discussed in section 3.2, *Criteria for lease classification — lessors*, with reference to the underlying asset (i.e., the item of property, plant or equipment that is the subject of the lease) when classifying a sublease. Refer to chapter 6, *Subleases*, for further discussion of the accounting for subleases. A sublessee assesses classification of the sublease in the same manner as any other lease using the criteria discussed in section 3.1, *Criteria for lease classification — lessees*. Refer to section 6, *Subleases,* for further discussion of the accounting for subleases by sublessors and sublessees.

3.5 Reassessment of lease classification

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-25-1

An entity shall classify each separate **lease** component at the **commencement date**. An entity shall not reassess the lease classification after the commencement date unless the **contract** is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. In addition, a **lessee** also shall reassess the lease classification after the commencement date if there is a change in the **lease term** or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the **underlying asset**.

Subsequent measurement

842-10-35-3

A **lessor** shall not reassess the lease term or a lessee option to purchase the underlying asset unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset, the lessor shall account for the exercise of that option in the same manner as a **lease modification**.

Lessees and lessors are required to reassess lease classification as noted in the following table:

	Reassess lease classification?	
Event	**Lessee**	**Lessor**
Lease modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that is not accounted for as a separate contract	Yes[1]	Yes[1]
Change in assessment of lease term	Yes	No[2]
Change in assessment of whether lessee is reasonably certain to exercise an option to purchase the underlying asset (refer to section 2.3.6, *Reassessment of the lease term and purchase options*)	Yes	N/A

[1] Refer to section 4.6, *Lease modifications*, and section 5.6, *Lease modifications*, for a discussion of which modifications are accounted for as separate contracts for lessees and lessors, respectively.

[2] When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset and the exercise of the option is inconsistent with the existing lease term determination, the lessor accounts for the exercise in the same manner as a lease modification (refer to section 5.6, *Lease modifications*, and section 5.6.1, *Summary of the accounting for lease modifications — lessors*, for further discussion).

Lessees and lessors reassess lease classification as of the effective date of a modification to a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations) that is not accounted for as a separate contract, using the modified terms and conditions and the facts and circumstances as of that date, including:

- The remaining economic life of the underlying asset on that date
- The fair value of the underlying asset on that date
- The discount rate for the lease on that date
- The remeasurement and reallocation of the remaining consideration in the contract on that date

If a modification to a contract is accounted for as a separate contract that contains a lease, that separate lease is classified in the same manner as any new lease. Refer to sections 3.1, *Criteria for lease classification — lessees*, and 3.2, *Criteria for lease classification — lessors*.

3.5.1 Summary of lease reassessment and remeasurement requirements

This table summarizes lessee and lessor reassessment and remeasurement requirements under ASC 842. See section 9.3, *Lessee transition,* and section 9.4, *Lessor transition,* for the requirements for leases that commenced prior to the effective date of ASU 2016-02.

<table>
<tr><th></th><th>Lessees</th><th>Lessors</th></tr>
<tr><td>Assessment of whether an arrangement contains a lease</td><td>Reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed.
(ASC 842-10-15-6 and section 1.3, Reassessment of the contract)</td><td>Reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed.
(ASC 842-10-15-6 and section 1.3, Reassessment of the contract)</td></tr>
<tr><td>Allocation of consideration in the contract between lease and non-lease components</td><td>Remeasure and reallocate[1] the consideration in the contract upon either of the following:
‣ A remeasurement of the lease liability (section 4.5, Remeasurement of lease liabilities and right-of-use assets — operating and finance leases)
‣ The effective date of a contract modification that is not accounted for as a separate contract (section 4.6.2, Determining whether a lease modification is accounted for as a separate contract)
(ASC 842-10-15-36 and section 1.4.3.3, Reassessment — determining and allocating the consideration in the contract)</td><td>‣ Remeasure and reallocate the remaining consideration in the contract upon a contract modification that is not accounted for as a separate contract (section 5.6.2, Determining whether a lease modification is accounted for as a separate contract).
‣ If the consideration in the contract changes, allocate those changes in accordance with the requirements in ASC 606-10-32-42 through 32-45.
(ASC 842-10-15-41 through 15-42 and section 1.4.4.5, Reassessment — determining and allocating the consideration in the contract)</td></tr>
<tr><td>Assessment of lease term and purchase options</td><td>Reassess upon any of the following:
‣ There is a significant event or change in circumstances within the lessee's control that directly affects whether the lessee is reasonably certain to (1) extend the lease term, (2) not terminate the lease or (3) purchase the underlying asset. A change in market-based factors should not, in isolation, trigger a reassessment.
‣ There is an event that is written into the contract that obliges the lessee to exercise or not to exercise an option to extend or terminate the lease.
‣ The lessee elects to exercise an option in the lease (i.e., extension, termination or purchase) even though it had previously determined that it was not reasonably certain to do so.
‣ The lessee elects not to exercise an option in the lease (i.e., extension, termination or purchase) even though it had previously determined that it was reasonably certain to do so.
(ASC 842-10-35-1 and section 2.3.6.1, Lessees)</td><td>‣ Reassess when the lease is modified, and the modified lease is not accounted for as a separate contract (section 5.6.2, Determining whether a lease modification is accounted for as a separate contract).
‣ When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset and the exercise of the option is inconsistent with the existing lease term determination, the lessor accounts for the exercise of that option in the same manner as a lease modification (refer to section 5.6, Lease modifications, and section 5.6.1, Summary of the accounting for lease modifications — lessors).
(ASC 842-10-35-3 and section 2.3.6.2, Lessors)</td></tr>
</table>

	Lessees	Lessors
Measurement of lease payments (including variable lease payments that depend on an index or rate, the exercise price of a purchase option and, for lessees only, amounts it is probable they will owe under residual value guarantees) Also, refer to sections 2.10.3, *Residual value guarantee of a group of assets — lessees*, and 2.10.4, *Residual value guarantee of a group of assets — lessors*	Remeasure upon any of the following: ▸ A lease modification that is not accounted for as a separate contract (section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*) ▸ A resolution of a contingency that results in some or all of the lease payments that were previously determined to be variable meeting the definition of lease payments ▸ A change in the lease term (section 2.3.6.1, *Lessees)* ▸ A change in the assessment of whether a lessee is reasonably certain to exercise an option in the lease to purchase the underlying asset (section 2.3.6.1, *Lessees)* ▸ A change in amounts it is probable that a lessee will owe under residual value guarantees (ASC 842-10-35-4 through 35-5 and section 2.4.11.1, *Lessees*)	Remeasure upon a modification that is not accounted for as a separate contract (section 5.6.2, *Determining whether a lease modification is accounted for as a separate contract*). (ASC 842-10-35-6 and section 2.4.11.2, *Lessors*)
Assessment of lease classification[2]	Reassess upon any of the following: ▸ A modification that is not accounted for as a separate contract (section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*) ▸ A change to the lease term or assessment of whether a lessee is reasonably certain to exercise an option in the lease to purchase the underlying asset (section 2.3.6.1, *Lessees*) (ASC 842-10-25-1 and section 3.5, *Reassessment of lease classification*)	Reassess upon a modification that is not accounted for as a separate contract (section 5.6.2, *Determining whether a lease modification is accounted for as a separate contract*). (ASC 842-10-25-1 and section 3.5, *Reassessment of lease classification*)
Assessment of the discount rate	Reassess upon any of the following: ▸ A change in the lease term or the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset if the discount rate for the lease liability does not already reflect the lessee's option in the lease to extend or terminate the lease or to purchase the underlying asset ▸ A modification that is not accounted for as a separate contract (section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*) (ASC 842-20-35-5, section 2.5.3.2, *Lessees,* and section 4.5, *Remeasurement of lease liabilities and right-of-use assets*)	Reassess, for purposes of lease classification, upon a modification that is not accounted for as a separate contract. (ASC 842-10-25-9 and section 3.5, *Reassessment of lease classification*) The discount rate used to account for the modified lease depends on the classification of the lease before and after the lease modification. (ASC 842-10-25-15 through 25-17, section 2.5.3.1, *Lessors*, and section 5.6.3, *Lessor accounting for a modification that is not accounted for as a separate contract*)

	Lessees	Lessors
Assessment of collectibility	Not applicable	If collectibility is probable at the commencement date for a sales-type or a direct financing lease, a lessor does not reassess collectibility for purposes of lease classification. Changes in collectibility are accounted for in accordance with the impairment guidance applicable to the net investment in the lease. (ASC 842-30-25-6, section 5.2.1.1, *Collectibility is probable at lease commencement*, for sales-type leases, and section 5.3.1, *Initial recognition and measurement*, for direct financing leases) If collectibility is not probable at the commencement date for a sales-type lease, a lessor continually reassesses collectibility until it becomes probable. (ASC 842-30-25-3 and section 5.2.1.2, *Collectibility is not probable at lease commencement*) If collectibility is not probable at the commencement date, a lease that would otherwise be classified as a direct financing lease is instead classified and accounted for as an operating lease. The classification of such a lease is not changed based upon a subsequent evaluation of collectibility. For an operating lease, a lessor continually reassesses collectibility. (ASC 842-30-25-13 and section 5.4, *Operating leases*)

Note: Refer to section 4.6, *Lease modifications*, and section 5.6, *Lease modifications*, for further details on accounting for lease modifications by lessees and lessors, respectively.

[1] ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component. Lessees that elect this practical expedient do not reallocate the remaining consideration in the contract to non-lease components upon the events discussed above. Refer to section 1.4.2.3, *Practical expedient — lessees*, for further detail.

[2] For leases that were classified as leveraged leases in accordance with ASC 840, and for which the commencement date is before the effective date of ASU 2016-02, a lessor applies the requirements in ASC 842-50 (i.e., the leveraged lease accounting guidance). If a leveraged lease is modified on or after the effective date, it is accounted for as a new lease as of the effective date of the modification in accordance with ASC 842-10 and 842-30 (i.e., it will no longer be accounted for as a leveraged lease) (ASC 842-10-65-1(z) and section 11.4.5, *Leases previously classified as leveraged leases under ASC 840*).

4 Lessee accounting

4.1 Initial recognition

Excerpt from Accounting Standards Codification

Leases — Lessee

Recognition

842-20-25-1

At the **commencement date**, a **lessee** shall recognize a **right-of-use asset** and a **lease liability**.

Master Glossary

Short-Term Lease

A **lease** that, at the **commencement date**, has a **lease term** of 12 months or less and does not include an option to purchase the **underlying asset** that the **lessee** is reasonably certain to exercise.

Right-of-Use Asset

An asset that represents a **lessee's** right to use an **underlying asset** for the **lease term.**

Lease Liability

A **lessee's** obligation to make the **lease payments** arising from a **lease**, measured on a discounted basis.

Leases — Lessee

Recognition

842-20-25-2

As an accounting policy, a **lessee** may elect not to apply the recognition requirements in this Subtopic to **short-term leases**. Instead, a lessee may recognize the **lease payments** in profit or loss on a straight-line basis over the **lease term** and **variable lease payments** in the period in which the obligation for those payments is incurred (consistent with paragraphs 842-20-55-1 through 55-2). The accounting policy election for short-term leases shall be made by class of **underlying asset** to which the right of use relates.

842-20-25-3

If the lease term or the assessment of a lessee option to purchase the underlying asset changes such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term or the lessee is reasonably certain to exercise its option to purchase the underlying asset, the lease no longer meets the definition of a short-term lease and the lessee shall apply the remainder of the guidance in this Topic as if the date of the change in circumstances is the **commencement date.**

At the commencement date of a lease, a lessee recognizes a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

The initial recognition of the right-of-use asset and the lease liability is the same for operating leases and finance leases, as is the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for operating leases and finance leases differs under ASC 842. Refer to section 4.2.2.2, *Right-of-use assets,* and 4.3.2.2, *Right-of-use assets*, on subsequent measurement of right-of-use assets for operating leases and finance leases, respectively.

4.1.1 Short-term leases

Lessees can make an accounting policy election (by class of underlying asset to which the right of use relates) to apply accounting similar to ASC 840's operating lease accounting to leases that meet ASC 842's definition of a short-term lease (i.e., the short-term lease exception). A short-term lease is defined as a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The short-term lease election can only be made at the commencement date (refer to section 2.2, *Commencement date of the lease*, for discussion of the commencement date).

ASC 842 does not address how an entity should identify a class of underlying asset. Entities may want to consider the following:

- ASC 360-50 also requires disclosures of "… balances of major classes of depreciable assets, by nature or function… ."
- The Master Glossary defines an intangible asset class as "a group of intangible assets that are similar, either by their nature or by their use in the operations of an entity."

A lessee that makes this accounting policy election does not recognize a lease liability or right-of-use asset on its balance sheet. Instead, the lessee recognizes lease payments as an expense on a straight-line basis over the lease term and variable lease payments that do not depend on an index or rate as expense in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable. Any recognized variable lease expense is reversed if it is probable that the specified target will no longer be met. Refer to section 2. 9, *Amounts not included in lease payments*, for a discussion of variable lease payments that do not depend on an index or rate.

When determining whether a lease qualifies as a short-term lease, a lessee evaluates the lease term and the purchase option in the same manner as all other leases. Refer to section 2.3, *Lease term and purchase options.* That is, the lease term includes the noncancelable term of the lease and all of the following:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain **not** to exercise that option
- Periods covered by an option to extend (or not terminate) the lease in which the exercise of the option is controlled by the lessor

A lease that qualifies as a short-term lease at the commencement date no longer meets the definition of a short-term lease when there is a change in a lessee's assessment of either:

- The lease term so that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term
- Whether it is reasonably certain to exercise an option to purchase the underlying asset

When the lease no longer meets the definition of a short-term lease, a lessee that is applying the short-term lease exception must apply the recognition and measurement guidance for all other leases as if the date of the change in circumstances is the commencement date.

The short-term lease accounting policy election is intended to reduce the cost and complexity of applying ASC 842. However, a lessee that makes the election must make certain quantitative and qualitative disclosures about short-term leases. Refer to section 4.10, *Disclosure*.

Once a lessee establishes a policy for a class of underlying assets, all future short-term leases for that class are required to be accounted for in accordance with the lessee's policy. A lessee evaluates any potential change in its accounting policy in accordance with the guidance in ASC 250, *Accounting Changes and Error Corrections*.

Illustration 22 — Short-term lease

Scenario A

A lessee enters into a lease with a nine-month noncancelable term with an option to extend the lease for four months. The lease does not include a purchase option. At the lease commencement date, the lessee concludes that it is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates. The lessee has an established accounting policy to use the short-term lease exception for the class of underlying asset subject to this lease.

Analysis: The lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee may not account for the lease as a short-term lease.

Scenario B

Assume the same facts as in Scenario A except, at the lease commencement date, the lessee concludes that it is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are what the lessee expects to be market rates, and there are no other factors that would make exercise of the renewal option reasonably certain.

Analysis: The lease term is 12 months or less (i.e., nine months). Therefore, the lessee accounts for the lease under the short-term lease exception (i.e., it recognizes lease payments as an expense on a straight-line basis over the lease term and does not recognize a lease liability or right-of-use asset on its balance sheet).

4.2 Operating leases

4.2.1 Initial measurement

Excerpt from Accounting Standards Codification

Leases — Lessee

Initial Measurement

842-20-30-1

At the **commencement date**, a **lessee** shall measure both of the following:

a. The **lease liability** at the present value of the **lease payments** not yet paid, discounted using the **discount rate for the lease** at lease commencement (as described in paragraphs 842-20-30-2 through 30-4)

b. The right**-of-use asset** as described in paragraph 842-20-30-5.

842-20-30-5

At the **commencement date**, the cost of the **right-of-use asset** shall consist of all of the following:

a. The amount of the initial measurement of the **lease liability**

b. Any **lease payments** made to the **lessor** at or before the commencement date, minus any lease incentives received

c. Any **initial direct costs** incurred by the **lessee** (as described in paragraphs 842-10-30-9 through 30-10).

4.2.1.1 Lease liabilities

At the commencement date (refer to section 2.2, *Commencement date of the lease*), a lessee initially measures the lease liability at the present value of the lease payments to be made over the lease term. Lessees apply the concepts previously described in chapter 1, *Scope and scope exceptions*, and chapter 2, *Key concepts*, to identify the lease components and to determine the lease term, lease payments and discount rate as of the commencement date of the lease.

4.2.1.2 Right-of-use assets

A lessee initially measures the right-of-use asset at cost, which consists of all of the following:

- The amount of the initial measurement of the lease liability
- Any lease payments made to the lessor at or before the commencement date, less any lease incentives received (refer to section 2.4.1.2, *Lease incentives*)
- Any initial direct costs incurred by the lessee (refer to section 2.6, *Initial direct costs*)

4.2.2 Subsequent measurement

Excerpt from Accounting Standards Codification

Leases — Lessee

Subsequent Measurement

842-20-35-3

After the commencement date, for an **operating lease**, a lessee shall measure both of the following:

a. The lease liability at the present value of the lease payments not yet paid discounted using the **discount rate for the lease** established at the commencement date (unless the rate has been updated after the commencement date in accordance with paragraph 842-20-35-5, in which case that updated rate shall be used)

b. The right-of-use asset at the amount of the lease liability, adjusted for the following, unless the right-of-use asset has been previously impaired, in which case the right-of-use asset is measured in accordance with paragraph 842-20-35-10 after the impairment:

   1. Prepaid or accrued lease payments
   2. The remaining balance of any lease incentives received, which is the amount of the gross lease incentives received net of amounts recognized previously as part of the single lease cost described in paragraph 842-20-25-6(a)
   3. Unamortized **initial direct costs**
   4. Impairment of the right-of-use asset.

842-20-35-4

After the **commencement date**, a **lessee** shall remeasure the **lease liability** to reflect changes to the **lease payments** as described in paragraphs 842-10-35-4 through 35-5. A lessee shall recognize the amount of the remeasurement of the lease liability as an adjustment to the **right-of-use asset**. However, if the carrying amount of the right-of-use asset is reduced to zero, a lessee shall recognize any remaining amount of the remeasurement in profit or loss.

Recognition

842-20-25-6

After the **commencement date**, a **lessee** shall recognize all of the following in profit or loss, unless the costs are included in the carrying amount of another asset in accordance with other Topics:

a. A single lease cost, calculated so that the remaining cost of the **lease** (as described in paragraph 842-20-25-8) is allocated over the remaining **lease term** on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the **underlying asset** (see paragraph 842-20-55-3), unless the **right-of-use asset** has been impaired in accordance with paragraph 842-20-35-9, in which case the single lease cost is calculated in accordance with paragraph 842-20-25-7

b. **Variable lease payments** not included in the **lease liability** in the period in which the obligation for those payments is incurred (see paragraphs 842-20-55-1 through 55-2)

c. Any impairment of the right-of-use asset determined in accordance with paragraph 842-20-35-9.

842-20-25-8

Throughout the lease term, the remaining cost of an **operating lease** for which the right-of-use asset has not been impaired consists of the following:

a. The total **lease payments** (including those paid and those not yet paid), reflecting any adjustment to that total amount resulting from either a remeasurement in accordance with paragraphs 842-10-35-4 through 35-5 or a **lease modification**; plus

b. The total **initial direct costs** attributable to the lease; minus

c. The periodic lease cost recognized in prior periods.

4.2.2.1 Lease liabilities

After lease commencement, a lessee measures the lease liability for an operating lease at the present value of the remaining lease payments using the discount rate determined at lease commencement, as long as the discount rate hasn't been updated as a result of a reassessment event (refer to section 2.5.3, *Reassessment of the discount rate*).

4.2.2.2 Right-of-use assets

A lessee subsequently measures the right-of-use asset for an operating lease at the amount of the remeasured lease liability (i.e., the present value of the remaining lease payments), adjusted for the remaining balance of any lease incentives received, any cumulative prepaid or accrued rent if the lease payments are uneven throughout the lease term and any unamortized initial direct costs. If the right-of-use asset becomes impaired, refer to section 4.2.3, *Expense recognition*.

The FASB indicated in the Basis for Conclusions (BC 253) that the carrying amount of the right-of-use asset for an operating lease is intended to approximate the present value of the remaining benefits to the lessee at each measurement date. Therefore, the subsequent measurement of the right-of-use asset reflects the subsequent measurement of the lease liability (i.e., the present value of the remaining lease payments), adjusted for the effect of uneven lease payments.

ASC 842 requires the right-of-use asset for an operating lease to be subsequently measured using the lease liability balance, adjusted for the effect of uneven lease payments, assuming there is no impairment. Therefore, the right-of-use asset is effectively a "plug" necessary to achieve straight-line expense recognition for operating leases.

ASC 842 does not address the accounting for lease incentives that are contingently receivable by the lessee at the lease commencement date (i.e., lease incentives that are not received or receivable until the occurrence of an event subsequent to lease commencement). Examples include reimbursements for moving costs or leasehold improvements that become receivable by the lessee when the lessee incurs these costs. Refer to section 2.4.1.2, *Lease incentives,* for a discussion of lease incentives, including the timing of recognition of contingently receivable incentives.

4.2.3 Expense recognition

Operating lease expense is made up of the following:

- A single lease cost
- Variable lease payments that are not included in the lease liability (i.e., variable lease payments that do not depend on an index or rate)
- Changes to variable lease payments that depend on an index or rate
- Impairment of the right-of-use asset (see section 4.2.5, *Impairment of right-of-use assets*)

Single lease cost

After lease commencement, a lessee recognizes a single lease cost for an operating lease on a straight-line basis. This is consistent with the concept of the lessee paying to use the asset during the lease term rather than paying to finance the acquisition of the underlying asset in a finance lease. The single lease cost for an operating lease differs from the cost for a finance lease (i.e., a lessee separately recognizes interest on the finance lease liability and amortization on the finance lease right-of-use asset).

Absent an impairment of the right-of-use asset, the single lease cost is calculated so that the remaining cost of the lease is allocated over the remaining lease term on straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset.

The remaining cost of the lease is calculated as:

- Total lease payments (including those previously paid and not yet paid)
- Plus total lessee initial direct costs (attributable to the lease)
- Minus the periodic lease cost recognized in prior periods
- Total lease payments are adjusted to reflect changes that arise from a lease modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or consideration for the lease) or the remeasurement of the lease liability not recognized in profit or loss at the date of remeasurement (e.g., a change in lease term). Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*.

Pattern of benefit from use of the underlying asset

Excerpt from Accounting Standards Codification

Leases — Lessee

Implementation Guidance and Illustrations

842-20-55-3

This Subtopic considers the right to control the use of the **underlying asset** as the equivalent of physical use. If the **lessee** controls the use of the underlying asset, recognition of **lease** cost in accordance with paragraph 842-20-25-6(a) or amortization of the **right-of-use asset** in accordance with paragraph 842-20-35-7 should not be affected by the extent to which the lessee uses the underlying asset.

Operating lease agreements may specify scheduled rent increases over the lease term (refer to section 2.3, *Lease term and purchase options*) or periods during the lease term for which rent payments are not required (i.e., rent holidays). Uneven rental payments (increases, decreases or holidays) are often designed to provide an inducement for the lessee, to reflect the anticipated effects of inflation, to ease the lessee's near-term cash flow requirements or to acknowledge the time value of money. For operating leases that include uneven rental payments, rental expense should be recognized by a lessee on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the time pattern in which a benefit is expected to be derived from the right to use the underlying asset, unless the right-of-use asset becomes impaired (refer to section 4.2.5, *Impairment of right-of-use assets after the effective date*). Using factors such as the time value of money or anticipated inflation is inappropriate because these factors do not relate to the physical usage of the underlying asset.

Lease agreements may include scheduled rent increases designed to accommodate the lessee's projected physical use of the underlying asset. For example, rents may escalate in contemplation of the lessee's physical use of the underlying asset even though the lessee takes possession of or controls the physical use of the underlying asset at commencement.

It is important to note the standard emphasizes the benefit from the "right to use" as opposed to how the lessee is expected to use the underlying asset. If rents escalate in contemplation of the lessee's physical use of the underlying asset but the lessee takes possession of or controls the physical use of the underlying asset at the beginning of the lease term, all rental payments, including the escalated rents, should be recognized as rental expense on a straight-line basis starting with the beginning of the lease term (i.e., rent expense is not affected by the extent to which the lessee uses the asset).

The application of the guidance above to an operating lease with uneven rental payments that are not representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset results in prepaid or accrued rentals. If the lessee purchases the leased asset prior to the expiration of the lease term, any prepaid or accrued rentals should be included in the determination of the purchase price of the asset (refer to section 4.8.2, *Purchase of a leased asset during the lease term,* for further discussion). If the lease agreement is extended, lessees should apply the guidance in section 4.6, *Lease modifications*.

Variable lease payments

Excerpt from Accounting Standards Codification

Leases — Lessee

Implementation Guidance and Illustrations

842-20-55-1

A **lessee** should recognize costs from **variable lease payments** (in annual periods as well as in interim periods) before the achievement of the specified target that triggers the variable lease payments, provided the achievement of that target is considered **probable**.

842-20-55-2

Variable lease costs recognized in accordance with paragraph 842-20-55-1 should be reversed at such time that it is probable that the specified target will not be met.

After the commencement date, lessees also recognize as an expense any variable lease payments not included in the operating lease liability. Variable lease payments are recognized in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable. Any recognized variable lease costs are reversed if it becomes probable that the specified target will no longer be met. Refer to section 2.9, *Variable lease payments,* for a discussion of variable leases payments that do not depend on an index or rate.

Impairment of the right-of-use asset

If a lessee determines that a right-of-use asset is impaired, it recognizes an impairment loss and measures the right-of-use asset at its carrying amount immediately after the impairment. Following an impairment, the single lease cost is calculated in the manner described in section 4.2.5, *Impairment of right-of-use assets after the effective date*.

4.2.4 Example — lessee accounting for an operating lease

Illustration 23 — Lessee accounting for an operating lease

Entity L (lessee) enters into a three-year lease of office space and concludes that the agreement is an operating lease. Entity L agrees to pay the following annual payments at the end of each year: \$10,000 in Year 1, \$12,000 in Year 2 and \$14,000 in Year 3. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is \$33,000 using a discount rate of 4.235%. Entity L uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Entity L calculates that the annual straight-line lease expense is \$12,000 per year [(\$10,000 + \$12,000 + \$14,000) ÷ 3].

Analysis: At lease commencement, Entity L would recognize the right-of-use asset and lease liability:

Right-of-use asset	\$ 33,000	
Lease liability		\$ 33,000

To initially recognize the right-of-use asset and lease liability

The following journal entries would be recorded in Year 1:

Lease expense	\$ 12,000	
Right-of-use asset		\$ 2,000
Cash		\$ 10,000
Lease liability	\$ 8,602	
Right-of-use asset		\$ 8,602

To record lease expense and adjust the right-of-use asset for the difference between cash paid and straight-line lease expense (i.e., accrued rent). To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of \$8,602 is calculated as the initially recognized lease liability (\$33,000) less the present value of remaining lease payments (\$24,398) at the end of Year 1.

A summary of the lease contract's accounting (assuming no changes due to reassessment, lease modification or impairment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments:		$ 10,000	$ 12,000	$ 14,000
Income statement:				
Periodic lease expense (straight-line)		12,000	12,000	12,000
Prepaid (accrued) rent for period		$ (2,000)	$ –	$ 2,000
Balance sheet:				
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –
Right-of-use asset				
Lease liability	$ 33,000	$ 24,398	$ 13,431	$ –
Adjust: prepaid/(accrued) rent (cumulative)	–	(2,000)	(2,000)	–
	$ 33,000	$ 22,398	$ 11,431	$ –

Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.

Refer to section 4.3.4, *Example — lessee accounting for a finance lease*, for a table that illustrates the similarities and differences in the accounting for an operating lease and a finance lease.

4.2.5 Impairment of right-of-use assets after the effective date

Excerpt from Accounting Standards Codification

Leases — Lessee

Subsequent Measurement

842-20-35-9

A **lessee** shall determine whether a **right-of-use asset** is impaired and shall recognize any impairment loss in accordance with Section 360-10-35 on impairment or disposal of long-lived assets.

842-20-35-10

If a right-of-use asset is impaired in accordance with paragraph 842-20-35-9, after the impairment, it shall be measured at its carrying amount immediately after the impairment less any accumulated amortization. A lessee shall amortize, in accordance with paragraph 842-20-25-7 (for an **operating lease**) or paragraph 842-20-35-7 (for a **finance lease**), the right-of-use asset from the date of the impairment to the earlier of the end of the **useful life** of the right-of-use asset or the end of the **lease term**.

Recognition

842-20-25-7

After a right-of-use asset has been impaired in accordance with paragraph 842-20-35-9, the single lease cost described in paragraph 842-20-25-6(a) shall be calculated as the sum of the following:

a. Amortization of the remaining balance of the right-of-use asset after the impairment on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the remaining economic benefits from its right to use the underlying asset

b. Accretion of the lease liability, determined for each remaining period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability.

Lessees' right-of-use assets, for both operating and finance leases (refer to section 4.3, *Finance leases*), are subject to existing impairment guidance in ASC 360, *Property, Plant, and Equipment*. The FASB indicated in the Basis for Conclusions (BC 255) that the impairment model in ASC 360 is appropriate to apply to a lessee's right-of-use assets because the right-of-use asset is a long-lived nonfinancial asset and should be accounted for the same way as an entity's other long-lived nonfinancial assets. This treatment is intended to give users of the financial statements comparable information about all of an entity's long-lived nonfinancial assets.

ASC 360 requires an analysis of impairment indicators at each reporting period for assets held for use. Testing and evaluation of impairment of a long-lived asset is performed at the asset or asset-group level depending on the facts and circumstances. If any indicators of impairment are present, a recoverability test using undiscounted cash flows is performed. If the right-of-use asset fails the recoverability test, ASC 360 requires a fair value test. Under ASC 842, if an impairment loss is recognized for a right-of-use asset, the adjusted carrying amount of a right-of-use asset would be its new accounting basis. Consistent with ASC 360, the impairment test for right-of-use assets will often be performed at an asset-group level with any impairment allocated among the asset group in accordance with ASC 360. ASC 360 prohibits the subsequent reversal of an impairment loss for an asset held and used.

ASC 360 provides principles for evaluating long-lived assets for impairment, but does not specifically address how operating lease liabilities and future cash outflows for lease payments should be considered when performing the recoverability test. Based on a 2016 FASB Technical Inquiry, the FASB staff believes that a lessee would include a lease liability as part of the carrying amount of the asset group. Additionally, only the principle component of future lease payments would be included as an outflow in the undiscounted future cash flows used to test recoverability of the asset group. That is, the lessee would include the future cash payments for the lease, excluding the component that effectively represents the accretion of the lease liability (even though interest expense is not recognized separately for an operating lease).

Refer to our Financial reporting developments publication, *Impairment or disposal of long-lived assets*, for further discussion of evaluating assets for impairment in accordance with ASC 360.

A lessee subsequently amortizes the held for use right-of-use asset, generally on a straight-line basis, from the date of the impairment to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. However, the amortization period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

Refer to section 6.3, *Sublessor accounting*, for discussion of evaluating right-of-use assets for impairment when a lessee enters into a sublease.

Single lease cost

If a held for use right-of-use asset has been impaired, the single lease cost is calculated as the sum of the following:

- Amortization of the remaining balance of the right-of-use asset after the impairment on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the remaining economic benefits from its right to use the underlying asset
- Accretion of the lease liability, determined for each remaining period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability

ASC 842 includes the following example of the subsequent accounting for an operating lease following an impairment of the right-of-use asset.

Excerpt from Accounting Standards Codification

Leases — Lessee

Implementation Guidance and Illustrations

Example 5 — Impairment of a Right-of-Use Asset in an Operating Lease

842-20-55-48

Lessee enters into a 10-year lease of a nonspecialized asset. Lease payments are $10,000 per year, payable in arrears. The lease does not transfer ownership of the underlying asset or grant Lessee an option to purchase the underlying asset. At lease commencement, the remaining economic life of the underlying asset is 50 years, and the fair value of the underlying asset is $600,000. Lessee does not incur any initial direct costs as a result of the lease. Lessee's incremental borrowing rate is 7 percent, which reflects the fixed rate at which Lessee could borrow the amount of the lease payments in the same currency, for the same term, and with similar collateral as in the lease at commencement. The lease is classified as an operating lease.

842-20-55-49

At the commencement date, Lessee recognizes the lease liability of $70,236 (the present value of the 10 lease payments of $10,000, discounted at the rate of 7 percent). Lessee also recognizes a right-of-use asset of $70,236 (the initial measurement of the lease liability). Lessee determines the cost of the lease to be $100,000 (the total lease payments for the lease term). The annual lease expense to be recognized is therefore $10,000 ($100,000 ÷ 10 years).

842-20-55-50

At the end of Year 3, when the carrying amount of the lease liability and the right-of-use asset are both $53,893, Lessee determines that the right-of-use asset is impaired in accordance with Section 360-10-35 and recognizes an impairment loss of $35,000. The right-of-use asset is part of an asset group that Lessee tested for recoverability because of a significant adverse change in the business climate that affects Lessee's ability to derive benefit from the assets within the asset group. The portion of the total impairment loss for the asset group allocated to the right-of-use asset in accordance with paragraph 360-10-35-28 is $35,000. After the impairment charge, the carrying amount of the right-of-use asset at the end of Year 3 is $18,893 ($53,893 — $35,000). Because of the impairment, the total expense recognized in Year 3 is $45,000 ($10,000 in lease expense + the $35,000 impairment charge). Beginning in Year 4, and for the remainder of the lease term, the single lease cost recognized by Lessee in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7 will equal the sum of the following:

a. Amortization of the right-of-use asset remaining after the impairment ($18,893 ÷ 7 years = $2,699 per year)

b. Accretion of the lease liability. For example, in Year 4, the accretion is $3,773 ($53,893 × 7%) and, in Year 5, the accretion is $3,337 ($47,665 × 7%).

842-20-55-51

Consequently, at the end of Year 4, the carrying amount of the lease liability is $47,665 (that is, calculated as either the present value of the remaining lease payments, discounted at 7 percent, or the previous balance of $53,893 — $10,000 Year 4 lease payment + the $3,773 accretion of the lease liability). The carrying amount of the right-of-use asset is $16,194 (the previous balance of $18,893 — $2,699 amortization). Lessee measures the lease liability and the right-of-use asset in this manner throughout the remainder of the lease term.

4.3 Finance leases

4.3.1 Initial measurement

The initial measurement of the lease liabilities and right-of-use assets for finance leases is the same as for operating leases.

4.3.1.1 Lease liabilities

At the commencement date (refer to section 2.2, *Commencement date of the lease*), a lessee initially measures the lease liability at the present value of the lease payments to be made over the lease term. Lessees apply the concepts previously described in chapter 1, *Scope and scope exceptions*, and chapter 2, *Key concepts*, to identify the lease components and to determine the lease term, lease payments and discount rate as of the commencement date of the lease.

4.3.1.2 Right-of-use assets

A lessee initially measures the right-of-use asset at cost, which consists of all of the following:

- The amount of the initial measurement of the lease liability
- Any lease payments made to the lessor at or before the commencement date, less any lease incentives received (refer to section 2.4.1.2, *Lease incentives*)
- Any initial direct costs incurred by the lessee (refer to section 2.6, *Initial direct costs*)

4.3.2 Subsequent measurement

Excerpt from Accounting Standards Codification

Leases — Lessee

Subsequent Measurement

842-20-35-1

After the **commencement date**, for a **finance lease**, a **lessee** shall measure both of the following:

a. The **lease liability** by increasing the carrying amount to reflect interest on the lease liability and reducing the carrying amount to reflect the **lease payments** made during the period. The lessee shall determine the interest on the lease liability in each period during the **lease term** as the amount that produces a constant periodic discount rate on the remaining balance of the liability, taking into consideration the reassessment requirements in paragraphs 842-10-35-1 through 35-5.

b. The **right-of-use asset** at cost less any accumulated amortization and any accumulated impairment losses, taking into consideration the reassessment requirements in paragraphs 842-10-35-1 through 35-5.

842-20-35-2

A lessee shall recognize amortization of the right-of-use asset and interest on the lease liability for a finance lease in accordance with paragraph 842-20-25-5.

842-20-35-7

A **lessee** shall amortize the **right-of-use asset** on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits. When the **lease liability** is remeasured and the right-of-use asset is adjusted in accordance with paragraph 842-20-35-4, amortization of the right-of-use asset shall be adjusted prospectively from the date of remeasurement.

842-20-35-8

A lessee shall amortize the right-of-use asset from the **commencement date** to the earlier of the end of the **useful life** of the right-of-use asset or the end of the **lease term**. However, if the **lease** transfers ownership of the **underlying asset** to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the right-of-use asset to the end of the useful life of the underlying asset.

Recognition

842-20-25-5

After the **commencement date**, a **lessee** shall recognize in profit or loss, unless the costs are included in the carrying amount of another asset in accordance with other Topics:

a. Amortization of the **right-of-use asset** and interest on the **lease liability**

b. **Variable lease payments** not included in the lease liability in the period in which the obligation for those payments is incurred (see paragraphs 842-20-55-1 through 55-2)

c. Any impairment of the right-of-use asset determined in accordance with paragraph 842-20-35-9.

Implementation Guidance and Illustrations

842-20-55-1

A **lessee** should recognize costs from **variable lease payments** (in annual periods as well as in interim periods) before the achievement of the specified target that triggers the variable lease payments, provided the achievement of that target is considered **probable**.

842-20-55-2

Variable lease costs recognized in accordance with paragraph 842-20-55-1 should be reversed at such time that it is probable that the specified target will not be met.

4.3.2.1 Lease liabilities

The FASB indicated in the Basis for Conclusions (BC 223) that a lease liability for finance leases should be accounted for in a manner similar to other financial liabilities (i.e., on an amortized cost basis). Consequently, the lease liability for finance leases is accreted using an amount that produces a constant periodic discount rate on the remaining balance of the liability (i.e., the discount rate determined at commencement, as long as a reassessment requiring a change in the discount rate has not been triggered) (refer to section 2.5.3, *Reassessment of the discount rate*). Lease payments reduce the lease liability as they are paid.

Periodic lease payments on finance leases are allocated between a reduction of the lease liability and interest expense to produce a constant periodic interest rate on the remaining balance of the lease liability. This will result in a remaining balance of the lease liability at the end of the lease term equal to the amount of any of the following that were included in lease payments used to measure the lease liability (refer to section 2.4, *Lease payments*):

- The exercise price of a purchase option (refer to section 2.4.3, *The exercise price of a purchase option*)
- Amounts that it is probable a lessee will owe under a residual value guarantee (refer to section 2.4.6, *Amount it is probable that a lessee will owe under residual value guarantees — lessees only*)
- A termination penalty (refer to section 2.4.4, *Payments for penalties for terminating a lease*)

While ASC 842 describes the subsequent measurement of a finance lease liability differently from that of an operating lease liability, from a practical perspective, we expect the lease liability balance to be the same. The difference in the expense recognition pattern of an operating lease (i.e., generally straight-line expense) and a finance lease (i.e., generally front-loaded expense) is driven by the subsequent accounting for the right-of-use asset.

4.3.2.2 Right-of-use assets

Amortization of the right-of-use asset is recognized in a manner consistent with existing guidance for nonfinancial assets that are measured at cost. Lessees amortize the right-of-use asset on a straight-line basis, unless another systematic basis better represents the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits. The right-of-use asset is amortized over the shorter of the lease term or the useful life of the right-of-use asset. However, the amortization period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

See Section 4.3.4, *Example — lessee accounting for a finance lease*, for a comprehensive example.

4.3.3 Expense recognition

Lessees recognize the following items in expense for finance leases:

- Amortization of the right-of-use asset
- Interest on the lease liability
- Variable lease payments that are not included in the lease liability (i.e., variable lease payments that do not depend on an index or rate)
- Changes to variable lease payments that depend on an index or rate
- Impairment of the right-of-use asset

Amortization of the right-of-use asset and interest on the lease liability

After the commencement date, a lessee recognizes amortization of the right-of-use asset and separately recognizes interest on the lease liability for a finance lease. The recognition of interest and amortization expense for finance leases is consistent with a view that such leases are effectively installment purchases. That is, the lessee is paying to finance the acquisition of the underlying asset that will be consumed during the lease term.

The total periodic expense (i.e., the sum of interest and amortization expense) of a finance lease is typically higher in the early periods and lower in the later periods. Because a constant interest rate is applied to the lease liability, interest expense decreases as cash payments are made during the lease term and the lease liability decreases. Therefore, more interest expense is incurred in the early periods and less in the later periods. This trend in the interest expense, combined with the straight-line amortization of the right-of-use asset, results in a front-loaded expense recognition pattern. This expense pattern is consistent with the subsequent measurement of capital leases under ASC 840.

Variable lease payments

After the commencement date, lessees also recognize in expense any variable lease payments not included in the finance lease liability in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable. Any recognized variable lease costs are reversed if it becomes probable that the specified target will no longer be met. Refer to section 2.9, Variable lease payments, for a discussion of variable leases payments that do not depend on an index or rate.

Impairment of the right-of-use asset

Lessees' right-of-use assets, for both finance leases and operating leases (refer to section 4.2, *Operating leases*), are subject to existing impairment guidance in ASC 360.

If a lessee determines that a finance lease right-of-use asset is impaired, it recognizes an impairment loss and measures the right-of-use asset at its carrying amount immediately after the impairment. A lessee subsequently amortizes, generally on a straight-line basis, the right-of-use asset from the date of the impairment to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. However, the amortization period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term. Refer to section 4.2.5, *Impairment of right-of-use assets after the effective date*, for additional discussion of impairment of right-of-use assets.

4.3.4 Example — lessee accounting for a finance lease

Illustration 24 — Lessee accounting for a finance lease

Entity H (lessee) enters into a three-year lease of equipment and concludes that the agreement is a finance lease because the lease term is for a major part of the remaining economic life of the underlying asset (also three years). Entity H agrees to make the following annual payments at the end of each year: $10,000 in Year 1, $12,000 in Year 2 and $14,000 in Year 3. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 (present value of lease payments using a discount rate of 4.235%). Entity H uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Entity H amortizes the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Entity H would recognize the right-of-use asset and lease liability:

Right-of-use asset	$	33,000		
Lease liability			$	33,000

To initially recognize the right-of-use asset and lease liability

- The following journal entries would be recorded in Year 1:

Interest expense	$	1,398		
Lease liability			$	1,398

To record interest expense and accrete the lease liability using the interest method ($33,000 x 4.235%)

Amortization expense	$	11,000		
Right-of-use asset			$	11,000

To record amortization expense on the right-of-use asset ($33,000 ÷ 3 years)

Lease liability	$	10,000		
Cash			$	10,000

To record lease payment

A summary of the lease contract's accounting (assuming no changes due to reassessment, lease modification or impairment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments		$ 10,000	$ 12,000	$ 14,000
Lease expense recognized				
Interest expense		$ 1,398	$ 1,033	$ 569
Amortization expense		11,000	11,000	11,000
Total periodic expense		$ 12,398	$ 12,033	$ 11,569
Balance sheet				
Right-of-use asset	$ 33,000	$ 22,000	$ 11,000	$ –
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –

Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.

Illustration 25 — Comparing a lessee's accounting for finance leases and operating leases

This table illustrates the similarities and differences in accounting for finance (see Illustration 11) and operating (see Illustration 10) leases:

Finance lease:

Time	Lease liability	Right-of-use asset	Interest expense	Amortization expense	Total expense
Initial	$ 33,000	$ 33,000			
Year 1	$ 24,398	$ 22,000	$ 1,398	$ 11,000	$ 12,398
Year 2	$ 13,431	$ 11,000	1,033	11,000	12,033
Year 3	$ –	$ –	569	11,000	11,569
			$ 3,000	$ 33,000	$ 36,000

Operating lease:

Time	Lease liability	Cumulative prepaid or (accrued) rent[1]	Right-of use asset	Lease expense
Initial	$ 33,000	$ –	$ 33,000	
Year 1	$ 24,398	$ (2,000)	$ 22,398	$ 12,000
Year 2	$ 13,431	$ (2,000)	$ 11,431	12,000
Year 3	$ –	$ –	$ –	12,000
				$ 36,000

1 Prepaid and accrued rent amounts would not be presented separately on the balance sheet. Instead, the right-of-use asset would be presented on the balance sheet net of cumulative prepaid or accrued amounts (if any).

The initial measurement of the right-of-use asset and the lease liability is the same for finance and operating leases. Also, the same total lease expense is recognized over the life of the arrangement, but it is classified differently in the income statement and recognized at different times. A lessee generally recognizes higher periodic lease expense in the earlier periods of a finance lease than it does for an operating lease.

4.4 Master lease agreements

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-17

Under a master **lease** agreement, the **lessee** may gain control over the use of additional **underlying assets** during the term of the agreement. If the agreement specifies a minimum number of units or dollar value of equipment, the lessee obtaining control over the use of those additional underlying assets is not a **lease modification**. Rather, the entity (whether a lessee or a **lessor**) applies the guidance in paragraphs 842-10-15-28 through 15-42 when identifying the separate lease components and allocating the **consideration in the contract** to those components. Paragraph 842-10-55-22 explains that a master lease agreement may, therefore, result in multiple **commencement dates**.

842-10-55-18

If the master lease agreement permits the lessee to gain control over the use of additional underlying assets during the term of the agreement but does not commit the lessee to doing so, the lessee's taking control over the use of an additional underlying asset should be accounted for as a lease modification in accordance with paragraphs 842-10-25-8 through 25-18.

Under a master lease agreement, a lessee may gain control over the use of additional underlying assets during the term of the agreement. In certain cases, a master lease agreement may specify a minimum number or value of underlying assets the lessee is required to obtain. For example, a lessee enters into an agreement to obtain the right to lease three floors of a building with an option to lease an additional floor (i.e., the fourth floor).

To the extent that a lessee is required to take a specified minimum quantity or value of the underlying assets, the lessee obtaining control over the use of those additional underlying assets is not a lease modification (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease). To identify the separate lease components and allocate the amount of consideration in the master lease agreement attributed to the additional underlying assets, the lessor applies the guidance in ASC 842-10-15-28 through 15-42 (refer to section 1.4, *Identifying and separating lease and non-lease components of a contract and allocating contract consideration*).

To the extent that additional underlying assets beyond the specified minimum are leased under the master lease agreement, the lessee obtaining control over the use of those additional underlying assets is considered a lease modification. Refer to section 4.6, *Lease modifications*, for the accounting of a lease modification.

If a master lease agreement does not include a specified minimum quantity or dollar value, the lessee obtaining control over the use any additional underlying asset is also considered a lease modification. Refer to section 4.6, *Lease modifications*, for the accounting of a lease modification.

4.5 Remeasurement of lease liabilities and right-of-use assets — operating and finance leases

Excerpt from Accounting Standards Codification

Leases — Lessee

Subsequent Measurement

842-20-35-4

After the **commencement date**, a **lessee** shall remeasure the **lease liability** to reflect changes to the **lease payments** as described in paragraphs 842-10-35-4 through 35-5. A lessee shall recognize the amount of the remeasurement of the lease liability as an adjustment to the **right-of-use asset**. However, if the carrying amount of the right-of-use asset is reduced to zero, a lessee shall recognize any remaining amount of the remeasurement in profit or loss.

842-20-35-5

If there is a remeasurement of the lease liability in accordance with paragraph 842-20-35-4, the lessee shall update the **discount rate for the lease** at the date of remeasurement on the basis of the remaining **lease term** and the remaining lease payments unless the remeasurement of the lease liability is the result of one of the following:

a. A change in the lease term or the assessment of whether the lessee will exercise an option to purchase the **underlying asset** and the discount rate for the lease already reflects that the lessee has an option to extend or terminate the **lease** or to purchase the underlying asset.

b. A change in amounts **probable** of being owed by the lessee under a **residual value guarantee** (see paragraph 842-10-35-4(c)(3)).

c. A change in the lease payments resulting from the resolution of a contingency upon which some or all of the **variable lease payments** that will be paid over the remainder of the lease term are based (see paragraph 842-10-35-4(b)).

Leases — Overall

Subsequent Measurement

842-10-35-4

A **lessee** shall remeasure the **lease payments** if any of the following occur:

a. The **lease** is modified, and that modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8.

b. A contingency upon which some or all of the **variable lease payments** that will be paid over the remainder of the **lease term** are based is resolved such that those payments now meet the definition of lease payments. For example, an event occurs that results in variable lease payments that were linked to the performance or use of the **underlying asset** becoming fixed payments for the remainder of the lease term.

c. There is a change in any of the following:

1. The lease term, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments on the basis of the revised lease term.

2. The assessment of whether the lessee is reasonably certain to exercise or not to exercise an option to purchase the underlying asset, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments to reflect the change in the assessment of the purchase option.

3. Amounts **probable** of being owed by the lessee under **residual value guarantees**. A lessee shall determine the revised lease payments to reflect the change in amounts probable of being owed by the lessee under residual value guarantees.

842-10-35-5

When a lessee remeasures the lease payments in accordance with paragraph 842-10-35-4, variable lease payments that depend on an index or a rate shall be measured using the index or rate at the remeasurement date.

Lessees are required to remeasure finance and operating lease liabilities when there is a lease modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that is not accounted for as a separate contract. Refer to section 4.6, *Lease modifications*.

Lessees are also required to remeasure finance and operating lease liabilities when any of the following occurs:

- A resolution of a contingency that results in some or all of the payments allocated to the lease component that were previously determined to be variable meeting the definition of a lease payment (e.g., an event occurs that results in variable payments that were linked to the performance or use of the underlying asset becoming fixed payments for the remainder of the lease term)

- A change in any of the following:

  - The lease term (refer to section 2.3.1, *Lease term*)

  - The assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset (refer to section 2.3.2, *Purchase options*)

  - The amount it is probable the lessee will owe under a residual value guarantee (refer to section 2.4.6, *Amounts it is probable that a lessee will owe under residual value guarantees — lessees only*)

In these cases, a lessee remeasures the lease liability at the reassessment date and adjusts the right-of-use asset by the change in the lease liability. However, if the right-of-use asset is reduced to zero, a lessee recognizes any remaining amount in profit or loss. The FASB indicated in the Basis for Conclusions (BC 225) that a right-of-use asset that was previously reduced to zero could be remeasured to an amount greater than zero if a reassessment of the lease term or a lessee's purchase option increases the lease liability. However, the FASB observed that a right-of-use asset would generally be measured at zero before the end of the lease term if it has been fully impaired (refer to section 4.2.5, *Impairment of right-of-use assets after the effective date*), and it would be unlikely that a lessee would reassess the lease term upward or conclude that it is reasonably certain to exercise an option to purchase the underlying asset when it has previously concluded the fair value of the right-of-use asset was fully impaired.

The discount rate is also revised at the remeasurement date based on the remaining lease term and lease payments unless the remeasurement of the lease liability is the result of one of the following:

- A change in the lease term or the assessment of whether the lessee will exercise an option to purchase the underlying asset and the discount rate for the lease already reflects that the lessee has an option to extend or terminate the lease or to purchase the underlying asset
- A change in the amount it is probable the lessee will owe under a residual value guarantee
- A resolution of a contingency that results in some or all of the lease payments that were previously determined to be variable meeting the definition of lease payments

Refer to Section 3.5.1, *Summary of lease reassessment and remeasurement requirements*.

4.6 Lease modifications

Excerpt from Accounting Standards Codification

Master Glossary

Lease Modification

A change to the terms and conditions of a **contract** that results in a change in the scope of or the consideration for a **lease** (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).

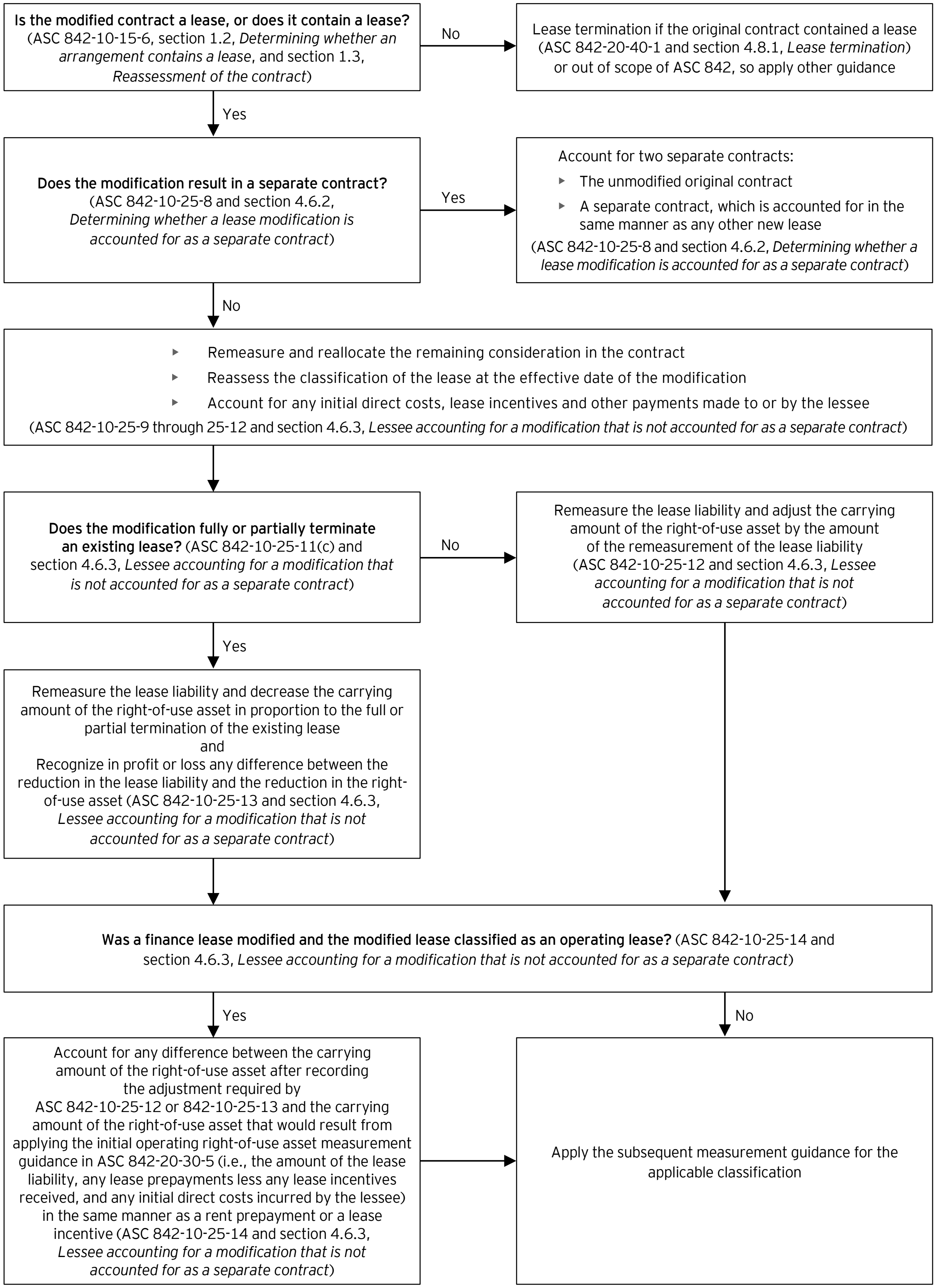
If a lease is modified (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or consideration for the lease), the modified contract is evaluated to determine whether it is or contains a lease (refer to section 1.3, *Reassessment of the contract*). If a lease continues to exist, lease modification can result in:

- A separate contract (refer to section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*)
- A change in the accounting for the existing lease and not a separate contract (refer to section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract*)

Refer to section 4.6.1, Summary of the accounting for lease modifications — lessees.

The exercise of an existing purchase or renewal option or a change in the assessment of whether such options are reasonably certain to be exercised is not a lease modification but can result in the remeasurement of lease liabilities and right-of-use assets. Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*.

4.6.1 Summary of the accounting for lease modifications — lessees



4.6.2 Determining whether a lease modification is accounted for as a separate contract

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-25-8

An entity shall account for a modification to a **contract** as a separate contract (that is, separate from the original contract) when both of the following conditions are present:

a. The modification grants the **lessee** an additional right of use not included in the original **lease** (for example, the right to use an additional asset).

b. The **lease payments** increase commensurate with the **standalone price** for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a **lessor** to incur costs that it would have incurred for a new lessee.

A lessee accounts for a lease modification (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or consideration for the lease) as a separate contract (i.e., separate from the original contract) when both of the following conditions are met:

- The modification grants the lessee an additional right of use that is not included in the original lease (e.g., a right to use an additional underlying asset).
- The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract.

If both of these conditions are met, the lease modification results in two separate contracts, the unmodified original contract and a separate new contract. Lessees account for the separate contract that contains a lease in the same manner as other new leases. Refer to Example 15 in ASC 842 that illustrates this concept in section 4.6.5, *Examples — lessees' accounting for lease modifications*.

If both of the conditions are not met, the modified lease is not accounted for as a separate contract. Refer to section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract*.

The FASB indicated in the Basis for Conclusions (BC 176(a)) that the right to use an additional underlying asset (e.g., an additional floor of a building) will generally be a separate lease component, even if the modification granting that additional right of use does not create a separate contract (i.e., separate from the original contract). To illustrate, if an existing lease for a floor of a building is modified to include a second floor, the right to use the second floor will often be a separate lease component from the right to use the first floor, even if the second floor is not accounted for under a separate contract (e.g., because the increase in lease payments is not commensurate with the standalone price for the additional floor). Refer to section 1.4.1, *Identifying and separating lease components of a contract*, and Example 17 in ASC 842 that illustrates this concept in section 4.6.5, Examples — lessees' accounting for lease modifications.

If the lease modification grants the lessee the right to use the existing leased asset for an additional period of time (i.e., a period of time not included in the original lease agreement), the modified lease is not accounted for as a separate contract. In such cases, as indicated in the Basis for Conclusions (BC 176(b)), the modification only changes an attribute of the lessee's existing right to use the underlying asset that it already controls. This is the case even if the extended term is priced at market. Refer to Example 16 in ASC 842 that illustrates this concept in section 4.6.5.2, *Modification increases the lease term*.

4.6.3 Lessee accounting for a modification that is not accounted for as a separate contract

Excerpt from Accounting Standards Codification

Master Glossary

Effective Date of the Modification

The date that a **lease modification** is approved by both the **lessee** and the **lessor**.

Leases — Overall

General

842-10-15-6

An entity shall reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed.

Recognition

842-10-25-9

If a lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the entity shall reassess the classification of the lease as of the **effective date of the modification** based on its modified terms and conditions and the facts and circumstances as of that date (for example, the **fair value** and remaining **economic life** of the **underlying asset** as of that date).

842-10-25-10

An entity shall account for **initial direct costs**, lease incentives, and any other payments made to or by the entity in connection with a modification to a lease in the same manner as those items would be accounted for in connection with a new lease.

842-10-25-11

A **lessee** shall reallocate the remaining **consideration in the contract** and remeasure the **lease liability** using a **discount rate for the lease** determined at the **effective date of the modification** if a contract modification does any of the following:

a. Grants the lessee an additional right of use not included in the original contract (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8)

b. Extends or reduces the term of an existing **lease** (for example, changes the **lease term** from five to eight years or vice versa), other than through the exercise of a contractual option to extend or terminate the lease (as described in paragraph 842-20-35-5)

c. Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease)

d. Changes the consideration in the contract only.

842-10-25-12

In the case of (a), (b), or (d) in paragraph 842-10-25-11, the lessee shall recognize the amount of the remeasurement of the lease liability for the modified lease as an adjustment to the corresponding **right-of-use asset**.

842-10-25-13

In the case of (c) in paragraph 842-10-25-11, the lessee shall decrease the carrying amount of the right-of-use asset on a basis proportionate to the full or partial termination of the existing lease. Any difference between the reduction in the lease liability and the proportionate reduction in the right-of-use asset shall be recognized as a gain or a loss at the effective date of the modification.

842-10-25-14

If a **finance lease** is modified and the modified lease is classified as an **operating lease**, any difference between the carrying amount of the right-of-use asset after recording the adjustment required by paragraph 842-10-25-12 or 842-10-25-13 and the carrying amount of the right-of-use asset that would result from applying the initial operating right-of-use asset measurement guidance in paragraph 842-20-30-5 to the modified lease shall be accounted for in the same manner as a rent prepayment or a lease incentive.

ASC 842 requires lessees to reassess whether a contract is or contains a lease when the terms and condition of a contract are changed. If the contract continues to be or contain a lease, the lessee will reassess lease classification at the effective date of a lease modification (i.e., the date that the lease modification is approved by both the lessee and the lessor) that is not accounted for as a separate contract. Lease classification is reassessed using the modified terms and conditions and the facts and circumstances as of that date, including:

- The remaining economic life of the underlying asset on that date
- The fair value of the underlying asset on that date
- The discount rate for the lease on that date
- The remeasurement and reallocation of the remaining consideration in the contract on that date

Lessees also remeasure and reallocate the remaining consideration in the contract and remeasure the lease liability (using the discount rate determined at the effective date of the modification) if a contract modification does any of the following:

Type of modification	Remeasurement and reallocation requirement	Implementation guidance
Grants the lessee an additional right of use that was not included in the original contract and the modification is not accounted for as a separate contract (refer to section 4.6.2, *Determining whether a modification is accounted for as a separate contract*)	ASC 842-10-25-12 requires the lessee to recognize the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of-use asset without affecting profit or loss.	Refer to Example 17 in section 4.6.5.3, *Modification grants an additional right of use — not a separate contract*.

Type of modification	Remeasurement and reallocation requirement	Implementation guidance
Extends or reduces the term of an existing lease (e.g., changes the lease term from five to eight years), other than through the exercise of a contractual option to extend or terminate the lease already included in the lease term	ASC 842-10-25-12 requires the lessee to recognize the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of-use asset without affecting profit or loss.	Refer to Example 16 in section 4.6.5.2, *Modification increases the lease term*.
Fully or partially terminates an existing lease (e.g., reduces the assets subject to the lease)	For a modification that fully or partially terminates the existing lease (e.g., reduces the square footage of leased space), ASC 842-10-25-13 requires a lessee to decrease the carrying amount of the right-of-use asset in proportion to the full or partial termination of the lease. Any difference between those adjustments is recognized in profit or loss at the effective date of the modification. Refer to Example 18 in ASC 842 in section 4.6.5, *Examples — lessees' accounting for lease modifications*, for an example of the accounting for a partial termination of a lease.	Refer to Example 18 in section 4.6.5.4, *Modification partially terminates a lease*.
Changes the consideration in the contract only	ASC 842-10-25-12 requires the lessee to recognize the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of-use asset without affecting profit or loss.	Refer to Example 19 in section 4.6.5.5, *Modification only changes lease payments*.

Modified lease — lease classification changes

If a finance lease is modified and the modified lease is classified as an operating lease, any difference between the carrying amount of the right-of-use asset after recording the adjustment required by ASC 842-10-25-12 or 842-10-25-13 (discussed above) and the carrying amount of the right-of-use asset that would result from applying the initial operating right-of-use asset measurement guidance in ASC 842-20-30-5 (i.e., the amount of the lease liability, any lease prepayments less any lease incentives received and any initial direct costs incurred by the lessee) to the modified lease is accounted for in the same manner as a rent prepayment or a lease incentive.

Refer to Example 16, Case B in section 4.6.5.2, *Modification increases the lease term*, for an example of an operating lease that is modified and becomes a finance lease.

Initial direct costs

Lessees account for initial direct costs, lease incentives and any other payments made to or by the lessee in connection with the lease modification in the same manner as those items are accounted for in connection with a new lease. Refer to chapter 2, *Key concepts*.

4.6.4 Lease modifications in connection with the refunding of tax-exempt debt

Excerpt from Accounting Standards Codification

Implementation Guidance and Illustrations

General

Lease Modifications

Lease Modifications in Connection with the Refunding of Tax-Exempt Debt

842-10-55-16

In some situations, tax-exempt debt is issued to finance construction of a facility, such as a plant or hospital, that is transferred to a user of the facility by **lease**. A lease may serve as collateral for the guarantee of payments equivalent to those required to service the tax-exempt debt. Payments required by the terms of the lease are essentially the same, as to both amount and timing, as those required by the tax-exempt debt. A **lease modification** resulting from a refunding by the **lessor** of tax-exempt debt (including an **advance refunding**) should be accounted for in the same manner (that is, in accordance with paragraphs 842-10-25-8 through 25-18) as any other lease modification. For example, if the perceived economic advantages of the refunding are passed through to the **lessee** in the form of reduced **lease payments**, the lessee should account for the modification in accordance with paragraph 842-10-25-12, while the lessor should account for the modification in accordance with the applicable guidance in paragraphs 842-10-25-15 through 25-17.

Tax-exempt debt is often issued by a governmental or quasi-governmental authority to finance the construction of a facility such as a plant or a hospital. The user of the facility either buys the facility or leases it from the authority. The mortgage note or the lease serves as collateral for the tax-exempt debt, and the amount and timing of payments on the note or lease are the same as the debt service requirements of the tax-exempt debt. Often, in the case of a lease, title passes at the end of the lease term, thereby meeting one of the criteria for classification as a finance lease.

Many tax-exempt organizations have entered into a refunding by replacing the old debt with new debt to obtain an economic advantage (e.g., lower interest costs) for the lessee or mortgagor. As a result of the refunding, the terms of the related mortgage note or lease are changed to conform with the terms of the new debt issued.

Refundings of tax-exempt debt transactions when the property is leased to the user are accounted for by the user in the same manner as any other lease modification. Refer to section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*, and section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract*, for further discussion of the accounting for lease modifications by lessees.

4.6.5 Examples — lessees' accounting for lease modifications

4.6.5.1 Modification is accounted for as a separate contract

ASC 842 includes the following example of a lessee's accounting for a modified lease that is accounted for as a separate contract.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

Example 15 — Modification Accounted for as a Separate Contract

842-10-55-160

Lessee enters into a 10-year lease for 10,000 square feet of office space. At the beginning of Year 6, Lessee and Lessor agree to modify the lease for the remaining 5 years to include an additional 10,000 square feet of office space in the same building. The increase in the lease payments is commensurate with the market rate at the date the modification is agreed for the additional 10,000 square feet of office space.

842-10-55-161

Lessee accounts for the modification as a new contract, separate from the original contract. This is because the modification grants Lessee an additional right of use as compared with the original contract, and the increase in the lease payments is commensurate with the standalone price of the additional right of use. Accordingly, from the effective date of the modification, Lessee would have 2 separate contracts, each of which contain a single lease component — the original, unmodified contract for 10,000 square feet of office space and the new contract for 10,000 additional square feet of office space, respectively. Lessee would not make any adjustments to the accounting for the original lease as a result of this modification.

4.6.5.2 Modification increases the lease term

ASC 842 includes the following example of a lessee's accounting for a modified lease that increases the term of the lease.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

Example 16 — Modification That Increases the Lease Term

Case A — No Change in Lease Classification

842-10-55-162

Lessee and Lessor enter into a 10-year lease for 10,000 square feet of office space in a building with a remaining economic life of 50 years. Annual payments are $100,000, paid in arrears. Lessee's incremental borrowing rate at the commencement date is 6 percent. The lease is classified as an operating lease. At the beginning of Year 6, Lessee and Lessor agree to modify the lease such that the total lease term increases from 10 years to 15 years. The annual lease payments increase to $110,000 per year for the remaining 10 years after the modification. Lessee's incremental borrowing rate is 7 percent at the date the modification is agreed to by the parties.

842-10-55-163

At the beginning of Year 6, Lessee's lease liability and its right-of-use asset both equal $421,236 (that is, because the lease payments are made annually in arrears and because the lease payments are even throughout the lease term, the lease liability and right-of-use asset will be equal).

842-10-55-164

The modification does not grant an additional right of use to the lessee; rather, it changes (modifies) an attribute of the right to use the 10,000 square feet of office space Lessee already controls. That is, after the modification, Lessee still controls only a single right of use transferred to Lessee at the original lease commencement date.

842-10-55-165

Because the modification does not grant Lessee an additional right of use, the modification cannot be a separate contract. Therefore, at the effective date of the modification, Lessee reassesses classification of the lease (which does not change in this Example — see Case B [paragraphs 842-10-55-166 through 55-167] for a change in lease classification) and remeasures the lease liability on the basis of the 10-year remaining lease term, 10 remaining payments of $110,000, and its incremental borrowing rate at the effective date of the modification of 7 percent. Consequently, the modified lease liability equals $772,594. The increase to the lease liability of $351,358 is recorded as an adjustment to the right-of-use asset (that is, there is no income or loss effect from the modification).

The example below assumes the same facts as Case A above except that the underlying asset is a piece of equipment with a 12-year remaining economic life at the effective date of the modification. Therefore, when the lessee reassesses classification as of the effective date of the modification, the modified lease is classified as a finance lease (i.e., lease classification changes).

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

Example 16 — Modification That Increases the Lease Term

Case B — Change in Lease Classification

842-10-55-166

Assume the same facts as in Case A (paragraphs 842-10-55-162 through 55-165), except that the underlying asset is a piece of equipment with a 12-year remaining economic life at the effective date of the modification. Consequently, when the lessee reassesses classification of the lease in accordance with paragraph 842-10-25-1 as of the effective date of the modification based on the modified rights and obligations of the parties, the lessee classifies the modified lease as a finance lease (that is, because the remaining lease term of 10 years is for a major part of the 12-year remaining economic life of the equipment).

842-10-55-167

Consistent with Case A, at the effective date of the modification, the lessee remeasures its lease liability based on the 10-year remaining lease term, 10 remaining payments of $110,000, and its incremental borrowing rate of 7 percent. Consequently, the modified lease liability equals $772,594. The increase to the lease liability of $351,358 is recorded as an adjustment to the right-of-use asset (that is, there is no income or loss effect from the modification). However, different from Case A, beginning on the effective date of the modification, Lessee accounts for the 10-year modified lease as a finance lease.

4.6.5.3 Modification grants an additional right of use — not a separate contract

ASC 842 includes the following example of a lessee's accounting for a modified lease that grants an additional right of use but is not accounted for as a separate contract.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

Example 17 — Modification That Grants an Additional Right of Use

842-10-55-168

Lessee enters into a 10-year lease for 10,000 square feet of office space. The lease payments are $100,000 per year, paid in arrears. Lessee's incremental borrowing rate at lease commencement is 6 percent. At the beginning of Year 6, Lessee and Lessor agree to modify the contract to include an additional 10,000 square feet of office space on a different floor of the building for the final 4 years of the original 10-year lease term for a total annual fixed payment of $150,000 for the 20,000 square feet.

842-10-55-169

The increase in the lease payments (of $50,000 per year) is at a substantial discount to the market rate at the date the modification is agreed to for leases substantially similar to that for the new 10,000 square feet of office space that cannot be attributed solely to the circumstances of the contract. Consequently, Lessee does not account for the modification as a separate contract.

842-10-55-170

Instead, Lessee accounts for the modified contract, which contains 2 separate lease components — first, the original 10,000 square feet of office space and, second, the right to use the additional 10,000 square feet of office space for 4 years that commences 1 year after the effective date of the modification. There are no nonlease components of the modified contract. The total lease payments, after the modification, are $700,000 (1 payment of $100,000 + 4 payments of $150,000).

842-10-55-171

Lessee allocates the lease payments in the modified contract to the 2 separate lease components on a relative standalone price basis, which, in this Example, results in the allocation of $388,889 to the original space lease and $311,111 to the additional space lease. The allocation is based on the remaining lease terms of each separate lease component (that is, 5 years for the original 10,000-square-foot lease and 4 years for the additional 10,000-square-foot lease). The remaining lease cost for each separate lease component is equal to the total payments, as allocated, which will be recognized on a straight-line basis over their respective lease terms. Lessee remeasures the lease liability for the original space lease as of the effective date of the modification — the lease classification of which does not change as a result of the modification — on the basis of all of the following:

a. A remaining lease term of 5 years

b. Annual allocated lease payments of $77,778 in Years 6 through 10 (see paragraph 842-10-55-173)

c. Lessee's incremental borrowing rate at the effective date of the modification of 7 percent.

842-10-55-172

The remeasured lease liability for the original space lease equals $318,904. Lessee recognizes the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification of $102,332 ($421,236 − $318,904) as an adjustment to the right-of-use asset.

842-10-55-173

During Year 6, Lessee recognizes lease cost of $77,778. At the end of Year 6, Lessee makes its lease payment of $100,000, of which $77,778 is allocated to the lease of the original office space and $22,222 is allocated to the lease of the additional office space as a prepayment of rent. Lessee allocates the lease payment in this manner to reflect even payments for the even use of the separate lease components over their respective lease terms.

842-10-55-174

At the commencement date of the separate lease component for the additional office space, which is 1 year after the effective date of the modification, Lessee measures and recognizes the lease liability at $241,896 on the basis of all of the following:

a. A lease term of 4 years

b. Four allocated annual payments of $72,222 ([allocated lease payments of $311,111 − $22,222 rent prepayment] ÷ 4 years)

c. Lessee's incremental borrowing rate at the commencement date of the separate lease component for the additional office space of 7.5 percent.

842-10-55-175

At the commencement date, the right-of-use asset for the additional office space lease component is recognized and measured at $264,118 (the sum of the lease liability of $241,896 and the prepaid rent asset of $22,222).

842-10-55-176

During Years 7–10, Lessee recognizes lease cost of $77,778 each year for each separate lease component and allocates each $150,000 annual lease payment of $77,778 to the original office space lease and $72,222 to the additional office space lease.

4.6.5.4 Modification partially terminates a lease

ASC 842 includes the following example of a lessee's accounting for a modified lease that partially terminates a lease.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

Example 18 — Modification That Decreases the Scope of a Lease

842-10-55-177

Lessee enters into a 10-year lease for 10,000 square feet of office space. The annual lease payment is initially $100,000, paid in arrears, and increases 5 percent each year during the lease term. Lessee's incremental borrowing rate at lease commencement is 6 percent. Lessee does not provide a residual value guarantee. The lease does not transfer ownership of the office space to Lessee or grant Lessee an option to purchase the space. The lease is an operating lease for all of the following reasons:

a. The lease term is 10 years, while the office building has a remaining economic life of 40 years.

b. The fair value of the office space is estimated to be significantly in excess of the present value of the lease payments.

c. The office space is expected to have an alternative use to Lessor at the end of the lease term.

842-10-55-178

At the beginning of Year 6, Lessee and Lessor agree to modify the original lease for the remaining 5 years to reduce the lease to only 5,000 square feet of the original space and to reduce the annual lease payment to $68,000. That amount will increase 5 percent each year thereafter of the remaining lease term.

842-10-55-179

The classification of the lease does not change as a result of the modification. It is clear based on the terms of the modified lease that it is not a finance lease because the modification reduces both the lease term and the lease payments. Lessee remeasures the lease liability for the modified lease at the effective date of the modification on the basis of all of the following:

a. A remaining lease term of 5 years

b. Lease payments of $68,000 in the year of modification (Year 6), increasing by 5 percent each year thereafter

c. Lessee's incremental borrowing rate at the effective date of the modification of 7 percent.

842-10-55-180

The remeasured lease liability equals $306,098.

Case A — Remeasuring the Right-of-Use Asset Based on Change in Lease Liability

842-10-55-181

The difference between the premodification liability and the modified lease liability is $284,669 ($590,767 − $306,098). That difference is 48.2 percent ($284,669 ÷ $590,767) of the premodification lease liability. The decrease in the lease liability reflects the early termination of the right to use 5,000 square feet of space (50 percent of the original leased space), the change in the lease payments, and the change in the discount rate.

842-10-55-182

Lessee decreases the carrying amount of the right-of-use asset to reflect the partial termination of the lease based on the adjustment to the carrying amount of the lease liability, with any difference recognized in profit or loss. The premodification right-of-use asset is $514,436. Therefore, at the effective date of the modification, Lessee reduces the carrying amount of the right-of-use asset by $247,888 (48.2% × $514,436). Lessee recognizes the difference between the adjustment to the lease liability and the adjustment to the right-of-use asset ($284,669 − $247,888 = $36,781) as a gain.

Case B — Remeasuring the Right-of-Use Asset Based on the Remaining Right of Use

842-10-55-183

Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset (that is, 5,000 square feet corresponding to 50 percent of the original right-of-use asset).

842-10-55-184

Fifty percent of the premodification right-of-use asset is $257,218 (50% x $514,436). Fifty percent of the premodification lease liability is $295,384 (50% x $590,767). Consequently, Lessee decreases the carrying amount of the right-of-use asset by $257,218 and the carrying amount of the lease liability by $295,384. At the effective date of the modification, Lessee recognizes the difference between the decrease in the lease liability and the decrease in the right-of-use asset of $38,166 ($295,384 − $257,218) as a gain.

842-10-55-185

Lessee recognizes the difference between the remaining lease liability of $295,384 and the modified lease liability of $306,098 (which equals $10,714) as an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate.

4.6.5.5 Modification only changes lease payments

ASC 842 includes the following example of a lessee's accounting for a modified lease that only changes the lease payments.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

Example 19 — Modification That Changes the Lease Payments Only

842-10-55-186

Lessee enters into a 10-year lease for 10,000 square feet of office space. The lease payments are $95,000 in Year 1, paid in arrears, and increase by $1,000 every year thereafter. The original discount rate for the lease is 6 percent. The lease is an operating lease. At the beginning of Year 6, Lessee and Lessor agree to modify the original lease for the remaining 5 years to reduce the lease payments by $7,000 each year (that is, the lease payments will be $93,000 in Year 6 and will continue to increase by $1,000 every year thereafter). The modification only changes the lease payments and, therefore, cannot be accounted for as a separate contract. The classification of the lease does not change as a result of the modification.

842-10-55-187

Lessee remeasures the lease liability for the modified lease on the basis of all of the following:

a. Remaining lease term of 5 years

b. Payments of $93,000 in Year 6, increasing by $1,000 each year for the remainder of the lease term

c. Lessee's incremental borrowing rate at the effective date of the modification of 7 percent.

842-10-55-188

The remeasured lease liability equals $388,965. Lessee recognizes the difference between the carrying amount of the modified lease liability and the lease liability immediately before the effective date of the modification of $40,206 ($429,171 premodification lease liability − $388,965 modified lease liability) as a corresponding reduction to the right-of-use asset. Therefore, the adjusted right-of-use asset equals $376,465 as of the effective date of the modification. Lessee calculates its remaining lease cost as $462,500 (the sum of the total lease payments, as adjusted for the effects of the lease modification, of $960,000 reduced by the total lease cost recognized in prior periods of $497,500), which it will recognize on a straight-line basis over the remaining lease term.

842-10-55-189

During Year 6, Lessee recognizes lease cost of $92,500 ($462,500 remaining lease cost ÷ 5 years). As of the end of Year 6, Lessee's lease liability equals $323,193 (present value of the remaining lease payments, discounted at 7 percent), and its right-of-use asset equals $311,193 (the balance of the lease liability − the remaining accrued rent balance of $12,000). Lessee recognizes additional lease cost of $92,500 each year of the remaining lease term and measures its lease liability and right-of-use asset in the same manner as at the end of Year 6 each remaining year of the lease term. The following are the balances of the lease liability and the right-of-use asset at the end of Years 7 through 10 of the lease.

	Lease Liability	Right-of-Use Asset
Year 7	$ 251,816	$ 241,316
Year 8	$ 174,443	$ 166,443
Year 9	$ 90,654	$ 86,154
Year 10	$ –	$ –

4.7 Lease incentives

Excerpt from Accounting Standards Codification

Leases — Overall

842-10-55-30

Lease incentives include both of the following:

a. Payments made to or on behalf of the **lessee**

b. Losses incurred by the **lessor** as a result of assuming a lessee's preexisting lease with a third party. In that circumstance, the lessor and the lessee should independently estimate any loss attributable to that assumption. For example, the lessee's estimate of the lease incentive could be based on a comparison of the new lease with the market rental rate available for similar **underlying assets** or the market rental rate from the same lessor without the lease assumption. The lessor should estimate any loss on the basis of the total remaining costs reduced by the expected benefits from the **sublease** of use of the assumed underlying asset.

A lease agreement might include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving expenses) or the assumption by the lessor of the lessee's preexisting lease with a third party.

Payments made to or on behalf of the lessee represent incentives that the lessee should consider reductions of the right-of-use asset and rental expense over the term of the lease (refer to section 4.2.3, *Expense recognition,* for further discussion of recognition of operating leases and section 4.3.3, *Expense recognition*, for principles relevant to finance leases). Similarly, losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party should be considered an incentive by the lessee. Incentives should be recognized on a straight-line basis over the term of the lease. The lessee should independently estimate any loss attributable to the assumption of a preexisting lease with a third party. For example, the lessee's estimate of the incentive could be based on a comparison of the lease with the market rental rate available for similar lease property or the market rental rate from the same lessor without the lease assumption.

4.7.1 Which party owns the improvements

In many instances, judgment will be required to determine whether the lessee is constructing leasehold improvements or leasing built-out space. For example, if a retailer leases general purpose retail space and has its own contractor build specific improvements to make the store look like the others it operates around the country, any amounts the lessor provides to pay a portion of the cost will generally be viewed as an incentive. In contrast, a lessee that contracts with a lessor to lease fully built-out space (e.g., a floor in an office building with interior walls and lighting) may be leasing fully built space. Examples of factors that would be considered in making this determination include:

- What happens to the improvements at the end of the lease term (i.e., whether they are removed or preserved for the landlord)
- Whether the improvements are unique (e.g., they include the décor and logo of a national retail chain rather than general purpose improvements)
- Which party is supervising construction and bears the risk of cost overruns
- Which party bears all costs of the improvements
- Which party owns the improvements

We note that it would be inconsistent with the unit of accounting concept for a lessee to recognize a partial asset in its financial statements (e.g., lessor funds 60% of an asset and the lessee recognizes 40% as an asset in the lessee's financial statements). We also note that, while the above-listed factors may be helpful, lessees will need to apply their accounting policies on a consistent basis.

In addition, determinations about whether there is lease incentive or whether the lease is for fully built-out space should be consistent with the determination of the commencement date of the lease (refer to section 2.2, *Commencement date of the lease*).

4.7.2 Lessee involvement in asset construction ('build-to-suit' lease transactions)

Build-to-suit lease transactions involve various forms of lessee involvement in the construction of an asset for the lessee's own use. The guidance in ASC 842 focuses on whether the lessee controls the asset being constructed rather than whether the lessee takes on risks during the construction period. Under ASC 842, if the lessee controls the asset during construction, the asset is capitalized as construction-in-progress and is subject to the sale and leaseback guidance at the end of construction.

Refer to section 7.7.2, *Determining whether the lessee controls the underlying asset being constructed*, and section 7.2, *Determining whether the transfer of an asset is a sale*, on the accounting for sale and leaseback transactions.

4.7.3 Amortization of leasehold improvements

Excerpt from Accounting Standards Codification

Leases — Lessee

Subsequent Measurement

842-20-35-12

Leasehold improvements shall be amortized over the shorter of the **useful life** of those leasehold improvements and the remaining **lease term**, unless the **lease** transfers ownership of the **underlying asset** to the **lessee** or the lessee is reasonably certain to exercise an option to purchase the underlying asset, in which case the lessee shall amortize the leasehold improvements to the end of their useful life.

ASC 842 requires lessees to amortize leasehold improvements over the shorter of the following:

- The useful life of those leasehold improvements
- The remaining lease term

However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, leasehold improvements are amortized over their useful life.

The accounting for the amortization of leasehold improvements should be consistent with the lease term.

4.7.3.1 Leasehold improvements placed in service subsequent to lease commencement

As discussed in ASC 842-10-35-1 (refer to section 2.3.6, *Reassessment of the lease term and purchase options*), a lessee is required to monitor events that could trigger a change in the lease term. One example would be a lessee's construction of significant leasehold improvements (e.g., in the eighth year of a 10-year lease) that are expected to have significant economic value for the lessee when a renewal option becomes exercisable. Regardless of when constructed, leasehold improvements should be amortized over the lesser of the remaining useful life of the asset(s) or the remaining lease term after reassessment in accordance with ASC 842-10-35-1. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee should amortize the leasehold improvements to the end of their useful life. This treatment is consistent with the guidance for leasehold improvements acquired in a business combination (refer to section 8.2.1, *Acquiree in a business combination is a lessee in a finance or operating lease*).

For example, Retailer A enters into a 10-year lease with a five-year renewal option. At the commencement date of the lease, Retailer A determined that the lease term was 10 years (i.e., it determined that it was not reasonably certain to exercise the five-year renewal option). Leasehold improvements placed in service at or near the commencement date of the lease are amortized over the shorter of their useful life or 10 years. In year eight, the retailer remodels the store and adds extensive leasehold improvements. Retailer A reassesses the lease term and determines that it is now reasonably certain that it will exercise the five-year renewal option, and the remaining lease term is now seven years. Retailer A would amortize the leasehold improvements added in year eight over the shorter of their useful life or seven years. After reassessing the lease term, we believe the lessee would also reassess the amortization period for those leasehold improvements placed into service (or contemplated) at or near commencement of the lease, which in the example above was the original 10-year term.

Judgment is required to analyze these situations, including the nature of the expenditures, to determine whether reassessment of the lease term is required as well as the appropriate amortization period. Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets,* for further discussion of a lessee's accounting for a lease when it reassesses the lease term.

4.7.3.2 Leasehold improvements acquired in business combinations

Excerpt from Accounting Standards Codification

Leases — Lessee

Subsequent Measurement

842-20-35-13

Leasehold improvements acquired in a **business combination** or an **acquisition by a not-for-profit entity** shall be amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition.

Subsequent Measurement

805-20-35-6

Leasehold improvements acquired in a business combination shall be amortized over the shorter of the useful life of the assets and the remaining **lease term** at the date of acquisition. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the leasehold improvements to the end of their useful life.

A leasehold improvement acquired in a business combination is similar to a leasehold improvement placed in service after the commencement date of a lease (as described in section 4.7.3.1, *Leasehold improvements placed in service subsequent to lease commencement*) and, as such, the asset should be amortized over the shorter of the useful life or the lease term (determined at the date the business combination is recorded) that includes renewals that are reasonably certain to be exercised. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee will amortize the leasehold improvements to the end of their useful life.

4.7.3.2.1 Asset acquisitions

We have seen numerous instances in which an entity has a land lease (as a lessee) and purchases leasehold improvements in an asset acquisition rather than a business combination. In such a transaction, we believe it is appropriate for the lessee to treat the land lease as a new lease and the asset acquired as a leasehold improvement placed in service at or near lease commencement (the accounting described in section 4.7.3.1, *Leasehold improvements placed into service subsequent to lease commencement*). Also, refer to chapter 8, *Business combinations,* for additional discussion.

4.7.3.2.2 Fresh start accounting

In general, the accounting for leasehold improvements that have been revalued in fresh start accounting should follow the guidance for business combinations noted in section 4.7.3.2, *Leasehold improvements acquired in business combinations*.

4.7.3.4 Salvage values

The amortization of leasehold improvements should take into account any net salvage value that would accrue to the lessee.

4.8 Other lessee matters

4.8.1 Lease termination

Excerpt from Accounting Standards Codification

Leases — Lessee

Derecognition

842-20-40-1

A termination of a **lease** before the expiration of the **lease term** shall be accounted for by the **lessee** by removing the **right-of-use asset** and the **lease liability**, with profit or loss recognized for the difference.

A termination of a lease (operating or finance) before the expiration of the lease term is accounted for by derecognizing the lease-related asset and liability. Any consideration paid or received upon termination that was not already included in the lease payments (e.g., a termination penalty that was not included in lease payments based on the lease term) is included in the gain or loss on termination of the lease.

If there is an ongoing arrangement between the lessee and the lessor that will arise in conjunction with the termination of a lease (e.g., a lease is reevaluated based on a change in the contractual terms and is determined to be a service contract), we believe the lessee would consider the net asset or liability associated with the lease in the measurement of the remaining arrangement.

ASC 405-20-40-1 provides guidance for determining when a liability (including a lease liability) has been extinguished and therefore can be removed from the obligor's (lessee's) balance sheet. A lease liability is considered extinguished (and a gain or loss is recognized) if either of the following two conditions is met:

- The lessee pays the lessor and is relieved of its obligation for the liability. Paying the lessor includes delivery of cash or other consideration.
- The lessee is legally released from being the primary obligor under the liability, either by a judicial body or by the lessor.

Some sale and assumption agreements may have other components that need to be accounted for. For example, a lessor might release a lessee as primary obligor on the condition that a third party assumes the obligation and that the original lessee becomes secondarily liable. While the release extinguishes the original lessee's liability as the primary obligor, the lessee becomes a guarantor, regardless of whether consideration was paid for the guarantee. As a guarantor, the original lessee will recognize a guarantee obligation at fair value (under ASC 460, *Guarantees*) in the same manner as a guarantor that had never been primarily liable to that lessor. Refer to chapter 6, *Subleases*, for further discussion of accounting for subleases.

Under ASC 460, recognition of the guarantee would take into consideration the likelihood that the new primary obligor will fulfill its obligation. For example, if the new primary obligor had little substance and, therefore, would be unable to honor its obligation, the guarantor of that obligation would have to recognize a fair value liability that would likely not differ significantly from the obligation that would be recorded if it were still the primary obligor because of the inability of the new primary obligor to fulfill its obligation. Additionally, the guarantee obligation, initially measured at fair value, reduces the gain or increases the loss recognized from the extinguishment.

Under the financial components approach (ASC 405-20-55-3 through 55-4), an "in-substance defeasance" transaction (for example, when the leased assets and the related obligations are transferred to a trust) does not meet the derecognition criteria for either the asset or the liability because the transaction lacks the following critical characteristics:

- The lessee is not released from the obligation by putting assets in a trust. For example, if the assets in a trust prove insufficient because a default by the lessee accelerates its obligation, the lessee is obligated to make the lessor whole.
- The lessor is not limited to the cash flows from the assets in trust.
- The lessor does not have the ability to dispose of the assets at will or to terminate the trust.
- If the assets in the trust exceed what is necessary to meet scheduled principal and interest payments, the lessee can remove the excess.
- Neither the lessor nor any of its representatives is a contractual party to establishing the defeasance trust, as holders of interests in a qualifying special-purpose entity or their representatives would be.

The lessee does not surrender control of the benefits of the assets because those assets are still being used for the lessee's benefit to extinguish its debt. Because no asset can be an asset of more than one entity, those benefits must still be the lessee's assets.

4.8.2 Purchase of a leased asset during the lease term

Excerpt from Accounting Standards Codification

Leases — Lessee

Derecognition

842-20-40-2

The termination of a **lease** that results from the purchase of an **underlying asset** by the **lessee** is not the type of termination of a lease contemplated by paragraph 842-20-40-1 but, rather, is an integral part of the purchase of the underlying asset. If the lessee purchases the underlying asset, any difference between the purchase price and the carrying amount of the lease liability immediately before the purchase shall be recorded by the lessee as an adjustment of the carrying amount of the asset. However, this paragraph does not apply to underlying assets acquired in a **business combination**, which are initially measured at **fair value** in accordance with paragraph 805-20-30-1.

A lease termination does not include the lessee purchasing the leased asset. Instead, the difference between the purchase price and the carrying amount of the lease liability is recorded as an adjustment to the carrying amount of the purchased asset. This guidance does not apply to underlying assets acquired in a business combination, which are initially measured at fair value. Refer to chapter 8, *Business combinations*.

Illustration 26 — Accounting for the purchase of a leased asset during the term of a lease

Entity X (lessee) has just completed the third year of a five-year finance lease agreement. The right-of-use asset has a net book value of $3,000, and the lease liability is $2,000. If the lease were terminated at the end of year three because the lessee purchased the asset for $1,500, Entity X would record the following entry:

Lease liability	$	2,000		
Fixed assets		2,500		
Right-of-use asset			$	3,000
Cash				1,500

The right-of-use asset is reclassified as an owned asset, and the carrying amount of the asset ($3,000) is adjusted by the difference between the carrying value of the lease liability ($2,000) and the consideration paid ($1,500).

4.8.3 Leases denominated in a foreign currency

Excerpt from Accounting Standards Codification

Leases — Lessee

Implementation Guidance and Illustrations

842-20-55-10

The **right-of-use asset** is a nonmonetary asset while the **lease liability** is a **monetary liability**. Therefore, in accordance with Subtopic 830-10 on foreign currency matters, when accounting for a **lease** that is denominated in a foreign currency, if remeasurement into the **lessee's** functional currency is required, the lease liability is remeasured using the current exchange rate, while the right-of-use asset is remeasured using the exchange rate as of the **commencement date**.

Lessees apply ASC 830, *Foreign Currency Matters*, to leases denominated in a foreign currency. As they do for other monetary liabilities, lessees remeasure a foreign currency-denominated lease liability using the exchange rate at each reporting date. Any changes to the lease liability due to exchange rate changes are recognized in profit or loss. Because the right-of-use asset is a nonmonetary asset measured at historical cost, it is not affected by subsequent changes in the exchange rate. Therefore, the subsequent measurement of the right-of-use asset will not equal the lease liability for operating leases denominated in a foreign currency.

The FASB acknowledged in the Basis for Conclusions (BC 247) that this approach could result in volatility in profit or loss from the recognition of foreign currency exchange gains or losses but believed it would be clear to users of financial statements that the gains or losses result solely from changes in exchange rates.

4.8.4 Portfolio approach

ASC 842 applies to individual leases. However, entities that have a large number of leases of similar assets (e.g., leases of a fleet of similar railcars) may face practical challenges in applying the leases model on a lease-by-lease basis. The FASB acknowledged these concerns and said in the Basis for Conclusions (BC 120) that an entity can use a portfolio approach when "the entity reasonably expects that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio." For example, applying a portfolio approach to four-year leases of new automobiles of the same make and model, entered into in the same month with the same terms and conditions, may not differ materially from applying ASC 842 to the individual leases in the portfolio.

ASC 842 does not define "reasonably expects" and "materially." The FASB also said in the Basis for Conclusions (BC 120) that "an entity would need to apply judgment in selecting the size and composition of the portfolio" and "it did not intend for an entity to quantitatively evaluate each outcome but, instead, that the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of leases."

The FASB also said in the Basis for Conclusions (BC 121) that "the cost relief offered by applying the leases guidance at a portfolio level need not be limited to simply grouping contracts together." The portfolio approach could also be applied to other aspects of the leases guidance for which lessees need to make judgments and estimates, such as determining the discount rate and determining and reassessing the lease term.

ASC 842 provides the following implementation guidance for applying the portfolio approach to establish the discount rate for the lease.

Excerpt from Accounting Standards Codification

Leases — Lessee

Implementation Guidance and Illustrations

Example 2 — Portfolio Approach to Establishing the Discount Rate for the Lease

842-20-55-18

Lessee, a public entity, is the parent of several consolidated subsidiaries. During the current period, 2 subsidiaries entered into a total of 400 individual leases of large computer servers, each with terms ranging between 4 and 5 years and annual payments ranging between $60,000 and $100,000, depending on the hardware capacity of the servers. In aggregate, total lease payments for these leases amount to $30 million.

842-20-55-19

The individual lease contracts do not provide information about the rate implicit in the lease. Lessee is BBB credit rated and actively raises debt in the corporate bond market. Both subsidiaries are unrated and do not actively engage in treasury operations in their respective markets. On the basis of its credit rating and the collateral represented by the leased servers, Lessee's incremental borrowing rate on $60,000 through $100,000 (the range of lease payments on each of the 400 leases) would be approximately 4 percent. Lessee notes that 5-year zero-coupon U.S. Treasury instruments are currently yielding 1.7 percent (a risk-free rate). Because Lessee conducts its treasury operations centrally (that is, at the consolidated group level), it is reasonably assumed that consideration of the group credit standing factored into how each lease was priced.

842-20-55-20

Lessee may determine the discount rate for the lease for the 400 individual leases entered into on different dates throughout the current period by using a portfolio approach. That is, Lessee can apply a single discount rate to the portfolio of new leases. This is because during the period, the new leases are all of similar terms (four to five years), and Lessee's credit rating and the interest rate environment are stable. Because the pricing of the lease is influenced by the credit standing and profile of Lessee rather than the subsidiaries (that is, because Lessee conducts treasury operations for the consolidated group), Lessee concludes that its incremental borrowing rate of 4 percent is an appropriate discount rate for each of the 400 leases entered into by Lessee's 2 subsidiaries during the period. Because Lessee is a public entity, it is not permitted to use a risk-free discount rate.

4.8.5 Income tax accounting

ASC 842 also affects lessees' accounting for income taxes. For lessees, ASC 842 requires recognition of additional lease-related assets and liabilities that will likely result in additional book-tax basis differences such as the following:

- Recognition and measurement of deferred tax assets and liabilities associated with book-tax basis differences
- Assessment of the recoverability of deferred tax assets (i.e., the need for and measurement of a valuation allowance)

Refer to our Financial reporting developments publication, *Income taxes*.

4.8.6 Rent capitalization

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-19

In some **lease** arrangements, the **lessor** may make the **underlying asset** available for use by the **lessee** (for example, the lessee may take possession of or be given control over the use of the underlying asset) before it begins operations or makes **lease payments** under the terms of the lease. During this period, the lessee has the right to use the underlying asset and does so for the purpose of constructing a lessee asset (for example, leasehold improvements).

842-10-55-20

The **contract** may require the lessee to make lease payments only after construction is completed and the lessee begins operations. Alternatively, some contracts require the lessee to make lease payments when it takes possession of or is given control over the use of the underlying asset. The timing of when lease payments begin under the contract does not affect the **commencement date** of the lease.

842-10-55-21

Lease costs (or income) associated with building and ground leases incurred (earned) during and after a construction period are for the right to use the underlying asset during and after construction of a lessee asset. There is no distinction between the right to use an underlying asset during a construction period and the right to use that asset after the construction period. Therefore, lease costs (or income) associated with ground or building leases that are incurred (earned) during a construction period should be recognized by the lessee (or lessor) in accordance with the guidance in Subtopics 842-20 and 842-30, respectively. That guidance does not address whether a lessee that accounts for the sale or rental of real estate projects under Topic 970 should capitalize rental costs associated with ground and building leases.

An end user lessee is prohibited from capitalizing rent under an operating lease as part of the cost of a constructed asset. Rental costs incurred during and after a construction period are for the right to direct the use of an underlying asset during and after construction of a lessee asset. There is no distinction between the right to use a leased asset during the construction period and the right to use that asset after the construction period. Therefore, lease costs associated with ground or building operating leases that are incurred during a construction period are recognized in accordance with ASC 842's guidance for lessee accounting for operating leases (refer to section 4.2, *Operating leases*). Interest related to a finance lease should be included in the interest cost used to determine capitalized interest in accordance with ASC 835-20.

The guidance in ASC 842-10-55-21 does not address whether a lessee of real estate under development within the scope of ASC 970-360 should capitalize rental costs associated with ground and building operating leases during development. See our Financial reporting developments publication, *Real estate project costs*, for further discussion on accounting for such costs.

It should be noted that it is not appropriate to defer occupancy costs as a component of start-up activities (ASC 720-15).

4.8.7 Lessee accounting for maintenance deposits

Excerpt from Accounting Standards Codification

Leases — Lessee

Implementation Guidance and Illustrations

842-20-55-4

Under certain **leases** (for example, certain equipment leases), a **lessee** is legally or contractually responsible for repair and maintenance of the **underlying asset** throughout the **lease term**. Additionally, certain lease agreements include provisions requiring the lessee to make deposits to the **lessor** to financially protect the lessor in the event the lessee does not properly maintain the underlying asset. Lease agreements often refer to these deposits as maintenance reserves or supplemental rent. However, the lessor is required to reimburse the deposits to the lessee on the completion of maintenance activities that the lessee is contractually required to perform under the lease agreement.

842-20-55-5

Under a typical arrangement, maintenance deposits are calculated on the basis of a performance measure, such as hours of use of the underlying asset, and are contractually required under the terms of the lease agreement to be used to reimburse the lessee for required maintenance of the underlying asset on the completion of that maintenance. The lessor is contractually required to reimburse the lessee for the maintenance costs paid by the lessee, to the extent of the amounts on deposit.

842-20-55-6

In some cases, the total cost of cumulative maintenance events over the term of the lease is less than the cumulative deposits, which results in excess amounts on deposit at the expiration of the lease. In those cases, some lease agreements provide that the lessor is entitled to retain such excess amounts, whereas other agreements specifically provide that, at the expiration of the lease agreement, such excess amounts are returned to the lessee (refundable maintenance deposit).

842-20-55-7

The guidance in paragraphs 842-20-55-8 through 55-9 does not apply to payments to a lessor that are not substantively and contractually related to maintenance of the leased asset. If at the **commencement date** a lessee determines that it is less than **probable** that the total amount of payments will be returned to the lessee as a reimbursement for maintenance activities, the lessee should consider that when determining the portion of each payment that is not addressed by the guidance in paragraphs 842-20-55-8 through 55-9.

842-20-55-8

Maintenance deposits paid by a lessee under an arrangement accounted for as a lease that are refunded only if the lessee performs specified maintenance activities should be accounted for as a deposit asset.

842-20-55-9

A lessee should evaluate whether it is probable that an amount on deposit recognized under paragraph 842-20-55-8 will be returned to reimburse the costs of the maintenance activities incurred by the lessee. When an amount on deposit is less than probable of being returned, it should be recognized in the same manner as variable lease expense. When the underlying maintenance is performed, the maintenance costs should be expensed or capitalized in accordance with the lessee's maintenance accounting policy.

Under certain lease arrangements, a lessee may be contractually or legally responsible for repair and maintenance of the leased asset during the term of the lease arrangement. In addition, the lease arrangement may require the lessee to make deposits (also commonly referred to as maintenance reserves or supplemental rent) with the lessor to protect the lessor if the lessee does not properly maintain the leased asset (i.e., the lessor would use the funds to restore the leased asset to proper working order).

Under a typical lease arrangement, the lessor is contractually required to reimburse the lessee a portion of the deposit as qualifying maintenance activities are performed and paid for by the lessee. If the deposits paid to the lessor exceed costs incurred for maintenance activities, the lease arrangement may allow the lessor to retain the excess amounts when the lease expires or may require the lessor to refund such excess amounts to the lessee. While refundable maintenance deposits are accounted for by lessees as a deposit, some had questioned the accounting for lessee maintenance deposits that are not automatically refundable in all instances, including those that are not refunded if the lessee does not perform the maintenance activities specified by the lease arrangement.

Maintenance deposits paid by the lessee under an arrangement accounted for as a lease that are refunded only if the lessee performs specified maintenance activities should be considered deposit assets by the lessee if it is probable that the deposits will be refunded. The cost of maintenance activities should be expensed or capitalized by the lessee, as appropriate, when the underlying maintenance is performed. If a lessee determines that it isn't probable that its maintenance deposit will be refunded, it will recognize the deposit is recognized as variable rent expense. If it is probable at inception of the lease that a portion of the deposits will not be refunded, the lessee should recognize as an expense a pro rata portion of the deposits as they are paid as variable lease payments (refer to section 2.9.1, *Lessee accounting for variable lease payments*).

Some lease agreements call for maintenance deposits and refunds to be made throughout the term of the lease. For instance, an airplane lease may require the lessee to make a deposit with the lessor based on usage of the airplane (e.g., pay a defined amount for every hour or cycle flown) and the lessor to refund those deposits upon the performance of required maintenance activities. In such leases, deposits can be made and refunded multiple times over the lease. The following illustration depicts the accounting treatment for multiple cycle maintenance deposits.

Illustration 27 — Deposits in leases with multiple maintenance cycles

Airline A leases an airplane from Lessor B for 10 years and agrees to provide Lessor B with maintenance deposits of $50 for every flight hour flown. Airline A is responsible for maintaining the airplane, and Lessor B must reimburse Airline A for engine overhaul maintenance costs incurred up to the amounts on deposit when the engine overhaul maintenance occurs. Any excess amounts on deposit are retained by Lessor B.

Assume that the airplane being leased requires engine overhaul maintenance after every 20,000 flight hours, and the expected cost of the engine overall maintenance exceeds the amounts to be placed on deposit (i.e., expected cost of engine overhaul is greater than $1,000,000 = $50/hour x 20,000 hours). Airline A expects to fly the leased airplane between 4,000 and 5,000 hours each year.

In the early periods of the lease, deposits made by Airline A are probable of being returned because Airline A expects to incur reimbursable maintenance costs by performing engine overhaul maintenance. As such, maintenance deposits made should be accounted for as deposit assets.

Toward the end of the lease, Airline A may be required to make maintenance deposits that are not probable of being returned if Airline A does not expect to perform another engine overall. For instance, assume that Airline A flies the airplane for a total of 40,000 hours over the first nine years of the lease, performs the second engine overhaul at the end of the ninth year and receives reimbursement from Lessor B for the funds on deposit. Airline A would still be required to make payments of $50 for every flight hour flown in the 10th year of the lease. However, because Airline A will not perform another engine overhaul, those payments will not be returned (i.e., not probable of being returned). As such, the maintenance deposit payments made by Airline A after the second engine overhaul would not be considered deposit assets (as they are less than probable of being returned to Airline A) and should be accounted for as variable lease payments.

To determine whether it is probable that the deposit will be refunded, entities should use the second definition of probable in the Master Glossary, which states: "the future events are likely to occur." This is the same threshold of probability that is used in ASC 450, *Contingencies*, with respect to the recognition of liabilities.

4.9 Presentation

Excerpt from Accounting Standards Codification

Leases — Lessee

Other Presentation Matters

Statement of Financial Position

842-20-45-1

A **lessee** shall either present in the statement of financial position or disclose in the notes all of the following:

a. **Finance lease right-of-use assets** and **operating lease** right-of-use assets separately from each other and from other assets

b. Finance **lease liabilities** and operating lease liabilities separately from each other and from other liabilities.

Right-of-use assets and lease liabilities shall be subject to the same considerations as other nonfinancial assets and financial liabilities in classifying them as current and noncurrent in classified statements of financial position.

842-20-45-2

If a lessee does not present finance lease and operating lease right-of- use assets and lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those right-of-use assets and lease liabilities.

842-20-45-3

In the statement of financial position, a lessee is prohibited from presenting both of the following:

a. Finance lease right-of-use assets in the same line item as operating lease right-of-use assets

b. Finance lease liabilities in the same line item as operating lease liabilities.

Statement of Comprehensive Income

842-20-45-4

In the statement of comprehensive income, a **lessee** shall present both of the following:

a. For **finance leases**, the interest expense on the **lease liability** and amortization of the **right-of-use asset** are not required to be presented as separate line items and shall be presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets, respectively

b. For **operating leases**, **lease** expense shall be included in the lessee's income from continuing operations.

Statement of Cash Flows

842-20-45-5

In the statement of cash flows, a **lessee** shall classify all of the following:

a. Repayments of the principal portion of the **lease liability** arising from **finance leases** within financing activities

b. Interest on the lease liability arising from finance leases in accordance with the requirements relating to interest paid in Topic 230 on cash flows

c. Payments arising from **operating leases** within operating activities, except to the extent that those payments represent costs to bring another asset to the condition and location necessary for its intended use, which should be classified within investing activities

d. **Variable lease payments** and **short-term lease** payments not included in the lease liability within operating activities.

Right-of-use assets and lease liabilities are subject to the same considerations as other nonfinancial assets and financial liabilities in classifying them as current and noncurrent in classified statements of financial position.

The following table summarizes how lease-related amounts and activities are presented in lessees' financial statements.

Financial statement	Lessee presentation

Balance sheet	▸ **Finance leases:**
	A lessee presents either in the statement of financial position or discloses in the notes all of the following:
	  ▸ Right-of-use assets presented either:
	    ▸ Separately from other assets (e.g., owned assets) and separately from operating lease right-of-use assets
	    ▸ Together with other assets and separate from operating lease right-of-use assets, with disclosures of the balance sheet line items that include finance lease right-of-use assets and their amounts
	  ▸ Lease liabilities presented either:
	    ▸ Separately from other liabilities and separately from operating lease liabilities
	    ▸ Together with other liabilities and separate from operating lease liabilities, with disclosure of the balance sheet line items that include finance lease liabilities and their amounts
	▸ **Operating leases:**
	A lessee presents either in the statement of financial position or discloses in the notes all of the following:
	  ▸ Right-of-use assets presented either:
	    ▸ Separately from other assets (e.g., owned assets) and separately from finance lease right-of-use assets
	    ▸ Together with other assets and separate from finance lease right-of-use assets, with disclosures of the balance sheet line items that include operating lease right-of-use assets and their amounts
	  ▸ Lease liabilities presented either:
	    ▸ Separately from other liabilities and separately from finance lease liabilities
	    ▸ Together with other liabilities and separate from finance lease liabilities, with disclosure of the balance sheet line items that include operating lease liabilities and their amounts

Income statement	▸ **Finance leases:** Lease-related amortization and lease-related interest expense are not required to be presented as separate line items and should be presented in a manner consistent with how the entity presents depreciation and amortization of similar assets and other interest expense. However, lease-related amortization and lease-related interest expense cannot be combined in the same line item. ▸ Operating leases: Lease expense is included in income from continuing operations.

Statement of cash flows	▸ **Finance leases:** Cash payments for the principal portion of the lease liability are presented within financing activities, and cash payments for the interest portion are presented in accordance with ASC 230, *Statement of Cash Flow*s.
	▸ **Operating leases:** Cash payments for lease payments are presented within operating activities, except for payments that represent costs to bring another asset to the condition and location necessary for its intended use, which are presented within investing activities.
	▸ **Both types of leases:**
	  ▸ Lease payments for short-term leases not recognized on the balance sheet and variable lease payments (not included in the lease liability) are presented within operating activities.
	  ▸ Noncash activity (e.g., the initial recognition of the lease at commencement) is disclosed as a supplemental noncash item.

4.10 Disclosure

The objective of lessee disclosures is to enable financial statement users to assess the amount, timing and uncertainty of cash flows arising from leases. ASC 842 requires a lessee to disclose quantitative and qualitative information about its leases, the significant judgments and assumptions made in applying ASC 842 and the amounts recognized in the financial statements related to those leases. ASC 842 does not require a specific format for lessees' quantitative disclosures but includes an example in a tabular format.

Lessees may need to exercise judgment to determine the appropriate level at which to aggregate or disaggregate disclosures so that meaningful information is not obscured by insignificant details or by groupings of items with different characteristics. The disclosure requirements apply to all entities.

ASC 842 includes the following disclosure requirements for lessees.

Excerpt from Accounting Standards Codification

Leases — Lessee

Disclosure

842-20-50-1

The objective of the disclosure requirements is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from **leases**. To achieve that objective, a **lessee** shall disclose qualitative and quantitative information about all of the following:

a. Its leases (as described in paragraphs 842-20-50-3(a) through (b) and 842-20-50-7 through 50-8)

b. The significant judgments made in applying the requirements in this Topic to those leases (as described in paragraph 842-20-50-3(c))

c. The amounts recognized in the financial statements relating to those leases (as described in paragraphs 842-20-50-4 and 842-20-50-6).

842-20-50-2

A lessee shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. A lessee shall aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.

842-20-50-3

A lessee shall disclose all of the following:

a. Information about the nature of its leases, including:

   1. A general description of those leases.
   2. The basis and terms and conditions on which **variable lease payments** are determined.
   3. The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its **right-of-use assets** and **lease liabilities** and those that are not.
   4. The existence and terms and conditions of **residual value guarantees** provided by the lessee.
   5. The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations.

A lessee should identify the information relating to **subleases** included in the disclosures provided in (1) through (5), as applicable.

b. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the **underlying asset**.

c. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:

   1. The determination of whether a **contract** contains a lease (as described in paragraphs 842-10-15-2 through 15-27)

   2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)

   3. The determination of the **discount rate for the lease** (as described in paragraphs 842-20-30-2 through 30-4).

842-20-50-4

For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's total lease cost, which includes both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset in accordance with other Topics, and the cash flows arising from lease transactions:

a. **Finance lease** cost, segregated between the amortization of the right-of-use assets and interest on the lease liabilities.

b. **Operating lease** cost determined in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7.

c. **Short-term lease** cost, excluding expenses relating to leases with a **lease term** of one month or less, determined in accordance with paragraph 842-20-25-2.

d. Variable lease cost determined in accordance with paragraphs 842-20-25-5(b) and 842-20-25-6(b).

e. Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense.

f. Net gain or loss recognized from sale and leaseback transactions in accordance with paragraph 842-40-25-4.

g. Amounts segregated between those for finance and operating leases for the following items:

   1. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows

   2. Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets

   3. Weighted-average remaining lease term

   4. Weighted-average discount rate.

842-20-55-53

The following Example illustrates how a lessee may meet the quantitative disclosure requirements in paragraph 842-20-50-4.

	Year Ending December 31,	
	20X2	20X1
Lease cost		
Finance lease cost:	$ XXX	$ XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	$ XXX	$ XXX
Other information		
(Gains) and losses on sale and leaseback transactions, net	$ (XXX)	$ XXX
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term — finance leases	XX years	XX years
Weighted-average remaining lease term — operating leases	XX years	XX years
Weighted-average discount rate — finance leases	X.X%	X.X%
Weighted-average discount rate — operating leases	X.X%	X.X%

842-20-50-6

A lessee shall disclose a maturity analysis of its finance lease liabilities and its operating lease liabilities separately, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessee shall disclose a reconciliation of the undiscounted cash flows to the finance lease liabilities and operating lease liabilities recognized in the statement of financial position.

842-20-50-7

A lessee shall disclose lease transactions between related parties in accordance with paragraphs 850-10-50-1 through 50-6.

842-20-50-8

A lessee that accounts for short-term leases in accordance with paragraph 842-20-25-2 shall disclose that fact. If the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments, a lessee shall disclose that fact and the amount of its short-term lease commitments.

842-20-50-9

A lessee that elects the practical expedient on not separating lease components from nonlease components in paragraph 842-10-15-37 shall disclose its accounting policy election and which class or classes of underlying assets it has elected to apply the practical expedient.

4.11 Lessee illustrations

Excerpt from Accounting Standards Codification

Leases — Lessee

Implementation Guidance and Illustrations

Example 3 — Initial and Subsequent Measurement by a Lessee and Accounting for a Change in the Lease Term

Case A—Initial and Subsequent Measurement of the Right-of-Use Asset and the Lease Liability

842-20-55-22

Lessee enters into a 10-year lease of an asset, with an option to extend for an additional 5 years. Lease payments are $50,000 per year during the initial term and $55,000 per year during the optional period, all payable at the beginning of each year. Lessee incurs initial direct costs of $15,000.

842-20-55-23

At the commencement date, Lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines the lease term to be 10 years.

842-20-55-24

The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5.87 percent, which reflects the fixed rate at which Lessee could borrow a similar amount in the same currency, for the same term, and with similar collateral as in the lease at the commencement date.

842-20-55-25

At the commencement date, Lessee makes the lease payment for the first year, incurs initial direct costs, and measures the lease liability at the present value of the remaining 9 payments of $50,000, discounted at the rate of 5.87 percent, which is $342,017. Lessee also measures a right-of-use asset of $407,017 (the initial measurement of the lease liability plus the initial direct costs and the lease payment for the first year).

842-20-55-26

During the first year of the lease, Lessee recognizes lease expense depending on how the lease is classified. Paragraphs 842-20-55-27 through 55-30 illustrate the lease expense depending on whether the lease is classified as a finance lease or as an operating lease.

If the Lease Is Classified as a Finance Lease

842-20-55-27

Lessee depreciates its owned assets on a straight-line basis. Therefore, the right-of-use asset would be amortized on a straight-line basis over the 10-year lease term. The lease liability is increased to reflect the Year 1 interest on the lease liability in accordance with the interest method. As such, in Year 1 of the lease, Lessee recognizes the amortization expense of $40,702 ($407,017 ÷ 10) and the interest expense of $20,076 (5.87% × $342,017).

842-20-55-28

At the end of the first year of the lease, the carrying amount of Lessee's lease liability is $362,093 ($342,017 + $20,076), and the carrying amount of the right-of-use asset is $366,315 ($407,017 − $40,702).

If the Lease Is Classified as an Operating Lease

842-20-55-29

Lessee determines the cost of the lease to be $515,000 (sum of the lease payments for the lease term and initial direct costs incurred by Lessee). The annual lease expense to be recognized is therefore $51,500 ($515,000 ÷ 10 years).

842-20-55-30

At the end of the first year of the lease, the carrying amount of Lessee's lease liability is $362,093 ($342,017 + $20,076), and the carrying amount of the right-of-use asset is $375,593 (the carrying amount of the lease liability plus the remaining initial direct costs, which equal $13,500).

Case B—Accounting for a Change in the Lease Term

842-20-55-31

At the end of Year 6 of the lease, Lessee makes significant leasehold improvements. Those improvements are expected to have significant economic value for Lessee at the end of the original lease term of 10 years. The improvements result in the underlying asset having greater utility to Lessee than alternative assets that could be leased for a similar amount and that are expected to have significant economic life beyond the original lease term. Consequently, construction of the leasehold improvements is deemed a significant event or significant change in circumstances that directly affects whether Lessee is reasonably certain to exercise the option to extend the lease and triggers a reassessment of the lease term. Upon reassessing the lease term, at the end of Year 6, Lessee concludes that it is reasonably certain to exercise the option to extend the lease for five years. Taking into consideration the extended remaining lease term, Lessee's incremental borrowing rate at the end of Year 6 is 7.83 percent. As a result of Lessee's remeasuring the remaining lease term to nine years, Lessee also would remeasure any variable lease payments that depend on an index or a rate; however, in this Example, there are no variable lease payments that depend on an index or a rate. In accordance with paragraph 842-10-25-1, Lessee reassesses the lease classification as a result of the change in the lease term. Assume for purposes of this Example that the reassessment does not change the classification of the lease from that determined at the commencement date.

842-20-55-32

At the end of Year 6, before accounting for the change in the lease term, the lease liability is $183,973 (present value of 4 remaining payments of $50,000, discounted at the rate of 5.87 percent). Lessee's right-of-use asset is $162,807 if the lease is classified as a finance lease or $189,973 if the lease is classified as an operating lease (the balance of the remeasured lease liability at the end of Year 6 plus the remaining initial direct costs of $6,000).

842-20-55-33

Lessee remeasures the lease liability, which is now equal to the present value of 4 payments of $50,000 followed by 5 payments of $55,000, all discounted at the rate of 7.83 percent, which is $355,189. Lessee increases the lease liability by $171,216, representing the difference between the remeasured liability and its current carrying amount ($355,189 − $183,973). The corresponding adjustment is made to the right-of-use asset to reflect the cost of the additional rights.

842-20-55-34

Following the adjustment, the carrying amount of Lessee's right-of-use asset is $334,023 if the lease is a finance lease (that is, $162,807 + $171,216) or $361,189 if the lease is an operating lease (that is, $189,973 + $171,216).

842-20-55-35

Lessee then makes the $50,000 lease payment for Year 7, reducing the lease liability to $305,189 ($355,189 − $50,000), regardless of how the lease is classified.

842-20-55-36

Lessee recognizes lease expense in Year 7 as follows, depending on how the lease had been classified at the commencement date.

If the Lease Is Classified as a Finance Lease at the Commencement Date

842-20-55-37

Lessee depreciates its owned assets on a straight-line basis. Therefore, the right-of-use asset will be amortized on a straight-line basis over the lease term. The lease liability will be reduced in accordance with the interest method. As such, in Year 7 (the first year following the remeasurement), Lessee recognizes amortization expense of $37,114 ($334,023 ÷ 9) and interest expense of $23,896 (7.83% × $305,189).

If the Lease Is Classified as an Operating Lease at the Commencement Date

842-20-55-38

Lessee determines the remaining cost of the lease as the sum of the following:

a. The total lease payments, as adjusted for the remeasurement, which is the sum of $500,000 (10 payments of $50,000 during the initial lease term) and $275,000 (5 payments of $55,000 during the term of the lease extension); plus

b. The total initial direct costs attributable to the lease of $15,000; minus c. The periodic lease cost recognized in prior periods of $309,000.

842-20-55-39

The amount of the remaining cost of the lease is therefore $481,000 ($775,000 + $15,000 − $309,000). Consequently, Lessee determines that the annual expense to be recognized throughout the remainder of the lease term is $53,444 ($481,000 ÷ the remaining lease term of 9 years).

5 Lessor accounting

The FASB indicated in the Basis for Conclusions (BC 90) that ASC 840's lessor accounting model did not need comprehensive improvements, and the costs of making changes would outweigh the benefits. Therefore, ASC 842 retains many aspects of the lessor accounting model under ASC 840. However, ASC 842 modifies ASC 840's lease classification test for lessors. Refer to section 3.2, *Criteria for lease classification — lessors*, for a discussion of the lessor classification test under ASC 842. The new guidance also modifies the accounting for sales-type and direct financing leases and eliminates leveraged lease accounting prospectively.

Sales-type leases

Under ASC 842, there is no requirement for a sales-type lease to have selling profit or loss as there is under ASC 840. Additionally, a lessor does not assess the collectibility of lease payments and any residual value guarantee provided by the lessee for purposes of evaluating whether a lease is classified as a sales-type lease under ASC 842. However, a lessor has to assess the collectibility of these amounts when accounting for a sales-type lease. Specifically, if at lease commencement, the collectibility of lease payments and any residual value guarantee provided by the lessee is not probable, the lessor does not derecognize the underlying asset and instead recognizes lease payments received, including variable lease payments that do not depend on an index or rate, as a deposit liability. Refer to section 5.2, *Sales-type leases*, for further discussion of the accounting for sales-type leases under ASC 842.

Direct financing leases

In another change from ASC 840, a direct financing lease could have selling profit or loss. However, selling profit on a direct financing lease is deferred at lease commencement, while selling loss is always recognized at lease commencement. The lease classification test is designed so that a lease can be classified as a direct financing lease only when the lessor obtains a residual value guarantee from an unrelated third party other than the lessee and that guarantee is sufficient to satisfy the "substantially all" criterion discussed in section 3.2, *Criteria for lease classification — lessors*. Although a residual value guarantee from an unrelated third party other than the lessee can exist in a sales-type lease or an operating lease, a lease without a residual value guarantee from an unrelated third party other than the lessee must be classified as either a sales-type lease or an operating lease. Refer to section 5.3, *Direct financing leases*, for further discussion of the accounting for direct financing leases under ASC 842.

Leveraged leases

ASC 842 eliminates leveraged lease accounting for new leases and existing leases modified on or after the standard's effective date. Refer to section 5.7.5, *Leveraged leases*.

5.1 Lessor accounting concepts

At lease commencement, lessors apply the key concepts described in chapter 2, *Key concepts*, such as determining the initial direct costs, lease term, lease payments, fair value of the underlying asset and the rate implicit in the lease. Lessors also apply the following lessor accounting concepts to recognize and measure their leases.

5.1.1 Net investment in the lease

Excerpt from Accounting Standards Codification

Master Glossary

Net investment in the lease

For a **sales-type lease**, the sum of the **lease receivable** and the **unguaranteed residual asset**.

For a **direct financing lease**, the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit.

Lease Receivable

A **lessor's** right to receive **lease payments** arising from a **sales-type lease** or a **direct financing lease** plus any amount that a lessor expects to derive from the underlying asset following the end of the **lease term** to the extent that it is guaranteed by the **lessee** or any other third party unrelated to the lessor, measured on a discounted basis.

Unguaranteed residual asset

The amount that a **lessor** expects to derive from the **underlying asset** following the end of the **lease term** that is not guaranteed by the **lessee** or any other third party unrelated to the lessor, measured on a discounted basis.

A lessor's net investment in a sales-type or a direct financing lease consists of the following:

- Lease receivable — The lease receivable is (1) the lessor's right to receive lease payments (refer to section 2.4, *Lease payments*) and (2) any amount a lessor expects to derive from the underlying asset at the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor (i.e., the guaranteed residual asset), both discounted using the rate implicit in the lease.
- Unguaranteed residual asset — The unguaranteed residual asset is any amount the lessor expects to derive from the underlying asset at the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease.
- Deferred selling profit (direct financing leases only) — Any selling profit (refer to section 5.1.3, *Selling profit or selling loss*) for a direct financing lease is deferred and reduces the lessor's net investment in the lease.

5.1.2 Leases with significant variable lease payments

Variable lease payments that do not depend on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset (e.g., the number of hours flown, the number of units produced), are not included as lease payments as discussed in section 2.4.10, *Amounts not included* in lease payments. If a lease arrangement includes significant variable lease payments that do not depend on an index or rate, the net investment in the lease recognized for a sales-type or a direct financing lease may be lower than the carrying amount of the underlying asset at lease commencement. In such circumstances, the difference between the initially recognized net investment in the lease and the carrying amount of the underlying asset derecognized is recognized as a selling loss at lease commencement.

5.1.3 Selling profit or selling loss

Excerpt from Accounting Standards Codification

Master Glossary

Selling Profit or Selling Loss

At the **commencement date**, selling profit or selling loss equals:

a. The **fair value** of the **underlying asset** or the sum of (1) the **lease receivable** and (2) any **lease payments** prepaid by the lessee, if lower; minus

b. The carrying amount of the underlying asset net of any **unguaranteed residual asset**; minus

c. Any deferred **initial direct costs** of the lessor.

Leases that give rise to selling profit or selling loss normally result when the lessor uses leasing as a means of marketing its products or disposing of an asset.

Under ASC 842, selling profit or selling loss is calculated as follows:

- The fair value (as defined in ASC 820, refer to section 2.8, *Fair value*) of the underlying asset or the sum of (1) the lease receivable and (2) any prepaid lease payments from the lessee (net of any lease incentives paid to the lessee), **if lower**
- Minus the carrying amount of the underlying asset, net of any unguaranteed residual asset
- Minus any deferred initial direct costs of the lessor

The calculation of selling profit is based on the lower of (1) the fair value of the underlying asset and (2) the sum of the lease receivable and any prepaid lease payments from the lessee (net of any lease incentives paid to the lessee) because lease revenue in a sales-type lease is limited to the sum of the receivable and any prepayments received (net of incentives paid to the lessee). Refer to section 5.8, *Presentation*.

Selling profit — sales-type leases

ASC 842 requires a lessor to recognize any selling profit on a sales-type lease at lease commencement, assuming that collectibility of both lease payments and any residual value guarantee provided by the lessee is probable (refer to section 5.2.1.1, *Collectibility is probable at lease commencement*). When collectibility of lease payments and any residual value guarantee provided by the lessee is not probable, the underlying asset is not derecognized, and no selling profit is recognized (refer to section 5.2.1.2, *Collectibility is not probable at lease commencement*).

The FASB included the collectibility threshold for the recognition of a sales-type lease to better align the leases guidance with the principles in ASC 606. The FASB indicated in the Basis for Conclusions (BC 93) that even though a sales-type lease is not necessarily identical to a sale, the transactions are economically similar (e.g., because sales-type lessors often use leasing as an alternative means to sell their assets and have no intention of reusing or re-leasing assets leased out under a sales-type lease).

Selling profit — direct financing leases

As noted above, the lease classification test is designed so that a lease can be a direct financing lease only when the lessor obtains a residual value guarantee from an unrelated third party other than the lessee and that guarantee is sufficient to satisfy (when added to lease payments) the "substantially all" criterion discussed in section 3.2, *Criteria for lease classification — lessors*. Although a residual value guarantee from an unrelated third party other than the lessee can exist in a sales-type lease or an operating lease, a lease without a residual value guarantee from an unrelated third party other than the lessee must be classified as either a sales-type lease or an operating lease.

ASC 842 requires a lessor to defer any selling profit on a direct financing lease at lease commencement and amortize it over the lease term in a manner that, when combined with the interest income on the lease receivable and the unguaranteed residual asset, produces a constant periodic discount rate on the remaining balance of the net investment in the lease. Refer to section 5.3.2, *Subsequent measurement,* for a discussion of the subsequent measurement for direct financing leases.

Selling loss

Any selling loss on a sales-type lease or direct financing lease is recognized immediately at lease commencement, but a loss may indicate that the underlying asset was impaired prior to lease commencement. Refer to section 5.2.1, *Initial recognition and measurement*, for discussion of the initial recognition of a sales-type lease and section 5.3.1, *Initial recognition and measurement*, for the initial recognition of a deferred financing lease.

A lessor that concludes, in accordance with ASC 842-10-55-3 (refer to section 3.4.6, *Fair value of the underlying asset*), that it is not practicable for it to determine the fair value of an underlying asset (particularly an identified portion of an underlying asset, such as a floor in a building) and does not evaluate the "substantially all" lease classification criterion may face practical challenges if the lease is classified as a sales-type lease based on the other applicable criteria discussed in section 3.2, *Criteria for lease classification — lessors*, (e.g., lease term). In that case, the lessor is still required to determine the fair value of the underlying asset for purpose of measurement under ASC 842 (e.g., to calculate selling profit or loss, determine the rate implicit in the lease).

5.1.4 Collectibility

Collectibility is not assessed for purposes of the sales-type lease classification test. Rather, lessors in sales-type leases assess the collectibility of lease payments and any residual value guarantee provided by the lessee for purposes of determining initial recognition and measurement. For example, if collection of lease payments and any residual value guarantee provided by the lessee is not probable (i.e., not likely to occur), the underlying asset is not derecognized, and all income is deferred. Under ASC 840, this type of lease would be classified as an operating lease. Refer to section 5.2, *Sales-type leases*.

ASC 842 requires lessors to evaluate the collectibility of lease payments and any residual value guarantee (i.e., a guarantee provided by a lessee or any other third party unrelated to the lessor) to determine lease classification for leases that would otherwise be classified as direct financing leases. That is, if collection of lease payments and any residual value guarantee is not probable (i.e., it is not likely to occur), a lease that would otherwise qualify as a direct financing lease is classified as an operating lease. Refer to section 3.2, *Criteria for lease classification — lessors*.

Collectibility of lease payments must also be evaluated for operating leases to determine the income recognition pattern for those leases. Refer to section 5.4, *Operating leases*.

The following table summarizes how the collectibility assessment affects lease classification, recognition and measurement for lessors.

	Sales-type lease	Direct financing lease	Operating lease
Classification at lease commencement	Collectibility has no effect on lease classification	Collectibility is probable (assuming the other classification criterion is met) — direct financing lease Collectibility is not probable — operating lease	Not applicable — operating leases are leases that do not meet the criteria to be classified as sales-type or direct financing leases (including leases that would otherwise be direct financing leases if collectibility was probable)
Initial recognition and measurement at lease commencement	Collectibility is probable — recognize any selling profit or loss Collectibility is not probable — do not derecognize the underlying asset and account for lease payments received as a deposit liability. Refer to section 5.2.1.2, *Collectibility is not probable at lease commencement*, for further details.	Not applicable	Not applicable
Subsequent measurement	Collectibility is probable at lease commencement — net investment is evaluated for impairment under ASC 310, *Receivables* (prior to the adoption of ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*) or ASC 326 (subsequent to the adoption of ASU 2016-13) Collectibility is not probable at lease commencement — refer to section 5.2.1.2, *Collectibility is not probable at lease commencement*	Direct financing lease net investment evaluated for impairment under ASC 310 (prior to the adoption of ASU 2016-13) or ASC 326 (subsequent to the adoption of ASU 2016-13)	Collectibility is probable — recognize income generally on a straight-line basis Collectibility is not probable — income recognition can be no greater than lease payments and variable lease payments received

5.1.5 Master lease agreements

Excerpt from Accounting Standards Codification

Leases — Lessor

Recognition

842-10-55-17

Under a master **lease** agreement, the **lessee** may gain control over the use of additional **underlying assets** during the term of the agreement. If the agreement specifies a minimum number of units or dollar value of equipment, the lessee obtaining control over the use of those additional underlying assets is not a **lease modification.** Rather, the entity (whether a lessee or a **lessor**) applies the guidance in paragraphs 842-10-15-28 through 15-42 when identifying the separate lease components and allocating the **consideration in the contract** to those components. Paragraph 842-10-55-22 explains that a master lease agreement may, therefore, result in multiple **commencement dates.**

842-10-55-18

If the master lease agreement permits the lessee to gain control over the use of additional underlying assets during the term of the agreement but does not commit the lessee to doing so, the lessee's taking control over the use of an additional underlying asset should be accounted for as a lease modification in accordance with paragraphs 842-10-25-8 through 25-18.

Under a master lease agreement, a lessee may gain control over the use of additional underlying assets during the term of the agreement. In certain cases, a master lease agreement may specify a minimum number or value of underlying assets the lessee is required to obtain. For example, a lessee enters into an agreement to obtain the right to lease three floors of a building with an option to lease an additional floor (i.e., the fourth floor).

To the extent that a lessee is required to take a specified minimum quantity or value of the underlying assets, the lessee obtaining control over the use of those additional underlying assets is not a lease modification (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease). To identify the separate lease components and allocate the amount of consideration in the master lease agreement attributed to the additional underlying assets, the lessor applies the guidance in ASC 842-10-15-28 through 15-42 (refer to section 1.4, *Identifying and separating lease and non-lease components of a contract and allocating contract consideration*). Further, refer to section 5.4.1, *Time pattern of use of property in an operating lease*, for the accounting of escalating lease payments of an operating lease under a master lease agreement.

To the extent that additional underlying assets beyond the specified minimum are leased under the master lease agreement, the lessee obtaining control over the use of those additional underlying assets is considered a lease modification. Refer to section 5.6, *Lease modifications*, for the accounting of a lease modification.

If a master lease agreement does not include a specified minimum quantity or dollar value, the lessee obtaining control over the use of any additional underlying asset is also considered a lease modification. Refer to section 5.6, *Lease modifications*, for the accounting of a lease modification.

To determine lease commencement date for master lease agreements, refer to section 2.2.1, *Lease commencement date for master lease agreements*.

5.2 Sales-type leases

5.2.1 Initial recognition and measurement

Excerpt from Accounting Standards Codification

Leases — Lessor

Recognition

842-30-25-1

At the **commencement date**, a **lessor** shall recognize each of the following and derecognize the **underlying asset** in accordance with paragraph 842-30-40-1:

a. A **net investment in the lease**, measured in accordance with paragraph 842-30-30-1

b. **Selling profit or selling loss** arising from the **lease**

c. **Initial direct costs** as an expense if, at the commencement date, the **fair value** of the underlying asset is different from its carrying amount. If the fair value of the underlying asset equals its carrying amount, initial direct costs (see paragraphs 842-10-30-9 through 30-10) are deferred at the commencement date and included in the measurement of the net investment in the lease. The **rate implicit in the lease** is defined in such a way that those initial direct costs eligible for deferral are included automatically in the net investment in the lease; there is no need to add them separately.

842-30-25-3

The guidance in paragraphs 842-30-25-1 through 25-2 notwithstanding, if collectibility of the **lease payments**, plus any amount necessary to satisfy a **residual value guarantee** provided by the **lessee**, is not **probable** at the commencement date, the lessor shall not derecognize the underlying asset but shall recognize lease payments received — including variable lease payments — as a deposit liability until the earlier of either of the following:

a. Collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, becomes probable. If collectibility is not probable at the commencement date, a lessor shall continue to assess collectibility to determine whether the lease payments and any amount necessary to satisfy a residual value guarantee are probable of collection.

b. Either of the following events occurs:

 1. The **contract** has been terminated, and the lease payments received from the lessee are nonrefundable.

 2. The lessor has repossessed the underlying asset, it has no further obligation under the contract to the lessee, and the lease payments received from the lessee are nonrefundable.

842-30-25-4

When collectibility is not probable at the commencement date, at the date the criterion in paragraph 842-30-25-3(a) is met (that is, the date at which collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee provided by the lessee is assessed as probable), the lessor shall do all of the following:

a. Derecognize the carrying amount of the underlying asset

b. Derecognize the carrying amount of any deposit liability recognized in accordance with paragraph 842-30-25-3

c. Recognize a net investment in the lease on the basis of the remaining lease payments and remaining **lease term**, using the rate implicit in the lease determined at the commencement date

d. Recognize selling profit or selling loss calculated as:

 1. The **lease receivable**; plus

 2. The carrying amount of the deposit liability; minus

 3. The carrying amount of the underlying asset, net of the **unguaranteed residual asset**.

842-30-25-5

When collectibility is not probable at the commencement date, at the date the criterion in paragraph 842-30-25-3(b) is met, the lessor shall derecognize the carrying amount of any deposit liability recognized in accordance with paragraph 842-30-25-3, with the corresponding amount recognized as lease income.

842-30-25-6

If collectibility is probable at the commencement date for a **sales-type lease** or for a **direct financing lease**, a lessor shall not reassess whether collectibility is probable. Subsequent changes in the credit risk of the lessee shall be accounted for in accordance with the impairment guidance applicable to the net investment in the lease in paragraph 842-30-35-3.

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Editor's note: The content of paragraph 842-30-25-6 will change upon the adoption of ASU 2016-13

If collectibility is probable at the commencement date for a **sales-type lease** or for a **direct financing lease**, a lessor shall not reassess whether collectibility is probable. Subsequent changes in the credit risk of the lessee shall be accounted for in accordance with the credit loss guidance applicable to the net investment in the lease in paragraph 842-30-35-3.

Derecognition

842-30-40-1

At the **commencement date**, a **lessor** shall derecognize the carrying amount of the **underlying asset** (if previously recognized) unless the **lease** is a **sales-type lease** and collectibility of the **lease payments** is not **probable** (see paragraph 842-30-25-3).

Initial Measurement

842-30-30-1

At the **commencement date**, for a **sales-type lease**, a **lessor** shall measure the **net investment in the lease** to include both of the following:

a. The **lease receivable**, which is measured at the present value, discounted using the **rate implicit in the lease**, of:
   1. The **lease payments** (as described in paragraph 842-10-30-5) not yet received by the lessor
   2. The amount the lessor expects to derive from the **underlying asset** following the end of the **lease term** that is guaranteed by the **lessee** or any other third party unrelated to the lessor

b. The **unguaranteed residual asset** at the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease.

5.2.1.1 Collectibility is probable at lease commencement

At lease commencement, a lessor accounts for a sales-type lease for which the collectibility of lease payments and any residual value guarantee provided by the lessee is probable as follows:

- Derecognizes the carrying amount of the underlying asset
- Recognizes the net investment in the lease (refer to section 5.1.1, *Net investment in the lease*)
- Recognizes, in net income, any selling profit or selling loss (refer to section 5.1.3, *Selling profit or selling loss*)
- Expenses any initial direct costs if the fair value of the underlying asset is different from its carrying amount (refer to section 2.6, *Initial direct costs*, and section 2.8, *Fair value*)
- Defers any initial direct costs and includes them in the net investment in the lease if the fair value of the underlying asset equals its carrying amount

If initial direct costs are deferred, they are included in the computation of the rate implicit in the lease and therefore automatically included in the measurement of the net investment in the lease. Refer to section 2.5, *Discount rates*, for further discussion of the rate implicit in the lease.

A lessor does not change lease classification after lease commencement due to changes in the assessment of collectibility. Subsequent changes in the collectibility of the lease payments that were determined to be probable of collection at lease commencement are identified and accounted for in the impairment assessment of the net investment in the sales-type lease. Refer to section 5.2.3, *Impairment of the net investment in the lease.* Also refer to section 5.5, *Examples — lessor accounting*, Example 1, Case A.

5.2.1.2 Collectibility is not probable at lease commencement

If the collection of the lease payments and any residual value guarantee provided by the lessee is not probable at lease commencement for a sales-type lease, a lessor does not derecognize the underlying asset and does not recognize its net investment in the lease. Instead, a lessor continues to account for the underlying asset using other US GAAP (e.g., depreciates, evaluates the asset for impairment in accordance with ASC 360) and recognizes lease payments received, including variable lease payments that do not depend on an index or rate, as a deposit liability until the earlier of either of the following:

- Collection of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, becomes probable.
- Either of the following events occurs:
  - The contract is terminated, and the lease payments received from the lessee are nonrefundable.
  - The lessor repossesses the underlying asset and has no further obligation to the lessee under the contract, and the lease payments received from the lessee are nonrefundable.

Collectibility of lease payments and any residual value guarantee provided by the lessee is continually reassessed when collection is not probable at the commencement date.

Also refer to section 5.5, *Examples — lessor accounting*, Example 1 Case B.

Collectibility is not probable at lease commencement but subsequently becomes probable

When collectibility of lease payments and any residual value guarantee provided by the lessee is not probable at lease commencement but subsequently becomes probable, a lessor accounts for the sales-type lease as follows:

- Derecognizes the carrying amount of the underlying asset
- Derecognizes the carrying amount of any deposit liability recognized
- Recognizes a net investment in the lease, measured based on the remaining lease payments and remaining lease term, using the rate implicit in the lease determined at the commencement date
- Recognizes selling profit or selling loss calculated as:
  - The lease receivable
  - Plus the carrying amount of the deposit liability
  - Minus the carrying amount of the underlying asset, net of the unguaranteed residual asset

Collectibility is not probable at lease commencement and the contract is subsequently terminated or the underlying asset is repossessed by the lessor

When collectibility of lease payments and any residual value guarantee provided by the lessee is not probable at lease commencement, a lessor derecognizes the carrying amount of any deposit liability previously recognized and recognizes lease income when the lease payments received from the lessee are nonrefundable and either:

- The contract terminates.
- The lessor repossesses the underlying asset and has no further obligation to the lessee under the contract.

5.2.2 Subsequent measurement

ASC 842's subsequent measurement guidance for sales-type leases is similar to the subsequent measurement guidance for direct financing leases, discussed in section 5.3.2, *Subsequent measurement*. Deferring selling profit as part of the net investment in the lease for direct financing leases is the key difference.

Excerpt from Accounting Standards Codification

Leases — Lessor

Subsequent Measurement

842-30-35-1

After the **commencement date**, a **lessor** shall measure the **net investment in the lease** by doing both of the following:

a. Increasing the carrying amount to reflect the interest income on the net investment in the lease. A lessor shall determine the interest income on the net investment in the lease in each period during the **lease term** as the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease.

b. Reducing the carrying amount to reflect the **lease payments** collected during the period.

Recognition

842-30-25-2

After the commencement date, a lessor shall recognize all of the following:

a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a)

b. **Variable lease payments** that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur

c. Impairment of the net investment in the lease (as described in paragraph 842-30-35-3).

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After the commencement date, a lessor shall recognize all of the following:

a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a)

b. **Variable lease payments** that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur

c. Credit losses on the net investment in the lease (as described in paragraph 842-30-35-3).

After lease commencement, a lessor accounts for a sales-type lease as follows:

- Recognizes interest income (in profit or loss) over the lease term in an amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease (i.e., using the rate implicit in the lease), including:
  - Interest on the lease receivable
  - Interest from accretion of the unguaranteed residual asset to its expected value at the end of the lease
- Reduces the net investment in the lease for lease payments received (net of interest income calculated above)
- Separately recognizes income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period when the changes in facts and circumstances on which the variable lease payments are based occur
- Recognizes changes to variable lease payments that depend on an index or rate in profit or loss in the period of the change
- Recognizes any impairment of the net investment in the lease (refer to section 5.2.3, *Impairment of the net investment in the lease*)

5.2.3 Impairment of the net investment in the lease

Excerpt from Accounting Standards Codification

Leases — Lessor

Subsequent Measurement

842-30-35-3

A **lessor** shall determine impairment related to the **net investment in the lease** and shall recognize any impairment in accordance with Topic 310 on receivables (as described in paragraphs 310-10-35-16 through 35-30). When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to derive from the **underlying asset** during the remaining **lease term** (for example, from sale of the asset or release of the asset for the remainder of the lease term), which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (for example, cash flows from leasing the asset after the end of the lease term).

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Editor's note: The content of paragraph 842-30-35-3 will change upon the adoption of ASU 2016-13:

Credit Losses on the Net Investment in the Lease

A **lessor** shall determine credit losses related to the **net investment in the lease** and shall record any credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to derive from the **underlying asset** during the remaining **lease term**, which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (for example, cash flows from leasing the asset after the end of the lease term).

ASC 842 requires lessors to evaluate their net investment in a sales-type lease and a direct financing lease (refer to section 5.3, *Direct financing leases*) for impairment using the guidance for receivables in ASC 310 (prior to the adoption of ASU 2016-13) or ASC 326 (subsequent to the adoption of ASU 2016-13). The FASB indicated in the Basis for Conclusions (BC 310) that even though the unguaranteed residual asset component of the net investment in the lease does not meet the definition of a financial asset in US GAAP, it would be overly complex and provide little benefit to require entities to separately assess the unguaranteed residual asset for impairment in accordance with ASC 360 while the receivable (i.e., the financial asset) is evaluated for impairment in accordance with ASC 310 (prior to the adoption of ASU 2016-13) or ASC 326 (subsequent to the adoption of ASU 2016-13).

When determining the loss allowance for a net investment in the lease, a lessor takes into consideration the collateral relating to the net investment in the lease, which represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term (e.g., cash flows from selling the asset or re-leasing it for the remainder of the lease term). This excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (e.g., cash flows from leasing the asset after the end of the lease term).

5.2.4 Remeasurement of the net investment in the lease

ASC 842's remeasurement provisions for a net investment in a sales-type lease are the same as for a direct financing lease, discussed in section 5.3.4, *Remeasurement of the net investment in the lease*.

Excerpt from Accounting Standards Codification

Leases — Overall

Subsequent Measurement

842-10-35-3

A **lessor** shall not reassess the lease term or a lessee option to purchase the underlying asset unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset, the lessor shall account for the exercise of that option in the same manner as a **lease modification**.

Leases — Lessor

Subsequent Measurement

842-30-35-2

After the commencement date, a lessor shall not remeasure the net investment in the **lease** unless the lease is modified and that modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8.

After lease commencement, the net investment in a sales-type lease is not remeasured unless the lease is modified (i.e., there is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for the lease) and the modified lease is not accounted for as a separate contract. Refer to section 5.6, *Lease modifications*.

Additionally, ASC 842-10-35-3 requires lessors to account for a lessee's exercise of an option to extend or terminate the lease or purchase the underlying asset in the same manner as a lease modification. That is, lessors reassess lease classification upon the exercise of these options. Refer to section 5.6.3, *Lessor accounting for a modification that is not accounted for as a separate* contract. Lessees are not required to account for such exercises as a lease modification.

We believe that the exercise of an option to extend or terminate the lease or purchase the underlying asset should be accounted for in the same manner as a lease modification only when the exercise of the option is inconsistent with the lessor's assumption about whether the lessee will exercise the option already included in the lease term. For example, if a lessor included an optional period to extend the lease in the lease term because it concluded that the lessee is reasonably certain to exercise that option, we do not believe that the exercise of the option should be accounted for as a lease modification.

5.2.5 Example — lessor accounting for a sales-type lease

The following illustration shows how a lessor accounts for a sales-type lease that gives rise to selling profit when the collectibility of lease payments and the residual value guarantee provided by the lessee is probable at lease commencement. Refer to section 5.5, *Examples — lessor accounting*, for additional examples of lessor accounting included in ASC 842.

Illustration 28 — Lessor accounting for a sales-type lease

Assume Entity X (Lessor) enters into a 10-year lease of equipment with Entity Y (Lessee). Lessor sells and leases the equipment, which is not specialized in nature and is expected to have alternative use to Lessor at the end of the 10-year lease term. Under the lease:

- Lessor receives annual lease payments of $15,000, payable at the end of each year.
- Lessor expects the residual value of the equipment to be $50,000 at the end of the 10-year lease term.
- Lessee provides a residual value guarantee that protects Lessor on the first $30,000 of loss below the estimated residual value at the end of the lease term of $50,000.
- The equipment has an estimated remaining economic life of 15 years, a carrying amount of $100,000 and a fair value of $111,000.
- Lessor incurred and paid costs of $2,000 for a broker's commission as a result of obtaining the lease. These costs qualify as initial direct costs and are capitalized when the lease is obtained.
- The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease term or contain an option for Lessee to purchase the equipment.
- The rate implicit in the lease is 10.078%.
- At lease commencement, Lessor concludes that it is probable it will collect the lease payments and any amount probable of being owed under the residual value guarantee provided by Lessee.

Lessor classifies the lease as a sales-type lease because the present value of the sum of lease payments and the residual value guaranteed by Lessee exceeds substantially all of the fair value of the underlying asset. None of the other criteria for classification as a sales-type lease are met. If the residual value guarantee was from an unrelated party other than the lessee, the Lessor would have excluded it when determining whether the lease met the requirements to be classified as a sales-type lease (refer to section 3.2, *Criteria for lease classification — lessors*).

At lease commencement, Lessor accounts for the sales-type lease as follows:

To record the net investment in the sales-type lease and derecognize the underlying asset:

Net investment in the lease	$ 111,000[(a)]	
Cost of goods sold	92,344[(b)]	
Broker's commission expense	2,000[(c)]	
Revenue		$ 103,344[(d)]
Property held for lease		100,000[(e)]
Capitalized initial direct costs		2,000[(c)]

[a] The net investment in the lease consists of (1) the present value of the 10 annual lease payments of $15,000 plus the present value of the guaranteed residual value of $30,000, both discounted at the rate implicit in the lease, which equals $103,344 (i.e., the lease receivable) and (2) the present value of unguaranteed residual asset of $20,000, which equals $7,656. Note that the net investment in the lease is subject to the same considerations as other assets when classifying its components as current or noncurrent assets in a classified balance sheet.

[b] Cost of goods sold is the carrying amount of the equipment of $100,000 less the present value of the unguaranteed residual asset of $7,656.

[c] Costs incurred and paid for a broker's commission as a result of obtaining the lease qualify are capitalized as initial direct costs when the lease is obtained but expensed at lease commencement.

[d] Revenue equals the lease receivable, which consists of (1) the present value of the 10 annual lease payments of $15,000 plus (2) the present value of the guaranteed residual value of $30,000, both discounted at the rate implicit in the lease, which equals $103,344.

[e] $100,000 is the carrying amount of the underlying asset.

At lease commencement, Lessor recognizes selling profit of $11,000, which is calculated as the lease receivable of $103,344 less the carrying amount of the asset of $100,000, net of any unguaranteed residual asset of $7,656, which equals $92,344.

Year 1 journal entries for the sales-type lease:

Cash	$ 15,000[f]	
Net investment in the lease		$ 3,813[g]
Interest income		11,187[h]

[f] Receipt of annual lease payment at the end of the year.

[g] Reduction of the net investment in the lease for lease payment received of $15,000, net of interest income of $11,187.

[h] Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease (see computation below).

The following table summarizes the interest income from this lease and the related amortization of the net investment over the lease term.

Year	Annual rental payment	Annual interest income[a]	Net investment at end of year
Initial net investment	$ –	$ –	$ 111,000
1	15,000	11,187	107,187
2	15,000	10,803	102,990
3	15,000	10,380	98,370
4	15,000	9,914	93,284
5	15,000	9,401	87,685
6	15,000	8,837	81,522
7	15,000	8,216	74,738
8	15,000	7,532	67,270
9	15,000	6,780	59,050
10	15,000	5,950	50,000[b]

[a] Interest income equals 10.078% of the net investment in the lease at the beginning of each year. For example, Year 1 annual interest income is calculated as $111,000 initial net investment x 10.078%.

[b] The estimated residual value of the equipment at the end of the lease term.

Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.

5.3 Direct financing leases

5.3.1 Initial recognition and measurement

Excerpt from Accounting Standards Codification

Leases — Lessor

Recognition

842-30-25-7

At the **commencement date**, a **lessor** shall recognize both of the following and derecognize the **underlying asset** in accordance with paragraph 842-30-40-1:

a. A **net investment in the lease**, measured in accordance with paragraph 842-30-30-2

b. Selling loss arising from the **lease**, if applicable.

842-30-25-8

Selling profit and **initial direct costs** (see paragraphs 842-10-30-9 through 30-10) are deferred at the commencement date and included in the measurement of the net investment in the lease. The **rate implicit in the lease** is defined in such a way that initial direct costs deferred in accordance with this paragraph are included automatically in the net investment in the lease; there is no need to add them separately.

842-30-25-6

If collectibility is probable at the commencement date for a **sales-type lease** or for a **direct financing lease**, a lessor shall not reassess whether collectibility is probable. Subsequent changes in the credit risk of the lessee shall be accounted for in accordance with the impairment guidance applicable to the net investment in the lease in paragraph 842-30-35-3.

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Editor's note: The content of paragraph 842-30-25-6 will change upon the adoption of ASU 2016-13:

If collectibility is probable at the commencement date for a **sales-type lease** or for a **direct financing lease**, a lessor shall not reassess whether collectibility is probable. Subsequent changes in the credit risk of the lessee shall be accounted for in accordance with the credit loss guidance applicable to the net investment in the lease in paragraph 842-30-35-3.

Initial Measurement

842-30-30-1

At the **commencement date**, for a **sales-type lease**, a **lessor** shall measure the **net investment in the lease** to include both of the following:

a. The **lease receivable**, which is measured at the present value, discounted using the ra**te implicit in the lease**, of:

   1. The **lease payments** (as described in paragraph 842-10-30-5) not yet received by the lessor

   2. The amount the lessor expects to derive from the **underlying asset** following the end of the **lease term** that is guaranteed by the **lessee** or any other third party unrelated to the lessor

b. The **unguaranteed residual asset** at the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease.

842-30-30-2

At the commencement date, for a **direct financing lease**, a lessor shall measure the net investment in the lease to include the items in paragraph 842-30-30-1(a) through (b), reduced by the amount of any selling profit.

Derecognition

842-30-40-1

At the **commencement date**, a **lessor** shall derecognize the carrying amount of the **underlying asset** (if previously recognized) unless the **lease** is a **sales-type lease** and collectibility of the **lease payments** is not **probable** (see paragraph 842-30-25-3).

The lease classification test is designed so that a lease can be a direct financing lease only when the lessor obtains a residual value guarantee from an unrelated third party other than the lessee and that guarantee is sufficient to satisfy the "substantially all" criterion discussed in section 3.2., *Criteria for lease classification — lessors*. Although a residual value guarantee from an unrelated third party other than the lessee can exist in a sales-type lease or an operating lease, a lease without a residual value guarantee from an unrelated third party other than the lessee must be classified as either a sales-type lease or an operating lease.

At lease commencement, a lessor accounts for a direct financing lease as follows:

- Derecognizes the carrying amount of the underlying asset
- Recognizes the net investment in the lease (refer to section 5.1.1, *Net investment in the lease*)
- Recognizes, in net income, any selling loss (refer to section 5.1.3, *Selling profit or selling loss*)
- Defers any selling profit and initial direct costs (refer to section 2.6, *Initial direct costs*) and includes those amounts in the initial measurement of the net investment in the lease

The initial measurement of the net investment in a direct financing lease is similar to that of a sales-type lease (i.e., the present value of the lease payments not yet received and the unguaranteed residual asset). However, for a direct financing lease, any selling profit is deferred at lease commencement and included in the initial measurement of the net investment in the lease (i.e., selling profit reduces the net investment in the lease). Any selling loss is recognized at lease commencement.

For a direct financing lease, because initial direct costs are deferred, they are included in the computation of the rate implicit in the lease and therefore automatically included in the measurement of the net investment in the lease (i.e., initial direct costs increase the net investment in the lease). Refer to section 2.5, *Discount rates*, for further discussion of the rate implicit in the lease.

The lease classification test is designed so that in order for a lessor to classify a lease as a direct financing lease, the collection of lease payments and any residual value guarantee (i.e., those guarantees provided by the lessee and any other third party unrelated to the lessor) must be probable at the commencement date. A lessor does not change lease classification after lease commencement due to changes in the assessment of collectibility. If a lease is classified as a direct financing lease at lease commencement, subsequent changes in collectibility are identified and accounted for in the impairment assessment of the net investment in the direct financing lease. Refer to section 5.3.3, *Impairment of the net investment in the lease*. If the lease that would otherwise be classified as a direct financing lease at lease commencement is instead classified as an operating lease because collection of lease payments and any residual value guarantee is not probable at lease commencement, the subsequent change in collectibility may affect the income recognition pattern of the operating lease but would not affect its lease classification. Also refer to section 5.5, *Examples — lessor accounting*, Example 1 Case D.

5.3.2 Subsequent measurement

ASC 842's subsequent measurement guidance for direct financing leases is similar to the subsequent measurement guidance for sales-type leases, discussed in section 5.2.2, *Subsequent measurement*. Deferring selling profit as part of the net investment in the lease for direct financing leases is the key difference.

Excerpt from Accounting Standards Codification

Leases — Lessor

Subsequent Measurement

842-30-35-1

After the **commencement date**, a **lessor** shall measure the **net investment in the lease** by doing both of the following:

a. Increasing the carrying amount to reflect the interest income on the net investment in the lease. A lessor shall determine the interest income on the net investment in the lease in each period during the **lease term** as the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease.

b. Reducing the carrying amount to reflect the **lease payments** collected during the period.

Recognition

842-30-25-9

After the commencement date, a lessor shall recognize all of the following:

a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a)

b. **Variable lease payments** that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur

c. Impairment of the net investment in the lease (as described in paragraph 842-30-35-3).

After lease commencement, a lessor accounts for a direct financing lease as follows:

- Recognizes interest income (in profit or loss) over the lease term in an amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease, including:
  - Interest on the lease receivable
  - Interest from accretion of the unguaranteed residual asset to its expected value at the end of the lease
  - Amortization of any deferred selling profit
- Reduces the net investment in the lease for lease payments received (net of interest income calculated above)
- Separately recognizes income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period when the changes in facts and circumstances on which the variable lease payments are based occur
- Recognizes changes to variable lease payments that depend on an index or rate in profit or loss in the period of the change

- Recognizes any impairment of the net investment in the lease (refer to section 5.2.3, *Impairment of the net investment in the lease*)

Note that as illustrated in section 5.3.5, *Example — lessor accounting for a direct financing lease*, the rate used to recognize interest income on a direct financing lease differs from the rate implicit in the lease when there is deferred selling profit. Also refer to section 5.5, *Examples — lessor accounting*, Example 1 Case C.

5.3.3 Impairment of the net investment in the lease

ASC 842's provisions for evaluating impairment of the net investment in a direct financing lease are the same as for a sales-type lease. Refer to section 5.2.3, *Impairment of the net investment in the lease*, for further discussion.

5.3.4 Remeasurement of the net investment in the lease

ASC 842's remeasurement provisions for the net investment in a direct financing lease are the same as for a sales-type lease, discussed in section 5.2.4, *Remeasurement of the net investment in the lease*.

Excerpt from Accounting Standards Codification

Leases — Lessor

Subsequent Measurement

842-30-35-2

After the commencement date, a lessor shall not remeasure the net investment in the lease unless the **lease** is modified and that modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8.

Leases — Overall

Subsequent Measurement

842-10-35-3

A **lessor** shall not reassess the lease term or a lessee option to purchase the underlying asset unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset, the lessor shall account for the exercise of that option in the same manner as a **lease modification**.

After lease commencement, the net investment in a direct financing lease is not remeasured unless the lease is modified (i.e., there is a change to terms and conditions of a contract that results in a change in the scope of or the consideration for the lease) and the modified lease is not accounted for as a separate contract. Refer to section 5.6, *Lease modifications*.

Additionally, ASC 842-10-35-3 requires lessors to account for a lessee's exercise of an option to extend or terminate the lease or purchase the underlying asset in the same manner as a lease modification. That is, lessors reassess lease classification upon the exercise of these options. Refer to section 5.6.3, *Lessor accounting for a modification that is not accounted for as a separate contract*. Lessees are not required to account for such exercises as a lease modification.

We believe that the exercise of an option to extend or terminate the lease or purchase the underlying asset should be accounted for in the same manner as a lease modification only when the exercise of the option is inconsistent with the lessor's assumption about whether the lessee will exercise the option already included in the lease term. For example, if a lessor included an optional period to extend the lease in the lease term because it concluded that the lessee is reasonably certain to exercise that option, we do not believe that the exercise of the option should be accounted for as a lease modification.

5.3.5 Example — lessor accounting for a direct financing lease

The following illustration shows how a lessor accounts for a direct financing lease that gives rise to selling profit. Refer to section 5.5, *Examples — lessor accounting*, for additional examples of lessor accounting included in ASC 842.

Illustration 29 — Lessor accounting for a direct financing lease

Assume Entity X (Lessor) enters into a 10-year lease of equipment with Entity Y (Lessee). Lessor sells and leases the equipment, which is not specialized in nature and is expected to have alternative use to Lessor at the end of the 10-year lease term. Under the lease:

- Lessor receives annual lease payments of $15,000, payable at the end of each year.
- Lessor expects the residual value of the equipment to be $50,000 at the end of the 10-year lease term.
- Lessor obtains a residual value guarantee from an unrelated third party other than Lessee that protects Lessor on the first $30,000 of loss below the estimated residual value of $50,000.
- The equipment has an estimated remaining economic life of 15 years, a carrying amount of $100,000 and a fair value of $111,000.
- The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease term or contain an option for Lessee to purchase the underlying asset.
- The rate implicit in the lease is 10.078%.
- At lease commencement, Lessor concludes that it is probable it will collect the lease payments and any amount owed under the residual value guarantee provided by the third party.

None of the criteria for a classification as a sales-type lease are met (e.g., the present value of the lease payments is 83% of the fair value of the equipment, which is less than the 90% threshold that Lessor uses in the lease classification test). Lessor classifies the lease as a direct financing lease because (1) the present value of the sum of the lease payments and the residual value guaranteed by the unrelated third party exceeds substantially all of the fair value of the underlying asset and (2) it is probable that Lessor will collect the lease payments and any amount owed under the residual value guarantee. If the residual value guarantee was provided by Lessee, the lease would be classified as a sales-type lease (refer to section 3.2, *Criteria for lease classification — lessors*).

At lease commencement, Lessor accounts for the direct financing lease as follows:

To record the net investment in the direct financing lease and derecognize the underlying asset:

Net investment in the lease	$ 100,000[(a)]	
Property held for lease		100,000[(b)]

(a) The net investment in the lease consists of (1) the present value of the 10 annual lease payments of $15,000 plus the present value of the guaranteed residual value of $30,000, both discounted at the rate implicit in the lease, which equals $103,344 (i.e., the lease receivable), plus (2) the present value of unguaranteed residual asset of $20,000, which equals $7,656, less (3) deferred selling profit of $11,000. Deferred selling profit is calculated as the lease receivable of $103,344, less the carrying amount of the underlying asset of $100,000, net of any unguaranteed residual asset of $7,656. Note that the net investment in the lease is subject to the same considerations as other assets when classifying its components as current or noncurrent assets in a classified balance sheet.

(b) $100,000 is the carrying amount of the underlying asset.

Year 1 journal entries for the direct financing lease:

Cash	$ 15,000[c]	
Net investment in the lease		$ 2,825[d]
Interest income		12,175[e]

[c] Receipt of annual lease payment at the end of the year.

[d] Reduction of the net investment in the lease for lease payment received of $15,000, net of interest income of $12,175.

[e] Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease (see computation below).

The following table summarizes the interest income for this lease and the related amortization of the net investment over the lease term.

Year	Annual rental payment	Annual interest income[a]	Net investment at end of year
Initial net investment	$ –	$ –	$100,000
1	15,000	12,175	97,175
2	15,000	11,831	94,006
3	15,000	11,445	90,451
4	15,000	11,012	86,463
5	15,000	10,527	81,990
6	15,000	9,982	76,972
7	15,000	9,371	71,343
8	15,000	8,686	65,029
9	15,000	7,917	57,946
10	15,000	7,054	50,000[b]

[a] Interest income includes interest on the lease receivable, accretion of the unguaranteed residual asset and amortization of deferred selling profit. The rate for recognizing interest income to produce a constant periodic rate of return on the remaining net investment is 12.175%.

[b] The estimated residual value of the equipment at the end of the lease term.

The following table summarizes the components of interest income recognized over the lease term.

Year	Interest on lease receivable[a]	Accretion of unguaranteed residual asset[b]	Amortization of deferred selling profit[c]	Annual interest income
1	$ 10,415	$ 772	$ 988	$ 12,175
2	9,954	849	1,028	11,831
3	9,445	935	1,065	11,445
4	8,885	1,029	1,098	11,012
5	8,269	1,133	1,125	10,527
6	7,590	1,247	1,145	9,982
7	6,843	1,373	1,155	9,371
8	6,021	1,511	1,154	8,686
9	5,117	1,663	1,137	7,917
10	4,119	1,831	1,104	7,054

[a] Interest on the lease receivable is based on the rate implicit in the lease of 10.078%. For example, Year 1 interest on the lease receivable is calculated as the lease receivable of $103,344 multiplied by the rate implicit in the lease of 10.078%.

[b] Accretion of the unguaranteed residual asset is based on the rate implicit in the lease of 10.078%. For example, Year 1 accretion of the residual asset is calculated as the present value of the unguaranteed residual asset at lease commencement of $7,656 multiplied by the rate implicit in the lease of 10.078%.

[c] Deferred selling profit is amortized into interest income over the lease term in a manner that, when combined with the interest income on the lease receivable and unguaranteed residual asset, produces a constant periodic rate of return on the lease of 12.175%.

Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.

5.4 Operating leases

Excerpt from Accounting Standards Codification

Leases — Lessor

Recognition

842-30-25-10

At the **commencement date**, a **lessor** shall defer **initial direct costs**.

842-30-25-11

After the commencement date, a lessor shall recognize all of the following:

a. The **lease payments** as income in profit or loss over the **lease term** on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the **underlying asset**, subject to paragraph 842-30-25-12

b. **Variable lease payments** as income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur

c. Initial direct costs as an expense over the lease term on the same basis as lease income (as described in (a)).

842-30-25-12

If collectibility of the lease payments plus any amount necessary to satisfy a **residual value guarantee** (provided by the **lessee** or any other unrelated third party) is not **probable** at the commencement date, lease income shall be limited to the lesser of the income that would be recognized in accordance with paragraph 842-30-25-11(a) through (b) or the lease payments, including variable lease payments, that have been collected from the lessee.

842-30-25-13

If the assessment of collectibility changes after the commencement date, any difference between the lease income that would have been recognized in accordance with paragraph 842-30-25-11(a) through (b) and the lease payments, including variable lease payments, that have been collected from the lessee shall be recognized as a current-period adjustment to lease income.

Initial Measurement

842-30-30-4

A **lessor** shall continue to measure the **underlying asset** subject to an **operating lease** in accordance with other Topics.

Subsequent Measurement

842-30-35-6

A **lessor** shall continue to measure, including testing for impairment in accordance with Section 360-10-35 on impairment or disposal of long-lived assets, the **underlying asset** subject to an **operating lease** in accordance with other Topics.

Implementation Guidance

842-30-55-17

This Subtopic considers the right to control the use of the **underlying asset** as the equivalent of physical use. If the **lessee** controls the use of the underlying asset, recognition of **lease** income in accordance with paragraph 842-30-25-11(a) should not be affected by the extent to which the lessee uses the underlying asset.

Under ASC 842, lessors account for operating leases in a manner similar to how they account for operating leases under ASC 840. That is, they continue to recognize the underlying asset and do not recognize a net investment in the lease on the balance sheet or initial profit (if any) in the income statement. The underlying asset continues to be accounted for in accordance with ASC 360.

If the collection of lease payments and any residual value guarantee (i.e., guarantees provided by the lessee or any other third party unrelated to the lessor) for an operating lease is probable at lease commencement, a lessor subsequently recognizes lease income over the lease term on a straight-line basis unless another systematic and rational basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. After lease commencement, lessors recognize variable lease payments that do not depend on an index or rate (e.g., performance- or usage-based payments) when the changes in facts and circumstances on which the variable lease payments are based occur. Similarly, lessors recognize changes to variable lease payments that depend on an index or rate in profit or loss in the period of the change.

If the collection of the lease payments and any residual value guarantee is not probable at the commencement date for an operating lease (including a lease that would otherwise have qualified as a direct financing lease if it had met the collectibility requirements — refer to section 3.2, *Criteria for lease classification — lessors*), a lessor's lease income is limited to the lesser of (1) the income that would have been recognized if collection were probable, including income from variable lease payments, and (2) the lease payments, including variable lease payments, that have been collected from the lessee.

If the collectibility assessment changes to probable after the commencement date, any difference between the lease income that would have been recognized if collectibility had always been assessed as probable and the income recognized to date is recognized as a current-period adjustment to lease income. Likewise, if the collectibility assessment changes to not probable after the commencement date, income is reversed if the lease payments, including variable lease payments, that have been collected from the lessee are less than the income recognized to date.

A lessor does not reassess lease classification if the collection of lease payments becomes probable after lease commencement. For example, a lease that would have otherwise been classified as a direct financing lease except that collectibility of lease payments and any residual value guarantee was not probable at lease commencement is classified as an operating lease. If the lease payments and any residual value guarantee are subsequently determined to be probable of collection, the lease continues to be classified as an operating lease. However, a change in collectibility could affect the timing of recognition of income for the operating lease.

Initial direct costs

ASC 842 requires lessors of operating leases to defer initial direct costs at lease commencement and amortize them over the lease term on the same basis as lease income.

5.4.1 Time pattern of use of property in an operating lease

Operating lease agreements may specify scheduled lease payment increases over the lease term, or periods during the lease term for which lease payments are not required ("rent holidays"). Uneven lease payments (increases, decreases or holidays) are often designed to provide an inducement for the lessee, to reflect the anticipated effects of inflation, to ease the lessee's near-term cash flow requirements or to acknowledge the time value of money. For operating leases that include uneven lease payments or rent holidays, lease income should be recognized by a lessor on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the time pattern in which benefit is expected to be derived from the use of the underlying asset, subject to the limitation when collectibility of lease payments is not probable as discussed in section 5.4, *Operating leases*, above. Using factors such as the time value of money or anticipated inflation is inappropriate because these factors do not relate to the benefit that is expected to be derived from the use of the underlying asset.

Lease agreements may also include scheduled lease payment increases designed to accommodate the lessee's projected use of the underlying asset. For example, lease payments may escalate in contemplation of the lessee's use of commercial real estate (i.e., the underlying asset) even though the lessee takes possession of or is given control over the use of the underlying asset(s) at the lease commencement.

We believe that FASB did not expect a change in practice in how such lease payments are recognized from the accounting under ASC 840 (i.e., a straight-line basis). Therefore, the lessor should recognize the lease payments as follows:

- If rents escalate in contemplation of the lessee's use of the underlying asset but the lessee takes possession of or is given control over the use of the underlying asset(s) at the lease commencement, all lease payments, including the escalated lease payments, should be recognized as lease income on generally a straight-line basis starting at the lease commencement.

- If lease payments escalate under a master lease agreement because the lessee gains control over the use of additional underlying assets and the right to use such additional assets is not accounted for as a lease modification (refer to section 5.1.5, *Master lease agreements*, for the accounting of master lease agreements), the escalated lease payments should be considered lease income attributable to the additional underlying assets in the periods that the lessee has control over the use of the additional underlying assets. To identify the separate lease components and allocate the amount of lease income attributed to the additional underlying assets, the lessor applies the guidance in ASC 842-10-15-28 through 15-42 (refer to section 1.4, *Identifying and separating lease and non-lease components of a contract and allocating contract consideration*).

The application of the above accounting to an operating lease with uneven lease payments results in prepaid or accrued lease payments to the lessor. If the lessee purchases the underlying asset prior to the expiration of the lease term, any prepaid or accrued rentals should be included in the determination of the gain or loss on the cancellation of the lease and the sale of the asset (refer to section 5.7.3, *Lease termination*).

5.4.1.1 Revenue recognition

Assuming collection of lease payments is probable, a lessor begins recording revenue under an operating lease when the lessor makes the underlying asset available for use by the lessee (e.g., the lessee takes possession of or is given control over the use of the underlying asset). It should be noted that this may be before or after lease payments begin. If the lessor turns the underlying asset over to the lessee so that the lessee can begin making lessee-owned improvements to the underlying asset (e.g., lessee begins constructing lessee assets — leasehold improvements), then the lessor would begin recognizing lease income when the underlying asset is turned over to the lessee for that purpose. If, instead, the lessor has determined that the lessee is acting on the lessor's behalf in constructing the improvements (e.g., lessee is constructing lessor assets), lease income would not begin until the leased property is substantially complete.

5.4.1.2 Impact of lessee vs. lessor asset on revenue recognition

Determining whether an improvement, which is paid for by the lessor, is a lessee or lessor asset (refer to section 4.7.1, *Which party owns the improvements*) generally impacts the determination of when the lessee takes possession of or is given control over the use of the underlying asset (and, consequently, impacts when the lessor can begin recognizing operating lease income). The lessee generally has not taken possession of or been given control over the use of the underlying asset until it is substantially complete. The following illustration demonstrates this point:

Illustration 30 — Impact of lessee vs. lessor asset on revenue recognition

Assume Lessee A contracts to lease a building from Lessor B. Lessor B agrees to reimburse Lessee A for $10 million of improvements (e.g., carpeting, interior walls and similar improvements that will be installed before the lessee occupies and begins to use the building for its intended purpose) as specified in the lease agreement. If Lessor B determines that the improvements are lessor assets (i.e., leasing the improved space to the lessee), it would record lease income on a straight-line basis once the lessee has possession of or is given control over the use of the space (generally when the building and improvements are substantially complete). However, if Lessor B determines that the improvements are lessee assets, it would record lease income on a straight-line basis once the lessee takes possession or is given control over the use of the unimproved space. In the case of lessee's improvements, the lessee would have possession of the space when it has access to begin constructing its improvements. The fact that the lessee may delay the date when they occupy the space (i.e., enter to make or have their agent make improvements) is not relevant — instead, control and possession are based on the lessee's rights to possess or use. Additionally, if Lessor B determines the improvements are lessee assets, Lessor B would be required to recognize the $10 million as a lease incentive (refer to section 5.4.2.1, *Lease incentives and tenant improvements*) and would record a liability for the incentive once incurred.

5.4.2 Lease incentives in an operating lease

A lessor may include incentives for the lessee to enter into the lease, such as an up-front cash payment to the lessee, payment of certain costs for the lessee (e.g., lessor may reimburse the lessee for its moving expenses or the construction of lessee-owned leasehold improvements) or the assumption by the lessor of the lessee's preexisting lease with a third party. A payment made to or on behalf of the lessee represents an incentive that should be capitalized at lease commencement and recognized on a straight-line basis over the lease term as a reduction to the lease income by the lessor (refer to section 2.4.1.2, *Lease incentives*). Similarly, losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party should be considered a lease incentive by the lessor. The lessor will often estimate the value of such lease incentive based on the total remaining costs reduced by the expected benefits from the sublease or use of the assumed underlying asset.

The following example illustrates the accounting by a lessor for lease incentives:

Illustration 31 — Lessor accounting for lease incentive

Lessor A enters into an operating lease of property with Lessee B for a five-year term at a monthly rental of $110. In order to induce Lessee B to enter into the lease, Lessor A provides $600 to Lessee B at lease commencement for lessee improvements (i.e., lessee assets).

At lease commencement, Lessor A accounts for the incentive as follows:

To record the lease incentive:

Deferred asset (lease incentive)	$	600		
Cash			$	600

Recurring monthly journal entries in Years 1–5:

To record cash received on the lease and amortization of lease incentive over the lease term:

Cash	$	110		
Lease income			$	100
Amortization of deferred asset (lease incentive) ($600 ÷ 60 months)				10

5.4.2.1 Lease incentives and tenant improvements

When a lessor makes an up-front payment to the lessee to fund (or partially fund) lessee asset improvements, the incentive is recorded as a receivable by the lessor (i.e., a credit to cash and an offsetting debit to lease incentive receivable) for an operating lease. As payments are received by the lessor under the lease, a portion (incentive ÷ lease term) of those payments are, in substance, repayments of the incentive (that is, a credit to the lease incentive receivable and an offsetting debit to cash). The fact that the incentive paid by the lessor is earmarked specifically to reimburse the lessee for the cost of the new leasehold improvements (lessee assets) does not impact the accounting for the incentive. That is, even if the funding is designated to partially or fully fund the lessee's leasehold improvements, the lessor would still record an incentive receivable. This accounting would also apply if, instead of receiving and paying cash, the lessee simply submits invoices to the lessor for a prescribed amount of improvements that are determined to be lessee assets and that the lessor has agreed to fund.

5.4.3 Asset impairment — operating leases

Assets leased out under an operating lease should be assessed for impairment, as necessary, under the provisions of ASC 360. Refer to our Financial reporting developments publication, *Impairment or disposal of long-lived assets*, for further discussion on assessing an asset for impairment.

5.5 Examples — lessor accounting

ASC 842 includes the following example of the accounting for a sales-type lease for which the collection of lease payments and the residual value guarantee provided by the lessee is probable at lease commencement.

Excerpt from Accounting Standards Codification

Leases — Lessors

Implementation Guidance and Illustration

Example 1 — Lessor Accounting Example

Case A — Lessor Accounting — Sales-Type Lease

842-30-55-19

Lessor enters into a 6-year lease of equipment with Lessee, receiving annual lease payments of $9,500, payable at the end of each year. Lessee provides a residual value guarantee of $13,000. Lessor concludes that it is probable it will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. The equipment has a 9-year estimated remaining economic life, a carrying amount of $54,000, and a fair value of $62,000 at the commencement date. Lessor expects the residual value of the equipment to be $20,000 at the end of the 6-year lease term. The lease does not transfer ownership of the underlying asset to Lessee or contain an option for Lessee to purchase the underlying asset. Lessor incurs $2,000 in initial direct costs in connection with obtaining the lease, and no amounts are prepaid by Lessee to Lessor. The rate implicit in the lease is 5.4839 percent.

842-30-55-20

Lessor classifies the lease as a sales-type lease because the sum of the present value of the lease payments and the present value of the residual value guaranteed by the lessee amounts to substantially all of the fair value of the equipment. None of the other criteria to be classified as a sales-type lease are met.

842-30-55-21

Lessor measures the net investment in the lease at $62,000 at lease commencement, which is equal to the fair value of the equipment. The net investment in the lease consists of the lease receivable (which includes the 6 annual payments of $9,500 and the residual value guarantee of $13,000, both discounted at the rate implicit in the lease, which equals $56,920) and the present value of the unguaranteed residual value (the present value of the difference between the expected residual value of $20,000 and the residual value guarantee of $13,000, which equals $5,080). Lessor calculates the selling profit on the lease as $8,000, which is the difference between the lease receivable ($56,920) and the carrying amount of the equipment net of the unguaranteed residual asset ($54,000 − $5,080 = $48,920). The initial direct costs do not factor into the calculation of the selling profit in this Example because they are not eligible for deferral on the basis of the guidance in paragraph 842-30-25-1(c) (that is, because the fair value of the underlying asset is different from its carrying amount at the commencement date).

842-30-55-22

At the commencement date, Lessor derecognizes the equipment (carrying amount of $54,000) and recognizes the net investment in the lease of $62,000 and the selling profit of $8,000. Lessor also pays and recognizes the initial direct costs of $2,000 as an expense.

842-30-55-23

At the end of Year 1, Lessor recognizes the receipt of a lease payment of $9,500 and interest on the net investment in the lease (the beginning balance of the net investment in the lease of $62,000 × the rate implicit in the lease of 5.4839% = $3,400), resulting in a balance in the net investment of the lease of $55,900. For disclosure purposes, Lessor also calculates the separate components of the net investment in the lease: the lease receivable and the unguaranteed residual asset. The lease receivable equals $50,541 (the beginning balance of the lease receivable of $56,920 — the annual lease payment received of $9,500 + the amount of interest income on the lease receivable during Year 1 of $3,121, which is $56,920 × 5.4839%). The unguaranteed residual asset equals $5,360 (the beginning balance of the unguaranteed residual asset of $5,081 + the interest income on the unguaranteed residual asset during Year 1 of $279, which is $5,081 × 5.4839%).

842-30-55-24

At the end of Year 6, Lessor reclassifies the net investment in the lease, then equal to the estimated residual value of the underlying asset of $20,000, as equipment.

The following example assumes the same facts as in Case A above except that the collection of lease payments and the residual value guarantee provided by the lessee is not probable at lease commencement.

Excerpt from Accounting Standards Codification

Implementation Guidance and Illustration

Example 1 — Lessor Accounting Example

Case B — Lessor Accounting — Sales-Type Lease — Collectibility of the Lease Payments Is Not Probable

842-30-55-25

Assume the same facts and circumstances as in Case A (paragraphs 842-30-55-19 through 55-24), except that it is not probable Lessor will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. In reaching this conclusion, the entity observes that Lessee's ability and intention to pay may be in doubt because of the following factors:

a. Lessee intends to make the lease payments primarily from income derived from its business in which the equipment will be used (which is a business facing significant risks because of high competition in the industry and Lessee's limited experience)

b. Lessee has limited credit history and no significant other income or assets with which to make the payments if the business is not successful.

842-30-55-26

In accordance with paragraph 842-30-25-3, Lessor does not derecognize the equipment and does not recognize a net investment in the lease or any selling profit or selling loss. However, consistent with Case A, Lessor pays and recognizes the initial direct costs of $2,000 as an expense at the commencement date.

842-30-55-27

At the end of Year 1, Lessor reassesses whether it is probable it will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee and concludes that it is not probable. In addition, neither of the events in paragraph 842-30-25-3(b) has occurred. The contract has not been terminated and Lessor has not repossessed the equipment because Lessee is fulfilling the terms of the contract. Consequently, Lessor accounts for the $9,500 Year 1 lease payment as a deposit liability in accordance with paragraph 842-30-25-3. Lessor recognizes depreciation expense on the equipment of $7,714 ($54,000 carrying value ÷ 7-year useful life).

842-30-55-28

Lessor's accounting in Years 2 and 3 is the same as in Year 1. At the end of Year 4, Lessee makes the fourth $9,500 annual lease payment such that the deposit liability equals $38,000. Lessor concludes that collectibility of the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee is now probable on the basis of Lessee's payment history under the contract and the fact that Lessee has been successfully operating its business for four years. Lessor does not reassess the classification of the lease as a sales-type lease.

842-30-55-29

Consequently, at the end of Year 4, Lessor derecognizes the equipment, which has a carrying amount of $23,143, and recognizes a net investment in the lease of $35,519. The net investment in the lease consists of the lease receivable (the sum of the 2 remaining annual payments of $9,500 and the residual value guarantee of $13,000, discounted at the rate implicit in the lease of 5.4839 percent determined at the commencement date, which equals $29,228) and the unguaranteed residual asset (the present value of the difference between the expected residual value of $20,000 and the residual value guarantee of $13,000, which equals $6,291). Lessor recognizes selling profit of $50,376, the difference between (a) the sum of the lease receivable and the carrying amount of the deposit liability ($29,228 lease receivable + $38,000 in lease payments already made = $67,228) and (b) the carrying amount of the equipment, net of the unguaranteed residual asset ($23,143 − $6,291 = $16,852).

842-30-55-30

After the end of Year 4, Lessor accounts for the remaining two years of the lease in the same manner as any other sales-type lease. Consistent with Case A, at the end of Year 6, Lessor reclassifies the net investment in the lease, then equal to the estimated residual value of the underlying asset of $20,000, as equipment.

The following example assumes the same facts as in Case A above except that the lease is classified as a direct financing lease because the residual value guarantee is provided by a third party unrelated to the lessee.

Excerpt from Accounting Standards Codification

Implementation Guidance and Illustration

Example 1 — Lessor Accounting Example

Case C — Lessor Accounting — Direct Financing Lease

842-30-55-31

Assume the same facts and circumstances as in Case A (paragraphs 842-30-55-19 through 55-24), except that the $13,000 residual value guarantee is provided by a third party, not by Lessee. Collectibility of the lease payments and any amount necessary to satisfy the third party residual value guarantee is probable.

842-30-55-32

None of the criteria in paragraph 842-10-25-2 to be classified as a sales-type lease are met. Lessor classifies the lease as a direct financing lease because the sum of the present value of the lease payments and the present value of the residual value guaranteed by the third party amounts to substantially all of the fair value of the equipment. In accordance with paragraph 842-10-25-4, the discount rate used to determine the present value of the lease payments and the guaranteed residual value (5.4839 percent) assumes that no initial direct costs will be deferred because, at the commencement date, the fair value of the equipment is different from its carrying amount.

842-30-55-33

At the commencement date, Lessor derecognizes the equipment and recognizes a net investment in the lease of $56,000, which is equal to the carrying amount of the underlying asset of $54,000 plus the initial direct costs of $2,000 that are included in the measurement of the net investment in the lease in accordance with paragraph 842-30-25-8 (that is, because the lease is classified as a direct financing lease). The net investment in the lease includes a lease receivable of $58,669 (the present value of the 6 annual lease payments of $9,500 and the third-party residual value guarantee of $13,000, discounted at the rate implicit in the lease of 4.646 percent), an unguaranteed residual asset of $5,331 (the present value of the difference between the estimated residual value of $20,000 and the third-party residual value guarantee of $13,000, discounted at 4.646 percent), and deferred selling profit of $8,000.

842-30-55-34

Lessor calculates the deferred selling profit of $8,000 in this Example as follows:

a. The lease receivable ($58,669); minus

b. The carrying amount of the equipment ($54,000), net of the unguaranteed residual asset ($5,331), which equals $48,669; minus

c. The initial direct costs included in the measurement of the net investment in the lease ($2,000).

842-30-55-35

At the end of Year 1, Lessor recognizes the receipt of the lease payment of $9,500 and interest on the net investment in the lease of $4,624 (the beginning balance of the net investment in the lease of $56,000 × the discount rate that, at the commencement date, would have resulted in the sum of the lease receivable and the unguaranteed residual asset equaling $56,000, which is 8.258 percent), resulting in a balance in the net investment of the lease of $51,124.

842-30-55-36

Also at the end of Year 1, Lessor calculates, for disclosure purposes, the separate components of the net investment in the lease: the lease receivable, the unguaranteed residual asset, and the deferred selling profit. The lease receivable equals $51,895 (the beginning balance of the lease receivable of $58,669 − the annual lease payment received of $9,500 + the amount of interest income on the lease receivable during Year 1 of $2,726, which is $58,669 × 4.646%). The unguaranteed residual asset equals $5,578 (the beginning balance of the unguaranteed residual asset of $5,331 + the interest income on the unguaranteed residual asset during Year 1 of $247, which is $5,331 × 4.646%). The deferred selling profit equals $6,349 (the initial deferred selling profit of $8,000 − $1,651 recognized during Year 1 [the $1,651 is the difference between the interest income recognized on the net investment in the lease during Year 1 of $4,624 calculated in paragraph 842-30-55-35 and the sum of the interest income earned on the lease receivable and the unguaranteed residual asset during Year 1]).

842-30-55-37

At the end of Year 2, Lessor recognizes the receipt of the lease payment of $9,500 and interest on the net investment in the lease (the beginning of Year 2 balance of the net investment in the lease of $51,124 × 8.258%, which is $4,222), resulting in a carrying amount of the net investment in the lease of $45,846.

842-30-55-38

Also at the end of Year 2, Lessor calculates the separate components of the net investment in the lease. The lease receivable equals $44,806 (the beginning of Year 2 balance of $51,895 — the annual lease payment received of $9,500 + the interest income earned on the lease receivable during Year 2 of $2,411, which is $51,895 × 4.646%). The unguaranteed residual asset equals $5,837 (the beginning of Year 2 balance of the unguaranteed residual asset of $5,578 + the interest income earned on the unguaranteed residual asset during Year 2 of $259, which is $5,578 × 4.646%). The deferred selling profit equals $4,797 (the beginning of Year 2 balance of deferred selling profit of $6,349 — $1,552 recognized during Year 2 [the $1,552 is the difference between the interest income recognized on the net investment in the lease during Year 2 of $4,222 and the sum of the interest income earned on the lease receivable and the unguaranteed residual asset during Year 2]).

842-30-55-39

At the end of Year 6, Lessor reclassifies the net investment in the lease, then equal to the estimated residual value of the underlying asset of $20,000, as equipment.

The following example assumes the same facts as in Case C above except that the collectibility of lease payments and the residual value guarantee provided by the third party unrelated to the lessee is not probable at lease commencement and the lease is classified as an operating lease.

Excerpt from Accounting Standards Codification

Implementation Guidance and Illustration

Example 1 — Lessor Accounting Example

Case D — Lessor Accounting — Collectibility Is Not Probable

842-30-55-40

Assume the same facts and circumstances as Case C (paragraphs 842-30-55-31 through 55-39), except that collectibility of the lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party is not probable and the lease payments escalate every year over the lease term. Specifically, the lease payment due at the end of Year 1 is $7,000, and subsequent payments increase by $1,000 every year for the remainder of the lease term. Because it is not probable that Lessor will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party in accordance with paragraph 842-10-25-3, Lessor classifies the lease as an operating lease.

842-30-55-41

Lessor continues to measure the equipment in accordance with Topic 360 on property, plant, and equipment.

842-30-55-42

Because collectibility of the lease payments is not probable, Lessor recognizes lease income only when Lessee makes the lease payments, and in the amount of those lease payments. Therefore, Lessor only recognizes lease income of $7,000 at the point in time Lessee makes the end of Year 1 payment for that amount.

842-30-55-43

At the end of Year 2, Lessor concludes that collectibility of the remaining lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party is probable; therefore, Lessor recognizes lease income of $12,000. The amount of $12,000 is the difference between lease income that would have been recognized through the end of Year 2 ($57,000 in total lease payments ÷ 6 years = $9,500 per year × 2 years = $19,000) and the $7,000 in lease income previously recognized. Collectibility of the remaining lease payments remains probable throughout the remainder of the lease term; therefore, Lessor continues to recognize lease income of $9,500 each year.

As illustrated in the example above, a lessor does not reassess lease classification solely due to collectibility of lease payments becoming probable after lease commencement (i.e., the lease remains an operating lease).

5.6 Lease modifications

Excerpt from Accounting Standards Codification

Master Glossary

Lease Modification

A change to the terms and conditions of a **contract** that results in a change in the scope of or the consideration for a **lease** (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).

If a lease is modified (i.e., there is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for the lease), the modified contract is evaluated to determine whether it is or contains a lease (refer to section 1.3, *Reassessment of the contract*). If a lease continues to exist, lease modification can result in:

- A separate contract (refer to section 5.6.2, *Determining whether a lease modification is accounted for as a separate contract*)
- A change in the accounting for the existing lease (i.e., not a separate contract — refer to section 5.6.3, *Lessor accounting for a lease modification that is not accounted for as a separate contract*)

Refer to section 5.6.1, *Summary of the accounting for lease modifications — lessors*.

5.6.1 Summary of the accounting for lease modifications — lessors

Is the modified contract a lease, or does it contain a lease?
(ASC 842-10-15-6, section 1.2, *Determining whether an arrangement contains a lease*, and section 1.3, *Reassessment of the contract*)

No →

Lease termination if the original contract contained a sales-type or direct financing lease (ASC 842-30-40-2 and section 5.7.3, *Lease termination*) or if previously an operating lease not specifically addressed in ASC 842 — apply other guidance

Yes ↓

Does the modification result in a separate contract?
(ASC 842-10-25-8 and section 5.6.2, *Determining whether a lease modification is accounted for as a separate contract*)

Yes →

Account for two separate contracts:

- The unmodified original contract
- A separate contract, which is accounted for in the same manner as any other new lease

(ASC 842-10-25-9 and section 5.6.2, *Determining whether a lease modification is accounted for as a separate contract*)

No ↓

- Remeasure and reallocate the remaining consideration in the contract
- Reassess the classification of the lease at the effective date of the modification
- Account for any initial direct costs, lease incentives and other payments made to or by the lessor

(ASC 842-10-25-9 through 25-10 and section 5.6.3, *Lessor accounting for a modification that is not accounted for as a separate contract*)

No change in classification of an operating lease A	An operating lease changes to a sales-type lease[1] B	An operating lease changes to a direct financing lease C	No change in classification of a direct financing lease or a sales-type lease[1] or a sales-type lease[1] changes to a direct financing lease D	A direct financing lease changes to an operating lease or a sales-type lease[1] changes to an operating lease E	A direct financing lease changes to a sales-type lease F

Note: Refer to the lease modifications guidance in the table on the next page

↓

Apply the subsequent measurement guidance for the applicable classification

	Result of reassessing lease classification	Accounting on the effective date of the modification	Section reference
A	No change in classification of an operating lease (ASC 842-10-25-15(a))	Recognize the lease payments to be made under the modified lease, adjusted for any prepaid or accrued rent from the original lease, generally on a straight-line basis over the remaining lease term.	5.6.3.1, *Modification to an operating lease that is not accounted for as a separate contract*
B	An operating lease changes to a sales-type lease[1] (ASC 842-10-25-15(b))	Apply the initial recognition and measurement guidance for sales-type leases and adjust the selling profit or selling loss by any prepaid or accrued rent from the original lease (i.e., derecognize any prepaid or accrued rent).	
C	An operating lease changes to a direct financing lease (ASC 842-10-25-15(b))	Apply the initial recognition and measurement guidance for direct financing leases and adjust the selling profit or selling loss by any prepaid or accrued rent from the original lease (i.e., derecognize any prepaid or accrued rent).	
D	No change in classification of a direct financing lease (ASC 842-10-25-16(a)) or a sales-type lease[1] (ASC 842-10-25-17(a)) or a sales-type lease[1] changes to a direct financing lease (ASC 842-10-25-17(a))	Adjust the discount rate in the measurement of the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.	5.6.3.2, *Modification to a direct financing lease that is not accounted for as a separate contract*, and 5.6.3.3, *Modification to a sales-type lease that is not accounted for as a separate contract*
E	A direct financing lease changes to an operating lease (ASC 842-10-25-16(c)) or a sales-type lease[1] changes to an operating lease (ASC 842-10-25-17(b))	Recognize the carrying amount of the underlying asset at an amount equal to the net investment in the original lease immediately before the effective date of the modification.	
F	A direct financing lease changes to a sales-type lease (ASC 842-10-25-16(b))	Apply the initial recognition and measurement guidance for sales-type leases and use the fair value of the underlying asset and the carrying value of the net investment in the direct financing lease as of the effective date of the modification to calculate any selling profit or loss.	5.6.3.2, *Modification to a direct financing lease that is not accounted for as a separate contract*

[1] This accounting is for sales-type leases for which the collectibility of lease payments and any residual value guarantee provided by the lessee is probable. Refer to section 5.2.1.2, *Collectibility is not probable at lease commencement*, for guidance on the accounting for sales-type leases for which the collectibility of these items is not probable.

5.6.2 Determining whether a lease modification is accounted for as a separate contract

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-25-8

An entity shall account for a modification to a **contract** as a separate contract (that is, separate from the original contract) when both of the following conditions are present:

a. The modification grants the **lessee** an additional right of use not included in the original **lease** (for example, the right to use an additional asset).

b. The **lease payments** increase commensurate with the **standalone price** for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a **lessor** to incur costs that it would have incurred for a new lessee.

A lessor accounts for a modification to a contract (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or consideration for the lease) as a separate contract (i.e., separate from the original contract) when both of the following conditions are met:

- The modification grants the lessee an additional right of use that is not included in the original lease (e.g., a right to use an additional underlying asset).
- The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract.

If both of these conditions are met, the lease modification results in two separate contracts, the unmodified original contract and a separate contract. Lessors account for the separate contract that contains a lease in the same manner as other new leases.

If both of the conditions are not met, the modified lease is not accounted for as a separate contract. Refer to section 5.6.3, *Lessor accounting for a modification that is not accounted for as a separate contract*.

The FASB indicated in the Basis for Conclusions (BC 176(a)) that the right to use an additional underlying asset (e.g., an additional floor of a building) will generally be a separate lease component, even if the modification granting that additional right of use does not create a separate contract. To illustrate, if an existing lease for a floor of a building is modified to include a second floor, the right to use the second floor will often be a separate lease component from the right to use the first floor, even if the second floor is not accounted for under a separate contract. Refer to section 1.4.1, *Identifying and separating lease components of a contract*.

If the lease modification grants the lessee the right to use the existing leased asset for an additional period of time (i.e., a period of time not included in the original lease agreement), the modified lease is not accounted for as a separate contract (refer to section 5.6.3, *Lessor accounting for a modification that is not accounted for as a separate contract*). In such cases, as indicated in the Basis for Conclusions (BC 176(b)), the modification only changes an attribute of the lessee's existing right to use the underlying asset that it already controls. This is the case even if the extended term is priced at market.

5.6.3 Lessor accounting for a modification that is not accounted for as a separate contract

Excerpt from Accounting Standards Codification

Master Glossary

Effective Date of the Modification

The date that a **lease modification** is approved by both the **lessee** and the **lessor**.

Leases — Overall

Recognition

842-10-25-9

If a lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the entity shall reassess the classification of the lease as of the **effective date of the modification** based on its modified terms and conditions and the facts and circumstances as of that date (for example, the **fair value** and remaining **economic life** of the **underlying asset** as of that date).

842-10-25-10

An entity shall account for **initial direct costs**, lease incentives, and any other payments made to or by the entity in connection with a modification to a lease in the same manner as those items would be accounted for in connection with a new lease.

ASC 842 requires lessors to reassess lease classification at the effective date of a lease modification (i.e., the date that the lease modification is approved by both the lessee and the lessor) that is not accounted for as a separate contract. Lease classification is reassessed using the modified terms and conditions and the facts and circumstances as of that date, including:

- The remaining economic life of the underlying asset on that date
- The fair value of the underlying asset on that date
- The rate implicit in the lease on that date (refer to section 2.5.1, *Lessors*)
- The remeasurement and reallocation of the remaining consideration in the contract on that date

Lessors account for initial direct costs, lease incentives and any other payments made to or by the lessor in connection with the lease modification in the same manner as those items are accounted for in connection with a new lease. Refer to chapter 2, *Key concepts*.

5.6.3.1 Modification to an operating lease that is not accounted for as a separate contract

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-25-15

If an **operating lease** is modified and the modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8, the **lessor** shall account for the modification as if it were a termination of the existing **lease** and the creation of a new lease that commences on the **effective date of the modification** as follows:

a. If the modified lease is classified as an operating lease, the lessor shall consider any prepaid or accrued lease rentals relating to the original lease as a part of the **lease payments** for the modified lease.

b. If the modified lease is classified as a **direct financing lease** or a **sales-type lease**, the lessor shall derecognize any deferred rent liability or accrued rent asset and adjust the **selling profit or selling loss** accordingly.

Operating lease to operating lease

If the original lease and the modified lease are both classified as operating leases (i.e., no change to lease classification), the lessor recognizes lease payments to be made under the modified lease, adjusted for any prepaid or accrued rent from the original lease, generally on a straight-line basis over the new lease term (i.e., the remaining lease term from the original lease at the date of modification, adjusted for the additional or terminated periods). Any initial direct costs incurred in connection with the modification are recognized as an expense over the new lease term. We believe that any unamortized initial direct costs recognized prior to the modification also should continue to be recognized as an expense over the new lease term.

ASC 842 includes the following example of a lessor's accounting for a modification of an operating lease that does not change lease classification.

Excerpt from Accounting Standards Codification

Implementation Guidance and Illustrations

Example 20 — Modification of an Operating Lease That Does Not Change Lease Classification

842-10-55-190

Lessor enters into a 10-year lease with Lessee for 10,000 square feet of office space. The annual lease payments are $100,000 in the first year, increasing by 5 percent each year thereafter, payable in arrears. The lease term is not for a major part of the remaining economic life of the office space (40 years), and the present value of the lease payments is not substantially all of the fair value of the office space. Furthermore, the title does not transfer to Lessee as a consequence of the lease, the lease does not contain an option for Lessee to purchase the office space, and the asset is not specialized such that it clearly has an alternative use to Lessor at the end of the lease term. Consequently, the lease is classified as an operating lease.

842-10-55-191

At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining 5 years to include an additional 10,000 square feet of office space in the same building for a total annual fixed payment of $150,000. The increase in total consideration is at a discount both to the current market rate for the new 10,000 square feet of office space and in the context of that particular contract. The modified lease continues to be classified as an operating lease.

842-10-55-192

At the effective date of the modification (at the beginning of Year 6), Lessor has an accrued lease rental asset of $76,331 (rental income recognized on a straight-line basis for the first 5 years of the lease of $628,895 [$1,257,789 ÷ 10 years = $125,779 per year] less lease payments for the first 5 years of $552,564 [that is, $100,000 in Year 1, 105,000 in Year 2, $110,250 in Year 3, $115,763 in Year 4, and $121,551 in Year 5]).

842-10-55-193

Because the change in pricing of the lease is not commensurate with the standalone price for the additional right-of-use asset, Lessor does not account for the modification as a new lease, separate from the original 10-year lease. Instead, Lessor accounts for the modified lease prospectively from the effective date of the modification, recognizing the lease payments to be made under the modified lease of $750,000 ($150,000 × 5 years), net of Lessor's accrued rent asset of $76,331, on a straight-line basis over the remaining 5-year lease term ($673,669 ÷ 5 years = $134,734 per year). At the end of the lease, Lessor will have recognized as lease income the $1,302,564 in lease payments it receives from Lessee during the 10-year lease term.

Operating lease to sales-type lease

If the original lease was an operating lease and the modified lease is classified as a sales-type lease (i.e., lease classification changes), a lessor derecognizes the underlying asset and applies the initial recognition and measurement guidance for sales-type leases (refer to section 5.2.1, *Initial recognition and measurement*) and adjusts the selling profit or loss by any prepaid or accrued rent from the original lease that is derecognized.

For modifications resulting in a sales-type lease with selling profit or loss, the profit or loss is recognized, and any initial direct costs incurred in connection with the modification are expensed.

ASC 842 includes the following example of a lessor's accounting for a modification to an operating lease that is not accounted for as a separate contract but changes lease classification (i.e., operating lease to sales-type lease).

Excerpt from Accounting Standards Codification

Implementation Guidance and Illustrations

Example 21 — Modification of an Operating Lease That Changes Lease Classification

Case A — Operating Lease to Sales-Type Lease

842-10-55-194

Lessor enters into a four-year lease of a piece of nonspecialized equipment. The annual lease payments are $81,000 in the first year, increasing by 5 percent each year thereafter, payable in arrears. The estimated residual value of the equipment is $90,000, of which none is guaranteed. The remaining economic life of the equipment at lease commencement is seven years. The carrying amount of the equipment and its fair value are both $425,000 at the commencement date. The lease is not for a major part of the remaining economic life of the equipment, and the present value of the lease payments is not substantially all of the fair value of the equipment. Furthermore, title does not transfer to Lessee as a result of the lease, the lease does not contain an option for Lessee to purchase the underlying asset, and because the asset is nonspecialized, it is expected to have an alternative use to Lessor at the end of the lease term. Consequently, the lease is classified as an operating lease.

842-10-55-195

At the beginning of Year 3, Lessee and Lessor agree to extend the lease term by two years. That is, the modified lease is now a six-year lease, as compared with the original four-year lease. The additional two years were not an option when the original lease was negotiated. The modification alters the Lessee's right to use the equipment; it does not grant Lessee an additional right of use. Therefore, Lessor does not account for the modification as a separate contract from the original four-year lease contract.

842-10-55-196

On the effective date of the modification, the fair value of the equipment is $346,250, and the remaining economic life of the equipment is 5 years. The estimated residual value of the equipment is $35,000, of which none is guaranteed. The modified lease is for a major part of the remaining economic life of the equipment at the effective date of the modification (four years out of the five-year- remaining economic life of the equipment). Consequently, the modified lease is classified as a sales-type lease.

842-10-55-197

In accounting for the modification, Lessor determines the discount rate for the modified lease (that is, the rate implicit in the modified lease) to be 7.6 percent. Lessor recognizes the net investment in the modified lease of $346,250 and derecognizes both the accrued rent and the equipment at the effective date of the modification. Lessor also recognizes, in accordance with paragraph 842-10-25-15(b), selling profit of $34,169 ($320,139 lease receivable − $8,510 accrued rent balance − the $277,460 carrying amount of the equipment derecognized, net of the unguaranteed residual asset [$277,460 = $303,571 − $26,111]). After the effective date of the modification, Lessor accounts for the modified lease in the same manner as any other sales-type lease in accordance with Subtopic 842-30.

Operating lease to direct financing lease

If the original lease was an operating lease and the modified lease is classified as a direct financing lease (i.e., lease classification changes), the lessor derecognizes the underlying asset and applies the initial recognition and measurement guidance for direct financing leases (refer to section 5.3.1, *Initial recognition and measurement*) and adjusts the selling profit or loss by any prepaid or accrued rent from the original lease that is derecognized. A lessor recognizes any selling loss at lease commencement. A lessor would need to consider if any indicators of impairment are present when a selling loss is present. Any selling profit and initial direct costs incurred in connection with the modification are deferred and included in the measurement of the initial net investment in the modified lease. We believe that any unamortized initial direct costs associated with the original lease may continue to be included in the measurement of the initial net investment in the modified lease. ASC 842 includes the following example of a lessor's accounting for a modification to an operating lease that is not accounted for as a separate contract but changes lease classification (i.e., operating lease to direct financing lease).

Excerpt from Accounting Standards Codification

Implementation Guidance and Illustrations

Example 21 — Modification of an Operating Lease That Changes Lease Classification

Case B — Operating Lease to Direct Financing Lease

842-10-55-198

At the beginning of Year 3, Lessee and Lessor enter into a modification to extend the lease term by 1 year, and Lessee agrees to make lease payments of $108,000 per year for each of the remaining 3 years of the modified lease. No other terms of the contract are modified. Concurrent with the execution of the modification, Lessor obtains a residual value guarantee from an unrelated third party for $40,000. Consistent with Case A (paragraphs 842-10-55-194 through 55-197), at the effective date of the modification the fair value of the equipment is $346,250, the carrying amount of the equipment is $303,571, and Lessor's accrued rent balance is $8,510. The estimated residual value at the end of the modified lease term is $80,000. The discount rate for the modified lease is 7.356 percent.

842-10-55-199

Lessor reassesses the lease classification as of the effective date of the modification and concludes that the modified lease is a direct financing lease because none of the criteria in paragraph 842-10-25-2 and both criteria in paragraph 842-10-25-3(b) are met.

842-10-55-200

Therefore, at the effective date of the modification, Lessor recognizes a net investment in the modified lease of $312,081, which is the fair value of the equipment ($346,250) less the selling profit on the lease ($34,169 =$313,922 lease receivable − $8,510 accrued rent balance − the $271,243 carrying amount of the equipment derecognized, net of the unguaranteed residual asset [$271,243 = $303,571 − $32,328]), which is deferred as part of the net investment in the lease. After the effective date of the modification, Lessor accounts for the modified lease in the same manner as any other direct financing lease in accordance with Subtopic 842-30.

5.6.3.2 Modification to a direct financing lease that is not accounted for as a separate contract

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-25-16

If a direct financing lease is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the lessor shall account for the modified lease as follows:

a. If the modified lease is classified as a direct financing lease, the lessor shall adjust the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

b. If the modified lease is classified as a sales-type lease, the lessor shall account for the modified lease in accordance with the guidance applicable to sales-type leases in Subtopic 842-30, with the **commencement date** of the modified lease being the effective date of the modification. In calculating the selling profit or selling loss on the lease, the **fair value** of the **underlying asset** is its fair value at the effective date of the modification and its carrying amount is the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

c. If the modified lease is classified as an operating lease, the carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification.

Direct financing lease to direct financing lease

If the original lease and the modified lease are both classified as direct financing leases (i.e., there is no change to lease classification), a lessor adjusts the discount rate used to measure the initial net investment in the modified lease so that it equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification, plus any capitalized initial direct costs incurred in connection with the modification. No gain or loss is recognized unless there is an impairment of the net investment in the lease, in which case, a loss is recognized. Refer to section 5.2.3, *Impairment of the net investment in the lease*.

ASC 842 includes the following example of a lessor's accounting for a modification to a direct financing lease that is not accounted for as a separate contract, and there is no change to lease classification.

Excerpt from Accounting Standards Codification

Implementation Guidance and Illustrations

Example 22 — Modification of a Direct Financing Lease

842-10-55-201

Lessor enters into a six-year lease of a piece of new, nonspecialized equipment with a nine-year economic life. The annual lease payments are $11,000, payable in arrears. The estimated residual value of the equipment is $21,000, of which $15,000 is guaranteed by a third-party unrelated to Lessee or Lessor. The lease does not contain an option for Lessee to purchase the equipment and the title does not transfer to Lessee as a consequence of the lease. The fair value of the equipment at lease commencement is $65,240, which is equal to its cost (and carrying amount). Lessor incurs no initial direct costs in connection with the lease. The rate implicit in the lease is 7.5 percent such that the present value of the lease payments is $51,632 and does not amount to substantially all of the fair value of the equipment.

842-10-55-202

The Lessor concludes that the lease is not a sales-type lease because none of the criteria in paragraph 842-10-25-2 are met. However, the sum of the present value of the lease payments and the present value of the residual value of the underlying asset guaranteed by the third-party guarantor is $61,352, which is substantially all of the fair value of the equipment, and collectibility of the lease payments is probable. Consequently, the lease is classified as a direct financing lease. Lessor recognizes the net investment in the lease of $65,240 (which includes the lease receivable of $61,352 and the present value of the unguaranteed residual value of $3,888 [the present value of the difference between the expected residual value of $21,000 and the guaranteed residual value of $15,000]) and derecognizes the equipment with a carrying amount of $65,240.

842-10-55-203

At the end of Year 1, Lessor receives a lease payment of $11,000 from Lessee and recognizes interest income of $4,893 ($65,240 × 7.5%). Therefore, the carrying amount of the net investment in the lease is $59,133 ($65,240 + $4,893 − $11,000).

Case A — Direct Financing Lease to Direct Financing Lease

842-10-55-204

At the end of Year 1, the lease term is reduced by 1 year and the annual lease payment is reduced to $10,000 for the remaining 4 years of the modified lease term. The estimated residual value of the equipment at the end of the modified lease term is $33,000, of which $30,000 is guaranteed by the unrelated third party, while the fair value of the equipment is $56,000. The remaining economic life of the equipment is 8 years and the present value of the remaining lease payments, discounted using the rate implicit in the modified lease of 8.857 percent is $32,499. Lessor concludes that the modified lease is not a sales-type lease because none of the criteria in paragraph 842-10-25-2 are met. However, the sum of the present value of the lease payments and the present value of the residual value of the underlying asset guaranteed by the third-party guarantor, discounted using the rate implicit in the modified lease of 8.857 percent, is $53,864, which is substantially all of the fair value of the equipment, and collectibility of the lease payments is probable. As such, the modified lease is classified as a direct financing lease.

842-10-55-205

In accounting for the modification in accordance with paragraph 842-10-25-16(a), Lessor carries forward the balance of the net investment in the lease of $59,133 immediately before the effective date of the modification as the opening balance of the net investment in the modified lease. To retain the same net investment in the lease even while the lease payments, the lease term, and the estimated residual value have all changed, Lessor adjusts the discount rate for the lease from the rate implicit in the modified lease of 8.857 percent to 6.95 percent. This discount rate is used to calculate interest income on the net investment in the lease throughout the remaining term of the modified lease and will result, at the end of the modified lease term, in a net investment balance that equals the estimated residual value of the underlying asset of $33,000.

Direct financing lease to sales-type lease

If the modified lease is classified as a sales-type lease (i.e., lease classification changes), a lessor applies the initial recognition and measurement guidance for sales-type leases (refer to section 5.2.1, *Initial recognition and measurement*) and uses the fair value of the underlying asset and the carrying value of the net investment in the direct financing lease as of the effective date of the modification to calculate any gain or loss to be recognized in profit or loss. If the modification results in a sales-type lease with selling profit or loss, a lessor recognizes initial direct costs incurred in connection with the modification as an expense.

ASC 842 includes the following example of a lessor's accounting for a modification to a direct financing lease that is not accounted for as a separate contract but changes lease classification. This example assumes the same facts as in Case A above, except that the modified lease is classified as a sales-type lease.

Excerpt from Accounting Standards Codification

Case B — Direct Financing Lease to Sales-Type Lease

842-10-55-206

At the end of Year 1, the lease term is extended for two years. The lease payments remain $11,000 annually, paid in arrears, for the remainder of the lease term. The estimated residual value is $6,500, of which none is guaranteed. The rate implicit in the modified lease is 7.58 percent. At the effective date of the modification, the remaining economic life of the equipment is 8 years and the fair value of the equipment is $62,000. Because the modified lease term is now for the major part of the remaining economic life of the equipment, the modified lease is classified as a sales-type lease.

842-10-55-207

On the effective date of the modification, Lessor recognizes a net investment in the sales-type lease of $62,000, which is equal to the fair value of the equipment at the effective date of the modification, and derecognizes the carrying amount of the net investment in the original direct financing lease of $59,133. The difference of $2,867 is the selling profit on the modified lease. After the effective date of the modification, Lessor accounts for the sales-type lease in the same manner as any other sales-type lease in accordance with Subtopic 842-30.

Direct financing lease to operating lease

If the modified lease is classified as an operating lease (i.e., lease classification changes), a lessor recognizes the carrying amount of the underlying asset at an amount equal to the net investment in the original lease immediately before the effective date of the modification. A lessor recognizes initial direct costs incurred in connection with the modification as an expense over the lease term. ASC 842 includes the following example of a lessor's accounting for a modification to a direct financing lease that is not accounted for as a separate contract but changes lease classification. This example assumes the same facts as in Case A above, except that the modified lease is classified as an operating lease.

Excerpt from Accounting Standards Codification

Case C — Direct Financing Lease to Operating Lease

842-10-55-208

At the end of Year 1, the lease term is reduced by 2 years, and the lease payments are reduced to $9,000 per year for the remaining 3-year lease term. The estimated residual value is revised to $33,000, of which only $13,000 is guaranteed by an unrelated third party. The fair value of the equipment at the effective date of the modification is $56,000. The modified lease does not transfer the title of the equipment to Lessee or grant Lessee an option to purchase the equipment. The modified lease is classified as an operating lease because it does not meet any of the criteria to be classified as a sales-type lease or as a direct financing lease.

842-10-55-209

Therefore, at the effective date of the modification, Lessor derecognizes the net investment in the lease, which has a carrying amount of $59,133, and recognizes the equipment at that amount. Collectibility of the lease payments is probable; therefore, Lessor will recognize the $27,000 ($9,000 × 3 years) in lease payments on a straight-line basis over the 3-year modified lease term, as well as depreciation on the rerecognized equipment.

5.6.3.3 Modification to a sales-type lease that is not accounted for as a separate contract

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-25-17

If a sales-type lease is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the lessor shall account for the modified lease as follows:

a. If the modified lease is classified as a sales-type or a direct financing lease, in the same manner as described in paragraph 842-10-25-16(a)

b. If the modified lease is classified as an operating lease, in the same manner as described in paragraph 842-10-25-16(c).

Sales-type lease to sales-type lease or to direct financing lease

If a modified sales-type lease is classified as a sales-type lease (i.e., there is no change to lease classification) or a direct financing lease (i.e., there is a change to lease classification), a lessor adjusts the discount rate used to measure the initial net investment in the modified lease so that it equals the carrying amount of its net investment in the original lease immediately before the effective date of the modification plus any capitalized initial direct costs incurred in connection with the modification. No gain or loss is recognized unless there is an impairment of the net investment in the lease, in which case, a loss is recognized. Refer to section 5.2.3, *Impairment of the net investment in the lease*. Lessors are prohibited from recognizing a second gain on a sales-type lease that is modified and remains a sales-type lease.

Sales-type lease to operating lease

If a modified sales-type lease is classified as an operating lease (i.e., lease classification changes), a lessor recognizes the carrying amount of the underlying asset at an amount equal to the net investment in the original lease immediately before the effective date of the modification. A lessor recognizes initial direct costs incurred in connection with the modification as an expense over the lease term.

5.7 Other lessor matters

5.7.1 Sale of lease receivables

Excerpt from Accounting Standards Codification

Leases — Lessor

Subsequent Measurement

842-30-35-4

If a **lessor** sells the **lease receivable** associated with a **sales-type lease** or a **direct financing lease** and retains an interest in the **unguaranteed residual asset**, the lessor shall not continue to accrete the unguaranteed residual asset to its estimated value over the remaining **lease term**. The lessor shall report any remaining unguaranteed residual asset thereafter at its carrying amount at the date of the sale of the lease receivable and apply Topic 360 on property, plant, and equipment to determine whether the unguaranteed residual asset is impaired.

In certain cases, a lessor sells a lease receivable (i.e., the future lease payments and any guaranteed residual value) associated with a sales-type or a direct financing lease but retains an interest in the unguaranteed residual asset. In a common transaction, a lessor securitizes lease receivables, retains the interest in the underlying assets (i.e., the unguaranteed residual assets) and manages the residual value risk. Under ASC 842, if a lessor retains an interest in an unguaranteed residual asset (after selling the lease receivable), it no longer accretes the value of the unguaranteed residual asset to its estimated value over the remaining lease term. Instead, the lessor reports any remaining unguaranteed residual asset at its carrying amount at the date of the sale of the lease receivable and applies ASC 360 to determine whether the unguaranteed residual asset is impaired.

Lessors should evaluate the sale of lease receivables associated with sales-type or direct financing leases (i.e., future lease payments and any guaranteed residual values) under the financial asset derecognition guidance in ASC 860, *Transfers and Servicing*. Refer to section 5.7.1.1, *Sales or securitizations of lease receivables associated with sales-type and direct financing leases*.

Refer to section 5.7.1.4, *Sale or assignment of operating lease payments by a lessor*, for the accounting of sale lease payments associated with an operating lease.

5.7.1.1 Sales or securitizations of lease receivables associated with sales-type and direct financing leases

Excerpt from Accounting Standards Codification

Transfers and Servicing - Overall

Implementation Guidance

860-10-55-6

Lease receivables from sales-type and direct financing leases are made up of two components: the right to receive lease payments and guaranteed residual values. Lease payments for sales-type and direct financing leases involve requirements for lessees to pay cash to lessors and meet the definition of a financial asset. Residual values represent the lessor's estimate of the salvage value of the underlying asset at the end of the lease term and may be either guaranteed or unguaranteed. Residual values meet the definition of financial assets to the extent that they are guaranteed at the commencement of the lease. Thus, transfers of lease receivables from sales-type and direct financing leases are subject to the requirements of this Subtopic. **Unguaranteed residual assets** do not meet the definition of financial assets, nor do residual values guaranteed after commencement, and transfers of them are not subject to the requirements of this Subtopic.

860-20-55-26

A transferor of lease receivables shall allocate the gross investment in receivables between **lease payments**, residual values guaranteed at commencement, and residual values not guaranteed at commencement using the individual carrying amounts of those components at the date of transfer. Those transferors also shall record a servicing asset or liability in accordance with Subtopic 860-50, if appropriate.

The original accounting for a sales-type or direct financing lease is not changed if the lease or the leased property is subsequently sold or assigned to a third party. The accounting for sale or assignment of the lease receivable and any residual values guaranteed at lease commencement relating to a sales-type or direct financing lease is addressed by the provisions of ASC 860, *Transfers and Servicing*. Refer to section 5.7.1.4, *Sale or assignment of operating lease payment by a lessor*, for operating leases.

Pursuant to the relevant provision of ASC 860, sales-type and direct financing receivables (gross investment in lease receivables) are made up of two components: lease receivables and guaranteed residual values. Lease receivables represent requirements for lessees to pay cash to lessors and meet the definition of a financial asset. Thus, transfers of lease receivables from sales-type and direct financing leases are subject to the requirements of ASC 860. The residual value component meets the definition of a financial asset only if it is guaranteed (by a third party) at the commencement of the lease. Transfers of guaranteed residual values that are guaranteed at the commencement of the lease are subject to the derecognition requirements of ASC 860, while transfers of unguaranteed residual assets and residual values guaranteed after the commencement of the lease are not (refer to section 5.7.1.3, *Sale of unguaranteed residual value in sales-type or direct financing leases*). As a result, if an unguaranteed residual asset or a residual value that is guaranteed subsequent to lease commencement exists as part of the gross investment, entities selling or securitizing all or part of lease receivables (without transferring title to the underlying asset or their right to the remaining unguaranteed residual asset) should allocate the gross investment in receivables between lease payments (including guaranteed residual value) and unguaranteed residual asset (or residual value guaranteed after commencement) using the individual carrying amounts of those components at the date of transfer. The allocated amount of financial assets being transferred (lease payments and residual value guaranteed at commencement of the lease) will represent the carrying amount to be used in the determination of gain or loss if the transfer meets the derecognition requirements of ASC 860. The transfers of unguaranteed residual asset (or residual value guaranteed after commencement) are subject to evaluation under the applicable revenue recognition/asset sale guidance. Entities also should recognize a servicing asset or liability in accordance with ASC 860, if applicable. The following example illustrates this allocation.

Excerpt from Accounting Standards Codification

Transfers and Servicing — Sales of Financial Assets

Illustrations

Example 5: Transfer of Lease Receivables with Residual Values

860-20-55-58

This Example illustrates the guidance in paragraph 860-20-25-1. At the beginning of the second year in a 10-year sales-type lease, Entity E transfers for $505 a nine-tenths participating interest in the lease receivable to an independent third party, and the transfer is accounted for as a sale. Entity E retains a one-tenth participating interest in the lease receivable and a 100 percent interest in the unguaranteed residual asset, which is not subject to the requirements of this Subtopic as discussed in paragraph 860-10-55-6 because it is not a financial asset and, therefore, is excluded from the analysis of whether the transfer of the nine-tenths participating interest in the lease receivable meets the definition of a participating interest. The servicing asset has a fair value of zero because Entity E estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities. The carrying amounts and related gain computation are as follows.

Carrying Amounts		
Lease receivable		$ 540
Unearned income related to lease receivable		370
Gross investment in lease receivable		910
Unguaranteed residual asset	$ 30	
Unearned income related to unguaranteed residual asset	60	
Gross investment in unguaranteed residual asset		90
Total gross investment in lease receivable		$ 1,000
Gain on Sale		
Cash received		$ 505
Nine-tenths of carrying amount of gross investment in lease receivable	$ 819	
Nine-tenths of carrying amount of unearned income related to lease receivable	333	
Net carrying amount of lease receivable sold		486
Gain on sale		$ 19

860-20-55-59

The following journal entry is made by Entity E:

Journal entry				
Cash	$	505		
Unearned income		333		
Lease receivable			$	819
Gain on sale				19

To record sale of nine-tenths of the lease receivable at the beginning of Year 2

As discussed above, only transfers of residual values guaranteed at the commencement of the lease are subject to the derecognition requirements of ASC 860. If the lessee guarantees the residual value, the lease payments (including the residual value guaranteed by the lessee) should be viewed as a single unit of account pursuant to ASC 860. If a third party guarantees the residual value, we believe the guaranteed residual value can be considered a separate unit of account) pursuant to ASC 860. Whether a third-party residual value guarantee should be considered a separate unit of account or combined with the payments due from the lessee into a single unit of account pursuant to ASC 860 is an accounting policy election.

See our Financial reporting developments publication, *Transfers and servicing of financial assets*, for further information.

5.7.1.2 Accounting for a guaranteed residual value

Excerpt from Accounting Standards Codification

Transfers and Servicing — Overall

Implementation Guidance and Illustrations

860-10-55-6

Lease receivables from sales-type and direct financing leases are made up of two components: the right to receive lease payments and guaranteed residual values. Lease payments for sales-type and direct financing leases involve requirements for lessees to pay cash to lessors and meet the definition of a financial asset. Residual values represent the lessor's estimate of the salvage value of the underlying asset at the end of the lease term and may be either guaranteed or unguaranteed. Residual values meet the definition of financial assets to the extent that they are guaranteed at the commencement of the lease. Thus, transfers of lease receivables from sales-type and direct financing leases are subject to the requirements of this Subtopic. **Unguaranteed residual assets** do not meet the definition of financial assets, nor do residual values guaranteed after commencement, and transfers of them are not subject to the requirements of this Subtopic.

A residual value of a leased asset is a financial asset to the extent of the guarantee of the residual value at commencement of the lease by the lessee or a third party unrelated to the lessor. Therefore, sales of lease receivables from sales-type and direct financing leases, including the residual value guaranteed at lease commencement, are in the scope of the guidance in ASC 860 on transfers and servicing of financial assets. Refer to section 5.7.1.1, *Sales or securitizations of lease receivables associated with sales-type and direct financing leases*.

5.7.1.3 Sale of unguaranteed residual value in sales-type or direct financing leases

If, in conjunction with a sale of lease receivables (in accordance with ASC 860, refer to 5.7.1.1, *Sales or securitizations of lease receivables associated with sales-type and direct financing leases*), a lessor also sells to a third party its interest in an unguaranteed residual value or in a residual interest that was guaranteed subsequent to lease commencement, the gain or loss on the sale of the residual value should be recognized in earnings if it qualifies as a sale in accordance with ASC 605 or ASC 360, as applicable (prior to the adoption of ASC 606 and ASC 610-20), or ASC 606 or ASC 610-20. If the lessor sells the unguaranteed residual value or a guaranteed residual value that was guaranteed subsequent to lease commencement to a third party, without selling the lease receivable, the gain or loss represents a revision in the estimate of the residual value based on a completed transaction and should be recognized at the time of the sale. It would not be appropriate to defer a gain or loss on the sale of an unguaranteed residual value or a guaranteed residual value that was guaranteed after lease commencement over the remaining lease term.

5.7.1.4 Sale or assignment of operating lease payments by a lessor

Sale of future lease payments

The sale or assignment by the lessor of future lease payments due under an operating lease is accounted for as a borrowing regardless of whether substantial risks have been retained. This is consistent with the accounting for a sale of future revenues under ASC 470, *Debt*, when the seller has an ongoing performance obligation.

A sale of future revenue typically involves an entity receiving an up-front payment from an investor in exchange for granting the investor the right to receive a specified percentage or amount of the future revenue (or other measure of income such as gross margin, operating income or pretax income) of a particular product or service of the entity for a defined period. Refer to section 2.2.6.8, *Sales of future revenues*, in our Financial reporting developments publication, *Issuer's accounting for debt and equity financings*, for further detail regarding the accounting of a sale of future revenue.

Sale of billed and earned lease payments

Lease payments that are billed and earned but not yet received under an operating lease are similar to other trade receivables as they represent requirements for lessees to pay cash to lessors and meet the definition of a financial asset. Therefore, the sale or assignment by the lessor of such payments is subject to the derecognition requirements of ASC 860.

5.7.2 Accounting for the underlying asset at the end of a lease

Excerpt from Accounting Standards Codification

Leases — Lessor

Subsequent Measurement

842-30-35-5

At the end of the **lease term**, a **lessor** shall reclassify the **net investment in the lease** to the appropriate category of asset (for example, property, plant, and equipment) in accordance with other Topics, measured at the carrying amount of the net investment in the lease. The lessor shall account for the **underlying asset** that was the subject of a **lease** in accordance with other Topics.

At the end of the lease term, lessors may receive the underlying asset back from the lessee. Under ASC 842, lessors reclassify the carrying amount of the net investment in the lease to the applicable category of assets (e.g., inventory or property, plant and equipment). Thereafter, lessors account for the underlying asset using ASC 330 or ASC 360, whichever is appropriate.

5.7.3 Lease termination

Excerpt from Accounting Standards Codification

Leases — Lessor

Derecognition

842-30-40-2

If a **sales-type lease** or a **direct financing lease** is terminated before the end of the **lease term**, a **lessor** shall do all of the following:

a. Test the **net investment in the lease** for impairment in accordance with Topic 310 on receivables and recognize any impairment loss identified

b. Reclassify the net investment in the lease to the appropriate category of asset in accordance with other Topics, measured at the sum of the carrying amounts of the **lease receivable** (less any amounts still expected to be received by the lessor) and the residual asset

c. Account for the **underlying asset** that was the subject of the **lease** in accordance with other Topics.

Pending Content:

Transition Date: (P) December 16, 2019; (N) December 16, 2020 | Transition Guidance: 326-10-65-1

Editor's note: The content of paragraph 842-30-40-2 will change upon the adoption of ASU 2016-13:

If a **sales-type lease** or a **direct financing lease** is terminated before the end of the **lease term**, a **lessor** shall do all of the following:

a. Measure **the net investment in the lease** for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost and record any credit loss identified

b. Reclassify the net investment in the lease to the appropriate category of asset in accordance with other Topics, measured at the sum of the carrying amounts of the **lease receivable** (less any amounts still expected to be received by the lessor) and the residual asset

c. Account for the **underlying asset** that was the subject of the **lease** in accordance with other Topics.

For a termination of a sales-type or direct financing lease before the expiration of the lease term, a lessor does the following:

- Tests the net investment in the lease for impairment in accordance with ASC 310 (prior to the adoption of ASU 2016-13) or ASC 326 (subsequent to the adoption of ASU 2016-13) and recognizes any impairment loss identified (refer to section 5.2.3, *Impairment of the net investment in the lease*)
- Reclassifies the net investment in the lease to the appropriate category of asset in accordance with ASC 330 or ASC 360, if applicable, measured at the sum of the carrying amount of the lease receivable (less any amounts still expected to be received by the lessor) and the residual asset
- Accounts for the underlying asset that was the subject of the lease under ASC 330 or 360, if applicable

ASC 842 does not address how lessors would account for terminations of operating leases. Upon a termination of an operating lease (with no other ongoing arrangement between the customer and supplier), we believe that the net lease-related asset or liability associated with the operating lease (e.g., remaining unamortized initial direct costs, prepaid lease payments) is written off with a gain or loss recognized in income. To the extent there is an ongoing arrangement between the customer and the supplier (e.g., a lease is modified such that it is no longer a lease for accounting purposes but instead a service contract), the net lease-related asset or liability associated with the operating lease would be considered when necessary in the accounting for the ongoing service arrangement.

5.7.4 Lease accounting for a group of assets

Lease accounting principles (including sale and leaseback agreements) are applied on a lease component-by-lease component basis. Accordingly, for transactions involving numerous pieces of equipment or properties, it is often necessary to segregate the related assets on a lease component-by-lease component basis. In general, the only assets that should be grouped as a single lease component are those assets that meet both of the criteria in ASC 842-10-15-28 (refer to section 1.4.1, *Identifying and separating lease components of a contract*).

5.7.4.1 Portfolio approach

ASC 842 applies to individual lease components. However, entities that have a large number of leases of similar leased assets (e.g., leases of a fleet of similar railcars) may face practical challenges in applying the leases model on a lease component-by-lease component basis. The FASB acknowledged these concerns and said in its Basis for Conclusions (BC 120) that an entity can use a portfolio approach when "the entity reasonably expects that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio." For example, applying a portfolio approach to four-year leases of fungible, new railcars entered into in the same month with lessees of a similar credit quality may not differ materially from applying ASC 842 to the individual lease components in the portfolio.

ASC 842 does not define "reasonably expects" and "materially." The FASB also said in the Basis for Conclusions (BC 120) that "an entity would need to apply judgment in selecting the size and composition of the portfolio" and "it did not intend for an entity to quantitatively evaluate each outcome but, instead, that the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of leases."

The FASB also said in the Basis for Conclusions (BC 121) that "the cost relief offered by applying the leases guidance at a portfolio level need not be limited to simply grouping contracts together." The portfolio approach could also be applied to other aspects of the leases guidance for which lessors need to make judgments and estimates, such as determining the discount rate and determining and reassessing the lease term. However, the portfolio approach cannot be applied to combine lease and non-lease components (refer to section 1.4, *Identifying and separating lease and non-lease components of a contract and allocating contract consideration*).

5.7.5 Leveraged leases

Excerpt from Accounting Standards Codification

Master Glossary

Leveraged Lease

From the perspective of a **lessor**, a **lease** that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the **commencement date** is before the effective date.

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

Leases previously classified as **leveraged leases** under Topic 840

z. For leases that were classified as **leveraged leases** in accordance with Topic 840, and for which the commencement date is before the effective date, a lessor shall apply the requirements in Subtopic 842-50. If a leveraged lease is modified on or after the effective date, it shall be accounted for as a new lease as of the effective date of the modification in accordance with the guidance in Subtopics 842-10 and 842-30.

    1. A lessor shall apply the pending content that links to this paragraph to a leveraged lease that meets the criteria in (z) that is acquired in a business combination or an **acquisition by a not-for-profit entity** on or after the effective date.

Leases — Leveraged Lease Arrangements

Scope and Scope Exceptions

842-50-15-1

This Subtopic addresses accounting for **leases** that meet the criteria in transition paragraph 842-10-65-1(z). If a **lessee** exercises an option to extend a lease that meets the criteria in transition paragraph 842-10-65-1(z) that it was not previously reasonably assured of exercising, the exercise of that option shall be considered a **lease modification** as described in paragraph 842-10-65-1(z).

ASU 2016-02 eliminates leveraged lease accounting for new leases on its effective date. That is, subsequent to the effective date, lessors account for all new leases, including those that would have qualified as leveraged leases under ASC 840, using the classification criteria discussed in section 3.2, *Criteria for lease classification — lessors* (i.e., sales-type, direct financing or operating). For such leases, entities apply other relevant US GAAP (e.g., ASC 740, *Income Taxes*, ASC 470) to account for the non-lease components of such transactions.

Leveraged lease arrangements that exist before the effective date are grandfathered and therefore continue to follow the existing recognition, measurement, presentation and disclosure guidance for leveraged leases that was carried forward to ASC 842-50. Leases of to-be-constructed assets that qualified to be leveraged leases at lease inception prior to the effective date under ASC 840 but are not completed (i.e. the lease has not commenced) prior to the effective date would not be grandfathered.

If an existing leveraged lease is modified on or after the effective date of the ASC 842, the existing leveraged lease is required to be reclassified as a sales-type, direct financing or operating lease, as applicable, using the lease classification guidance in ASC 842. Refer to section 3.2, *Criteria for lease classification — lessors*, and section 11.2, *Transition*. In that case, there would be no basis to net the remaining non-recourse debt balance with the lease receivable (if any), and any deferred tax balances would need to be adjusted as required under ASC 740 to comply with that guidance.

In addition, if a lessee exercises an option to extend a leveraged lease on or after the effective date of ASC 842 that it was not previously reasonably assured of exercising (i.e., under ASC 840, the renewal option was not included in the original accounting lease term for purposes of classifying the lease at inception), the exercise of that option is accounted for as a lease modification, and the lease no longer qualifies for leveraged lease accounting. Refer to section 5.6, *Lease modifications*.

Refer to chapter 10, *Leveraged leases*, for an in-depth discussion of the accounting for leveraged leases.

5.7.6 Income tax accounting

ASC 842 could affect certain aspects of lessors' accounting for income taxes. For example, it could affect the timing of recognition of lease income for some leases, recognition and measurement of deferred tax assets and liabilities, and assessment of the recoverability of deferred tax assets (i.e., the need for and measurement of valuation allowances). In addition, the special accounting for leveraged leases is eliminated, except for leveraged leases that exist at the transition date, which are grandfathered (refer to section 5.7.5, *Leveraged leases*).

Refer to our Financial reporting developments publication, *Income taxes*.

5.7.7 Sales of equipment with guaranteed minimum resale amount

Excerpt from Accounting Standards Codification

Leases — Lessor

Implementation Guidance

842-30-55-1

This implementation guidance addresses the application of the provisions of this Subtopic in the following circumstances. A manufacturer sells equipment with an expected **useful life** of several years to end users (purchasers) utilizing various sales incentive programs. Under one such sales incentive program, the manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of, contingent on certain requirements.

842-30-55-2

The manufacturer provides the guarantee by agreeing to do either of the following:

a. Reacquire the equipment at a guaranteed price at specified time periods as a means to facilitate its resale

b. Pay the purchaser for the deficiency, if any, between the sales proceeds received for the equipment and the guaranteed minimum resale value.

There may be dealer involvement in these types of transactions, but the minimum resale guarantee is the responsibility of the manufacturer.

842-30-55-3

A sales incentive program in which an entity (for example, a manufacturer) contractually guarantees that it has either a right or an obligation to reacquire the equipment at a guaranteed price (or prices) at a specified time (or specified time periods) as a means to facilitate its resale should be evaluated in accordance with the guidance on satisfaction of performance obligations in paragraph 606-10-25-30 and the guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78. If that evaluation results in a **lease**, the manufacturer should account for the transaction as a lease using the principles of lease accounting in Subtopic 842-10 and in this Subtopic.

842-30-55-4

A sales incentive program in which an entity (for example, a manufacturer) contractually guarantees that it will pay a purchaser for the deficiency, if any, between the sales proceeds received for the equipment and the guaranteed minimum resale value should be accounted for in accordance with Topic 460 on guarantees and Topic 606 on revenue from **contracts** with customers.

842-30-55-5

The **lease payments** used as part of the determination of whether the transaction should be classified as an **operating lease**, a **direct financing lease**, or a **sales-type lease** generally will be the difference between the proceeds upon the equipment's initial transfer and the amount of the **residual value guarantee** to the purchaser as of the first exercise date of the guarantee.

842-30-55-6

If the transaction qualifies as an operating lease, the net proceeds upon the equipment's initial transfer should be recorded as a liability in the manufacturer's balance sheet.

842-30-55-7

The liability is then subsequently reduced on a pro rata basis over the period to the first exercise date of the guarantee to the amount of the guaranteed residual value at that date with corresponding credits to revenue in the manufacturer's income statement. Any further reduction in the guaranteed residual value resulting from the purchaser's decision to continue to use the equipment should be recognized in a similar manner.

842-30-55-8

The equipment should be included in the manufacturer's balance sheet and depreciated following the manufacturer's normal depreciation policy.

842-30-55-9

The Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10 on property, plant, and equipment provide guidance on the accounting for any potential impairment of the equipment.

842-30-55-10

At the time the purchaser elects to exercise the residual value guarantee by selling the equipment to another party, the liability should be reduced by the amount, if any, paid to the purchaser. The remaining undepreciated carrying amount of the equipment and any remaining liability should be removed from the balance sheet and included in the determination of income of the period of the equipment's sale.

842-30-55-11

Alternatively, if the purchaser exercises the residual value guarantee by selling the equipment to the manufacturer at the guaranteed price, the liability should be reduced by the amount paid to the purchaser. Any remaining liability should be included in the determination of income of the period of the exercise of the guarantee.

842-30-55-12

The accounting for a guaranteed minimum resale value is not in the scope of Topic 815 on derivatives and hedging. In the transaction described, the embedded guarantee feature is not an embedded derivative instrument that must be accounted for separately from the lease because it does not meet the criterion in paragraph 815-15-25-1(c).

842-30-55-13

Specifically, if freestanding, the guarantee feature would be excluded from the scope of paragraph 815-10-15-59(b) because of both of the following conditions:

a. It is not exchange traded.

b. The underlying on which settlement is based is the price of a nonfinancial asset of one of the parties, and that asset is not readily convertible to cash. It is assumed that the equipment is not readily convertible to cash, as that phrase is used in Topic 815.

842-30-55-14

Paragraph 815-10-15-59(b)(2) states that the related exception applies only if the nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the price or value of the nonfinancial asset. (In some circumstances, the exclusion in paragraph 815- 10-15-63 also would apply.)

842-30-55-15

Lastly, Topic 460 on guarantees does not affect the guarantor's accounting for the guarantee because that Topic does not apply to a guarantee for which the underlying is related to an asset of the guarantor. Because the manufacturer continues to recognize the residual value of the equipment guaranteed by the manufacturer as an asset (included in the seller-lessor's **net investment in the lease**) if recording a sales-type lease, that guarantee does not meet the characteristics in paragraph 460-10-15-4 and is, therefore, not subject to the guidance in Topic 460. Additionally, if the lease is classified as an operating lease, the manufacturer does not remove the asset from its books, and its guarantee would be a market value guarantee of its own asset. A market value guarantee of the guarantor's own asset is not within the scope of Topic 460, and the guidance in paragraphs 842-10-55-32 through 55-33 for an operating lease is not affected. As a result, the guarantor's accounting for the guarantee is unaffected by Topic 460.

Although not a lease transaction, in some transactions, a manufacturer sells equipment utilizing a sales incentive program. Under the sales incentive program, the manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of, contingent on certain requirements. This guarantee is provided by agreeing to (1) reacquire the equipment at a guaranteed price (or prices) at specified time period (or specified time periods) as a means to facilitate its resale or (2) pay the purchaser for the deficiency, if any, between the sales proceeds received for equipment and the guaranteed minimum resale value. Although a third-party dealer may be involved in this type of transaction, the minimum resale guarantee remains the responsibility of the manufacturer.

Pay the purchaser for the deficiency

If the manufacturer provides the guarantee by paying a purchaser for the deficiency, if any, between the sales proceeds received for the equipment and the guaranteed minimum resale value, the manufacturer should account for such guarantee and sale in accordance with ASC 460 and ASC 606 (even if the entity has not yet adopted ASC 606).

Reacquire the equipment at a guaranteed price

A manufacturer should evaluate the sales incentive program, which includes the guarantees in accordance with the guidance on satisfaction of performance obligations in ASC 606-10-25-30 and the guidance on repurchase agreements in ASC 606-10-55-66 through 55-78. If such evaluation results in a lease (e.g., the guaranteed price is less than the original selling price of the asset, and the transaction is not part of a sale and leaseback transaction), the manufacturer accounts for the transaction as lease in accordance with ASC 842.

The lease payments used as a part of the determination of whether the transaction should be classified as an operating lease, a direct financing lease or a sales-type lease generally will be the difference between the proceeds on the equipment's initial transfer and the amount of the residual value guarantee to the purchaser as of the first exercise date of the guarantee.

It is our view that the guaranteed resale (residual) should be viewed on a net present value basis in determining the classification of the transaction.

Illustration 32 — Accounting for a sale with guaranteed minimum resale amount

Company X sells a computer with a cost of $80 for $100 and agrees to reacquire the equipment in five years for $10. In accordance with ASC 606-10-55-68, the arrangement is accounted for as a lease because Company X is obligated to repurchase the computer for an amount that is less than the original selling price.

The present value of the $10 repurchase obligation is $6. As a result, the transaction qualifies as a sales-type lease because the proceeds on sale ($100) less the present value of the repurchase obligation ($6) exceed substantially all of the equipment's fair value ($100). Company X accounts for the sales-type lease as follows:

Cash (received at time of sale)	$	100		
Sales			$	100
Cost of sale	$	80		
Inventory			$	80
Residual value of asset sold	$	6		
Guaranteed repurchase obligation			$	6

Both the residual value and the guarantee should be accreted to $10 at the end of the five-year period. If, at any time, the residual value of the computer is deemed to be less than $10, a loss for the shortfall should be recorded.

If the transaction should be accounted for by the manufacturer as an operating lease, the net proceeds on the equipment's initial transfer should be recorded as a liability in the manufacturer's balance sheet. The liability subsequently would be reduced on a pro rata basis over the period to the first exercise date of the guarantee, to the amount of the guaranteed residual value at that date, with corresponding credits to revenue in the manufacturer's income statement. Any further reduction in the guaranteed residual value resulting from the purchaser's decision to continue to use the equipment should be recognized in a similar manner. The equipment should be included in the manufacturer's balance sheet and depreciated following the manufacturer's normal depreciation policy. ASC 360 provides guidance on the accounting for any potential impairment of the equipment. At the time the purchaser elects to exercise the residual value guarantee by selling the equipment to another party, the liability should be reduced by the amount, if any, paid to the purchaser. The remaining undepreciated carrying amount of the equipment and any remaining liability should be removed from the balance sheet and included in the determination of income in the period of the equipment's sale. Alternatively, if the purchaser exercises the residual value guarantee by selling the equipment to the manufacturer at the guaranteed price, the liability should be reduced by the amount paid to the purchaser. Any remaining liability should be included in the determination of income in the period of the exercise of the guarantee.

ASC 460 does not apply to a guarantee for which the underlying is related to an asset of the guarantor. Because the manufacturer continues to recognize the residual value of the equipment guaranteed by the manufacturer as an asset (included in the seller-lessor's net investment in the lease) when recording a sales-type lease, that guarantee does not meet the characteristics in ASC 460-10-15-4 and is, therefore, not subject to the provisions of ASC 460. Additionally, if the lease is classified as an operating lease, the manufacturer does not remove the asset from its books, and its guarantee would be a market value guarantee of its own asset. A market value guarantee of the guarantor's own asset is not within the scope of ASC 460 and, as a result, the accounting prescribed in ASC 842-10-55-32 through 55-33 is unaffected by ASC 460.

ASC 842 does not address a transaction where the seller can be required by the buyer, at a specified time subsequent to the sale, to repurchase the asset at fair value as determined at the time of the buyback. ASC 842 also does not address the accounting for an arrangement that gives a customer the right to trade in an asset at a guaranteed value or specified price that can only be exercised when the customer purchases a new asset or require arrangements that include such rights to be accounted for as a lease.

5.8 Presentation

Excerpt from Accounting Standards Codification

Leases — Lessor

Other Presentation Matters

Sales-Type and Direct Financing Leases

Statement of Financial Position

842-30-45-1

A **lessor** shall present lease assets (that is, the aggregate of the lessor's net investment in **sales-type leases** and **direct financing leases**) separately from other assets in the statement of financial position.

842-30-45-2

Lease assets shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet.

Statement of Comprehensive Income

842-30-45-3

A **lessor** shall either present in the statement of comprehensive income or disclose in the notes income arising from **leases**. If a lessor does not separately present lease income in the statement of comprehensive income, the lessor shall disclose which line items include lease income in the statement of comprehensive income.

842-30-45-4

A lessor shall present any profit or loss on the lease recognized at the **commencement date** in a manner that best reflects the lessor's business model(s). Examples of presentation include the following:

a. If a lessor uses leases as an alternative means of realizing value from the goods that it would otherwise sell, the lessor shall present revenue and cost of goods sold relating to its leasing activities in separate line items so that income and expenses from sold and leased items are presented consistently. Revenue recognized is the lesser of:
   1. The **fair value** of the **underlying asset** at the commencement date
   2. The sum of the **lease receivable** and any **lease payments** prepaid by the **lessee**.

Cost of goods sold is the carrying amount of the underlying asset at the commencement date minus the **unguaranteed residual asset**.

b. If a lessor uses leases for the purposes of providing finance, the lessor shall present the profit or loss in a single line item.

Statement of Cash Flows

842-30-45-5

In the statement of cash flows, a **lessor** shall classify cash receipts from **leases** within operating activities.

Operating Leases

Statement of Financial Position

842-30-45-6

A **lessor** shall present the **underlying asset** subject to an **operating lease** in accordance with other Topics.

Statement of Cash Flows

842-30-45-7

In the statement of cash flows, a **lessor** shall classify cash receipts from **leases** within operating activities.

The table below summarizes how lease-related amounts and activities are presented in lessors' financial statements:

Financial statement	Lessor presentation
Balance sheet	▸ **Sales-type and direct financing leases:** ▸ The net investment in the lease is presented separately from other assets. ▸ The net investment in the lease is subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet. ▸ **Operating leases:** ▸ Underlying assets are presented in accordance with applicable guidance.
Income statement	▸ **All leases:** ▸ Income arising from leases is presented separately from other activity, or disclosed in the notes (along with the corresponding line item(s) in the income statement). ▸ **Sales-type leases and direct financing leases:** ▸ Profit (for sales-type leases) or loss (for sales-type and direct financing leases) recognized at the commencement date is presented on either a gross or net basis, based on the lessor's business model. ▸ For example, lessors that use leasing as an alternative means to realize value from goods they would otherwise sell present lease revenue and cost of goods sold on a gross basis (i.e., revenue and cost of goods sold in separate line items). ▸ For example, lessors that use leases for the purpose of providing financing present the profit or loss on a net basis (i.e., in a single line item).
Statement of cash flows	▸ **All leases:** ▸ Cash lease payments received are presented within operating activities.

5.9 Disclosure

The objective of lessor disclosures is to enable financial statement users to assess the amount, timing and uncertainty of lease-related cash flows. ASC 842 requires a lessor to disclose quantitative and qualitative information about its leases, the significant judgments made in applying ASC 842 and the amounts recognized in the financial statements related to those leases.

Lessors may need to exercise judgment to determine the appropriate level at which to aggregate or disaggregate disclosures so that meaningful information is not obscured by insignificant details or by grouping items with different characteristics. The disclosure requirements apply to both public and nonpublic entities.

For interim disclosures, a lessor is required to disclose a table of all lease-related income items in its interim financial statements in accordance with ASC 842-30-50-5 and ASC 270-10-50-6A.

ASC 842 includes the following disclosure requirements for lessors:

Excerpt from Accounting Standards Codification

Leases — Lessor

Disclosure

842-30-50-3

A lessor shall disclose both of the following:

a. Information about the nature of its leases, including:
   1. A general description of those leases
   2. The basis and terms and conditions on which **variable lease payments** are determined
   3. The existence and terms and conditions of options to extend or terminate the lease
   4. The existence and terms and conditions of options for a **lessee** to purchase the **underlying asset.**

b. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:
   1. The determination of whether a **contract** contains a lease (as described in paragraphs 842-10-15-2 through 15-27)
   2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)
   3. The determination of the amount the lessor expects to derive from the underlying asset following the end of the **lease term.**

842-30-50-4

A lessor shall disclose any lease transactions between related parties (see Topic 850 on related party disclosures).

842-30-50-5

A lessor shall disclose lease income recognized in each annual and interim reporting period, in a tabular format, to include the following:

a. For **sales-type leases** and **direct financing leases**:
   1. Profit or loss recognized at the **commencement date** (disclosed on a gross basis or a net basis consistent with paragraph 842-30-45-4)
   2. Interest income either in aggregate or separated by components of the **net investment in the lease**.

b. For **operating leases**, lease income relating to **lease payments**.

c. Lease income relating to variable lease payments not included in the measurement of the **lease receivable**.

842-30-50-6

A lessor shall disclose in the notes the components of its aggregate net investment in sales-type and direct financing leases (that is, the carrying amount of its lease receivables, its **unguaranteed residual assets**, and any deferred selling profit on direct financing leases).

842-30-50-7

A lessor shall disclose information about how it manages its risk associated with the residual value of its leased assets. In particular, a lessor should disclose all of the following:

a. Its risk management strategy for residual assets

b. The carrying amount of residual assets covered by **residual value guarantees** (excluding guarantees considered to be lease payments for the lessor, as described in paragraph 842-30-30-1(a)(2))

c. Any other means by which the lessor reduces its residual asset risk (for example, buyback agreements or variable lease payments for use in excess of specified limits).

Sales-Type and Direct Financing Leases

842-30-50-8

In addition to the disclosures required by paragraphs 842-30-50-3 through 50-7, a **lessor** also shall provide the disclosures in paragraphs 842-30-50-9 through 50-10 for **sales-type leases** and **direct financing leases**.

842-30-50-9

A lessor shall explain significant changes in the balance of its **unguaranteed residual assets** and deferred selling profit on direct financing leases.

842-30-50-10

A lessor shall disclose a maturity analysis of its **lease receivables**, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall disclose a reconciliation of the undiscounted cash flows to the lease receivables recognized in the statement of financial position (or disclosed separately in the notes).

Operating Leases

842-30-50-11

In addition to the disclosures required by paragraphs 842-30-50-3 through 50-7, a **lessor** also shall provide the disclosures in paragraphs 842-30-50-12 through 50-13 for **operating leases.**

842-30-50-12

A lessor shall disclose a maturity analysis of **lease payments**, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall present that maturity analysis separately from the maturity analysis required by paragraph 842-30-50-10 for **sales-type leases** and **direct financing leases**.

842-30-50-13

A lessor shall provide disclosures required by Topic 360 on property, plant, and equipment separately for **underlying assets** under operating leases from owned assets.

6 Subleases

6.1 Definition

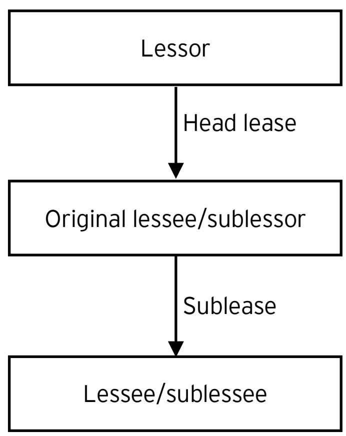
Excerpt from Accounting Standards Codification

Master Glossary

Sublease

A transaction in which an **underlying asset** is re-leased by the **lessee** (or intermediate **lessor**) to a third party (the sublessee) and the original (or head) **lease** between the lessor and the lessee remains in effect.

Lessees often enter into arrangements to sublease an underlying asset to a third party. In these arrangements, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a head lease, the original lessee is often referred to as an intermediate lessor or sublessor, and the ultimate lessee is often referred to as the sublessee.



In some cases, the sublease is a separate lease agreement. In other cases, a third party assumes the original lease, but the original lessee remains the primary obligor under the original lease.

6.1.1 The original lessee is relieved of the primary obligation — not a sublease

Excerpt from Accounting Standards Codification

Leases — Overall

Derecognition

842-20-40-3

If the nature of a **sublease** is such that the original **lessee** is relieved of the primary obligation under the original **lease**, the transaction shall be considered a termination of the original lease. Paragraph 842-20-35-14 addresses subleases in which the original lessee is not relieved of the primary obligation under the original lease. Any consideration paid or received upon termination that was not already included in the **lease payments** (for example, a termination payment that was not included in the lease payments based on the **lease term**) shall be included in the determination of profit or loss to be recognized in accordance with paragraph 842-20-40-1. If a sublease is a termination of the original lease and the original lessee is secondarily liable, the guarantee obligation shall be recognized by the lessee in accordance with paragraph 405-20-40-2.

If the original lessee is relieved of the primary obligation under the original lease, the transaction is not a sublease. Such transactions are considered a termination (refer to section 4.8.1, *Lease termination*) of the original lease, and the lease-related assets and obligations are derecognized. Any consideration paid or received upon termination that was not already included in the lease payments (e.g., a termination penalty that was not included in lease payments based on the lease term) is included in the gain or loss on termination of the original lease. If the original lessee remains secondarily liable for the original lease, the guarantee obligation is recognized by the lessee in accordance with ASC 405-20-40-2 (i.e., measured at fair value and included in the determination of gain or loss on lease termination).

6.2 Original lessor accounting

Excerpt from Accounting Standards Codification

Leases — Lessor

Subsequent Measurement

842-30-35-7

If the original **lessee** enters into a **sublease** or the original **lease** agreement is sold or transferred by the original lessee to a third party, the original **lessor** shall continue to account for the lease as it did before.

Derecognition

842-30-40-3

If the original **lease** agreement is replaced by a new agreement with a new **lessee**, the **lessor** shall account for the termination of the original lease as provided in paragraph 842-30-40-2 and shall classify and account for the new lease as a separate transaction.

If the original lessee enters into a sublease or sells or transfers the original lease to a third party, the original lessor does not change its accounting for the original lease. However, if the original lease agreement is replaced by a new agreement with a new lessee, the original lessor accounts for both the termination of the original lease and the new lease as separate transactions. Refer to section 5.7.3, *Lease termination*.

6.3 Sublessor accounting

Excerpt from Accounting Standards Codification

Leases — Overall

Recognition

842-10-25-6

When classifying a **sublease**, an entity shall classify the sublease with reference to the underlying asset (for example, the item of property, plant, or equipment that is the subject of the lease) rather than with reference to the **right-of-use asset**.

Subsequent Measurement

842-20-35-14

If the nature of a **sublease** is such that the original **lessee** is not relieved of the primary obligation under the original **lease**, the original lessee (as sublessor) shall continue to account for the original lease in one of the following ways:

a. If the sublease is classified as an **operating lease**, the original lessee shall continue to account for the original lease as it did before commencement of the sublease. If the lease cost for the term of the sublease exceeds the anticipated sublease income for that same period, the original lessee shall treat that circumstance as an indicator that the carrying amount of the **right-of-use asset** associated with the original lease may not be recoverable in accordance with paragraph 360-10-35-21.

b. If the original lease is classified as a **finance lease** and the sublease is classified as a **sales-type lease** or a **direct financing lease**, the original lessee shall derecognize the original right-of-use asset in accordance with paragraph 842-30-40-1 and continue to account for the original **lease liability** as it did before commencement of the sublease. The original lessee shall evaluate its investment in the sublease for impairment in accordance with paragraph 842-30-35-3.

c. If the original lease is classified as an operating lease and the sublease is classified as a sales-type lease or a direct financing lease, the original lessee shall derecognize the original right-of-use asset in accordance with paragraph 842-30-40-1 and, from the sublease **commencement date**, account for the original lease liability in accordance with paragraphs 842-20-35-1 through 35-2. The original lessee shall evaluate its investment in the sublease for impairment in accordance with paragraph 842-30-35-3.

842-20-35-15

The original lessee (as sublessor) in a sublease shall use the **rate implicit in the lease** to determine the classification of the sublease and to measure the net investment in the sublease if the sublease is classified as a sales-type or a direct financing lease unless that rate cannot be readily determined. If the rate implicit in the lease cannot be readily determined, the original lessee may use the **discount rate for the lease** established for the original (or head) lease.

If an underlying asset is re-leased by a lessee to a third party and the original lessee retains the primary obligation under the original lease, the transaction is a sublease. A sublessor assesses sublease classification independently of the classification assessment that it made as the lessee of the same asset. A sublessor considers the lease classification criteria in section 3.2, *Criteria for lease classification — lessors*, with reference to the underlying asset when classifying a sublease (e.g., the underlying asset subject to the sublease) rather than the right-of-use asset recognized as part of the head lease. A sublessor uses the rate implicit in the lease (i.e., the rate implicit in the sublease) to determine the classification of the sublease and to measure the net investment in a sublease that is classified as a sales-type or a direct financing lease. If the rate implicit in the lease cannot be readily determined, the sublessor uses the discount rate for the lease established for the head lease. Refer to section 3.4.10, *Classification of subleases,* and section 2.5, *Discount rates*.

The following table summarizes how the original lessee/sublessor accounts for the head lease and sublease at the commencement of the sublease.

<table>
<tr><th></th><th>Sublease — sales-type or direct financing lease</th><th>Sublease — operating lease</th></tr>
<tr><td>Head lease — finance lease</td><td>The original lessee derecognizes the original right-of-use asset and continues to account for the original lease liability as it did before the commencement of the sublease (i.e., in accordance with the finance lease provisions of the lessee accounting guidance). The original lessee, as the sublessor, recognizes a net investment in the sublease and evaluates it for impairment under ASC 310 (prior to the adoption of ASU 2016-13) or ASC 326 (subsequent to the adoption of ASU 2016-13). Refer to section 5.2.3, Impairment of the net investment in the lease.</td><td rowspan="2">The original lessee continues to account for the head lease as it did before the commencement date of the sublease (i.e., in accordance with the lessee accounting guidance).
If the lease cost for the term of the sublease exceeds the sublessor's anticipated sublease income for the same period, this indicates that the right-of-use asset associated with the head lease should be assessed for impairment under the long-lived asset impairment provisions of ASC 360 (i.e., an impairment indicator).</td></tr>
<tr><td>Head lease — operating lease</td><td>The original lessee derecognizes the original right-of-use asset at the sublease commencement date and accounts for the original lease liability in accordance with the finance lease provisions of the lessee accounting guidance. The original lessee, as the sublessor, recognizes a net investment in the sublease and evaluates it for impairment under ASC 310 (prior to the adoption of ASU 2016-13) or ASC 326 (subsequent to the adoption of ASU 2016-13). Refer to section 5.2.3, Impairment of the net investment in the lease.</td></tr>
</table>

Sublease may affect head lease classification

When a sublessor enters into sublease arrangements and determines that the term of the sublease (including the noncancelable term and any lease renewal options that are reasonably certain to be exercised by the sublessee or controlled by the sublessor) is longer than the lease term of the head lease, the sublessor is required to reassess the lease term of the head lease in accordance with ASC 842-10-35-1(a) as discussed in section 2.3.6.1, *Lessees*. However, the existence of the renewal option on its own does not result in the head lease being extended. For example, assume a head lease has a noncancelable term of five years and provides a lessee with an option to renew for two additional years that it determines it is not reasonably certain to exercise. If the lessee subleases the underlying asset and provides the sublessee with the same noncancelable term and renewal option and determines that the sublessee is reasonably certain to exercise that renewal option, the lessee would reassess the term of the head lease as the renewal options are now reasonably certain to be exercised. This is because the lease term under the sublease effectively establishes an obligation to renew the head lease. If the lease term of the head lease changes, the sublessor is also required to reassess the lease classification of the head lease. Refer to section 3.5, *Reassessment of lease classification*. Alternatively, if the lessee determines that the sublessee is not reasonably certain to exercise the renewal options, the lessee would not remeasure the lease term on the head lease solely as a result of entering into the sublease (refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements*, for a discussion of events that could result in reassessment).

Likewise, a head lease may provide a lessee with an option to purchase the underlying asset that it determines it is not reasonably certain to exercise. If the lessee then subleases the underlying asset and provides the sublessee with the a purchase option and determines that the sublessee is reasonably certain to exercise that option, the sublessor will change its assessment of whether it is reasonably certain to exercise its purchase option on the head lease to fulfill the terms of the sublease in accordance with ASC 842-10-35-1(c) as discussed in section 2.3.6.1, *Lessees*. The sublessor is also required to reassess the lease classification of the head lease as discussed in section 3.5, *Reassessment of lease classification*.

Recognition of profit or loss

ASC 842 does not address when the sublessor should recognize the selling profit (sales-type lease) or loss (sales-type or direct financing lease) resulting from a sublease. We believe that any selling profit should be recognized at the sublease commencement date (i.e., the date on which a sublessor makes the underlying asset available for use by a sublessee) when a sublease is classified as a sales-type lease or deferred when a sublease is classified as a direct financing lease. When a sublease is classified as a sales-type or direct financing lease, we believe that any selling loss should be recognized no later than the sublease commencement date (i.e., selling loss is not deferred), consistent with the accounting for a sales-type or direct financing lease, and in some cases earlier as an impairment of the right-of-use asset under the head lease.

We also believe that when a sales-type sublease is for a portion of the underlying asset, the sublessor must determine the portion of the right-of-use asset to derecognize on a rational and systematic basis (e.g., by relative fair value). Likewise, a sublessor must determine the portion of the lease liability that may be converted from an operating lease to a finance lease for purposes of subsequent measurement on a rational and systematic basis (e.g., in proportion to the right-of-use asset).

6.4 Sublessee accounting

A sublessee accounts for a sublease in the same manner as any other lease (i.e., as a new lease subject to ASC 842's recognition and measurement provisions). Refer to chapter 4, *Lessee accounting*. A sublessee classifies the sublease by referring to the underlying asset rather than by referring to the right-of-use asset arising from the head lease.

6.5 Disclosure

In addition to making other lessor disclosures (refer to section 5.9, *Disclosure*), ASC 842 requires an original lessee/sublessor to disclose (1) the existence, and terms and conditions, of residual value guarantees provided by the sublessee and (2) sublease income, on a gross basis, separate from the finance or operating lease expense.

7 Sale and leaseback transactions

7.1 Overview

Excerpt from Accounting Standards Codification

Leases — Sale and Leaseback Transactions

Scope and Scope Exceptions

842-40-15-2

If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer **contract** and the **lease** in accordance with Sections 842-40-25, 842-40-30, and 842-40-50.

Implementation Guidance and Illustrations

842-40-55-1

A **lessee** may obtain legal title to the **underlying asset** before that legal title is transferred to the **lessor** and the asset is leased to the lessee. If the lessee controls the underlying asset (that is, it can direct its use and obtain substantially all of its remaining benefits) before the asset is transferred to the lessor, the transaction is a sale and leaseback transaction that is accounted for in accordance with this Subtopic.

842-40-55-2

If the lessee obtains legal title, but does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a sale and leaseback transaction. For example, this may be the case if a manufacturer, a lessor, and a lessee negotiate a transaction for the purchase of an asset from the manufacturer by the lessor, which in turn is leased to the lessee. For tax or other reasons, the lessee might obtain legal title to the underlying asset momentarily before legal title transfers to the lessor. In this case, if the lessee obtains legal title to the asset but does not control the asset before it is transferred to the lessor, the transaction is accounted for as a purchase of the asset by the lessor and a **lease** between the lessor and the lessee.

Sale and leaseback accounting applies to both the seller-lessee and the buyer-lessor. A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee. Because ASC 842 requires lessees to recognize most leases on their balance sheets (i.e., all leases except for short-term leases if the lessee makes an accounting policy election to use this exception), sale and leaseback transactions do not provide lessees with a source of off-balance sheet financing. Both the seller-lessee and the buyer-lessor are required to apply ASC 842 and certain provisions in ASC 606 to determine whether to account for a sale and leaseback transaction as a sale and purchase of an asset, respectively. Finally, ASC 842-40's guidance on sale and leaseback transactions applies to all assets that are within the scope of ASC 842. We believe this includes the sale of a legal entity when the assets leased back constitute substantially all of the assets of the legal entity that is sold.

In some cases, a lessee may obtain legal title to the underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. For example, a manufacturer, a lessor and a lessee together negotiate a transaction for the purchase of a piece of equipment from the manufacturer by the lessor, which in turn is leased to the lessee. For tax or other reasons, the lessee obtains legal title to the underlying asset shortly before legal title transfers to the lessor. If the lessee obtains legal title, but does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a sale and leaseback transaction. If the lessee controls the underlying asset (that is, it can direct its use and obtain substantially all of its remaining benefits) before the asset or legal title is transferred to the lessor, the transaction is a sale and leaseback transaction and accounted for in accordance ASC 842-40.

A frequent transaction involves the transfer of a purchase option to a third party that exercises the purchase option and leases the property to the original holder of the purchase option. In our view, if the lessee does not enter the chain of ownership and does not obtain control of the underlying asset, we do not believe the transaction should be accounted for as a sale and leaseback under ASC 842-40. If, however, the lessee exercises the purchase option, thereby entering the chain of ownership, and obtains control of the underlying asset, we would view the transaction as a sale and leaseback transaction.

7.1.1 Seller leases back less than 100% of asset sold

The sale and leaseback provisions of ASC 842-40 apply regardless of whether the seller-lessee leases back 100% or 1% of the asset sold. For example, if the asset sold is a 20-floor office building and 10 floors are leased back, sale and leaseback accounting under the provisions of ASC 842-40 is applicable.

7.1.2 Partial sale and leaseback

ASC 842 does not specifically address the application of the sale and leaseback provisions of ASC 842-40 for partial sale and leaseback transactions. For example, assume Entity A owns 100% of a limited liability company (LLC) (whose sole asset is a building Entity A uses for its manufacturing operations) and sells a 51% interest in the LLC, deconsolidates the LLC and leases the building back from the deconsolidated LLC. To determine whether to account for the partial sale and leaseback transaction as a sale and purchase of an asset, the seller-lessee and the buyer-lessor are required to apply ASC 842 and certain provisions in ASC 606 as discussed in section 7.2, *Determining whether the transfer of an asset is a sale*. In this example, we believe the transaction would be subject to sale and leaseback accounting.

Note: In an exposure draft released in June 2016, the FASB provides guidance on partial sales of nonfinancial assets and clarifies the scope of asset derecognition guidance. Readers should monitor developments on this proposal.

7.1.3 Asset sold is different from the asset leased back

In certain sale and leaseback transactions, the asset sold is not the same as the asset leased back. In considering such transactions, we believe that despite the fact that the assets sold and leased back are different, the transaction should be recorded as a sale and leaseback if the sale and lease were entered into as part of a single transaction and the assets involved would be required to be accounted for as a nonmonetary exchange under ASC 845, *Nonmonetary Transactions*, if they had been exchanged (i.e., the assets exchanged are essentially identical, or the future cash flows are not expected to significantly change as a result of the exchange).

7.1.4 Lease-leaseback transactions (LILO's)

In a lease transaction where the owner of an asset leases an asset to a third party and then leases it back, the question often arises as to whether the transaction should be accounted for as a sale and leaseback. Transactions of this type are often tax driven (refer to chapter 10, *Leveraged leases*). Lease-leaseback transactions should be assessed in consideration of the guidance in ASC 842-10-25-19 (refer to section 1.5, *Contract combinations*), which requires that two or more contracts entered into at or near the same time with the same counterparty (or related party) be considered a single contract if at least one of the contracts is or contains a lease and certain criteria are met. That is, both the original lease out of the asset from the owner to the third party and the leaseback from the third party to the owner should be evaluated concurrently when the criteria under ASC 842-10-25-19 are met. Often, this evaluation results in the determination that a lease does not exist (i.e., in substance a financing recorded on the balance sheet and/or a lease for only a portion of the term) as the right to control the use of the asset is not conveyed from the owner to the third party when both the original lease out and the leaseback are considered a single arrangement. For example, an entity leases its medical equipment with a 10-year useful life to a third party and then leases the equipment back for the first seven years. In this case, the right to control the use of the equipment is not transferred to the third party until the completion of the leaseback period (i.e., the first seven years). Therefore, the entity would record the transaction as a financing during the leaseback period and then account for the lease to the third party at the end of the leaseback period (and allocate the consideration in the contract accordingly).

7.1.5 Sale subject to a preexisting lease

Excerpt from Accounting Standards Codification

Leases — Sale-Leaseback Transactions

Implementation Guidance and Illustrations

842-40-55-8

An entity owns an interest in an **underlying asset** and also is a **lessee** under an **operating lease** for all or a portion of the underlying asset. Acquisition of an ownership interest in the underlying asset and consummation of the **lease** occurred at or near the same time. This owner-lessee relationship can occur, for example, when the entity has an investment in a partnership that owns the underlying asset (or a larger asset of which the underlying asset is a distinct portion). The entity subsequently sells its interest or the partnership sells the underlying asset to an independent third party, and the entity continues to lease the underlying asset under the preexisting operating lease.

842-40-55-9

A transaction should be subject to the guidance in this Subtopic if the scope or price of the preexisting lease is modified in connection with the sale. If the scope or the price of the preexisting lease is not modified in conjunction with the sale, the sale should be accounted for in accordance with other Topics.

842-40-55-10

A lease between parties under common control should not be considered a preexisting lease. Accordingly, the guidance in this Subtopic should be applied to transactions that include nonfinancial assets within its scope, except if Topic 980 on regulated operations applies. That is, if one of the parties under common control is a regulated entity with a lease that has been approved by the appropriate regulatory agency, that lease should be considered a preexisting lease.

An entity has an ownership interest in an underlying asset (e.g., 30% noncontrolling ownership interest in a partnership that owns the underlying asset) and also leases all or a portion of the underlying asset under an operating lease. Subsequently, the entity sells its interest in the underlying asset to an independent third party and continues to lease all or a portion of the underlying asset under the preexisting operating lease. If the scope or the consideration of the preexisting operating lease is not modified in connection with the sale, the sale of the entity's interest is accounted for in accordance with other US GAAP and the entity's accounting of the preexisting lease is not changed. Alternatively, if the preexisting operating lease is modified in connection with the sale and such modification meets the definition of lease modification as discussed in section 5.6, *Lease modifications*, (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease), the transaction is accounted for as a sale and leaseback transaction. If the entity consolidates the lessor, this guidance would not apply, and instead, the sale of a controlling interest of the lessor would be subject to leaseback accounting.

7.1.6 Sale-leaseback-sublease transactions

Excerpt from Accounting Standards Codification

Leases — Sale and Leaseback Transactions

Recognition

842-40-55-18

An entity enters into a sale and leaseback of an asset that meets either of the following criteria:

a. The asset is subject to an **operating lease**.

b. The asset is subleased or intended to be subleased by the seller-lessee to another party under an operating lease.

842-40-55-19

A sale-leaseback-sublease transaction is within the scope of this Subtopic. The existence of the **sublease** (that is, the operating lease in paragraph 842-40-55-18(a) or (b)) does not, in isolation, prevent the buyer-lessor from obtaining control of the asset in accordance with paragraphs 842-40-25-1 through 25-3, nor does it prevent the seller-lessee from controlling the asset before its transfer to the buyer-lessor (that is, the seller-lessee is subject to the same requirements for determining whether the transfer of the asset is a sale as it would be without the sublease). All facts and circumstances should be considered in determining whether the buyer-lessor obtains control of the **underlying asset** from the seller-lessee in a sale-leaseback-sublease transaction.

Under a sale-leaseback-sublease arrangement, the owner of an asset sells an asset to a third party and leases it back, then, concurrently or subsequently, subleases the asset to another party. Under ASC 842-40, the existence of the sublease in a sale and leaseback transaction, on its own, does not preclude the application of sale and leaseback accounting if both the leaseback and the sublease are classified as operating leases. An entity will need to consider all facts and circumstances in determining whether the buyer-lessor obtains control of the underlying asset from the seller-lessee in a sale-leaseback-sublease transaction.

7.2 Determining whether the transfer of an asset is a sale

Excerpt from Accounting Standards Codification

Master Glossary

Integral Equipment

Integral equipment is any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost.

Leases — Sale and Leaseback Transactions

Recognition

842-40-25-1

An entity shall apply the following requirements in Topic 606 on revenue from **contracts** with customers when determining whether the transfer of an asset shall be accounted for as a sale of the asset:

a. Paragraphs 606-10-25-1 through 25-8 on the existence of a contract

b. Paragraph 606-10-25-30 on when an entity satisfies a performance obligation by transferring control of an asset.

842-40-25-2

The existence of a leaseback (that is, a seller-lessee's right to use the **underlying asset** for a period of time) does not, in isolation, prevent the buyer-lessor from obtaining control of the asset. However, the buyer-lessor is not considered to have obtained control of the asset in accordance with the guidance on when an entity satisfies a performance obligation by transferring control of an asset in Topic 606 if the leaseback would be classified as a **finance lease** or a **sales-type lease**.

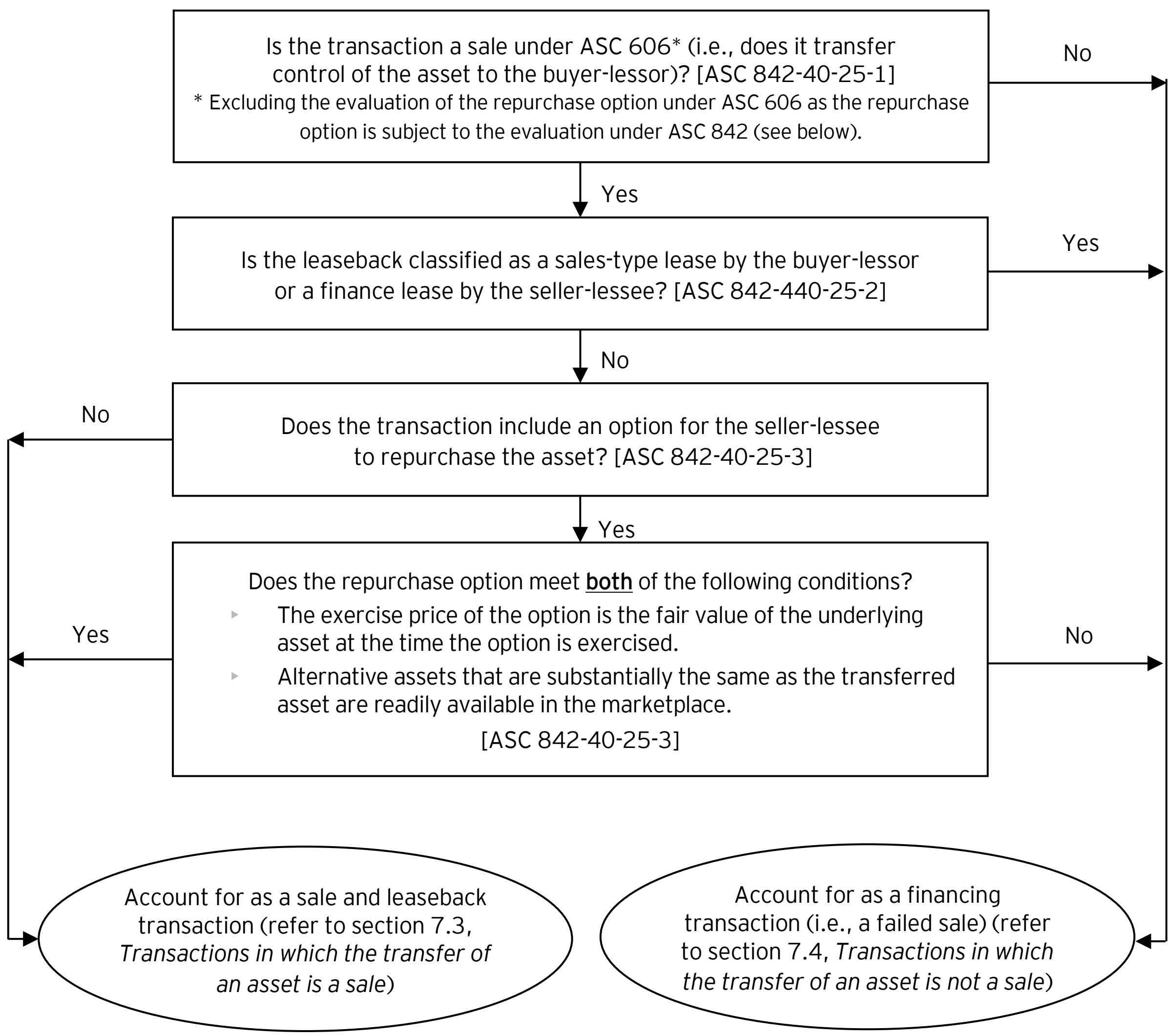
842-40-25-3

An option for the seller-lessee to repurchase the asset would preclude accounting for the transfer of the asset as a sale of the asset unless both of the following criteria are met:

a. The exercise price of the option is the **fair value** of the asset at the time the option is exercised.

b. There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

The following flowchart depicts the decision-making process for determining whether the transfer of an asset is a sale.



When determining whether the transfer of an asset should be accounted for as a sale and purchase, both the seller-lessee and the buyer-lessor apply the guidance in (1) ASC 606-10-25-1 through 25-8 on the existence of a contract, (2) ASC 606-10-25-30 on when an entity satisfies a performance obligation by transferring control of an asset and (3) ASC 842-40-25-2 through 25-3.

Refer to chapter 3, *Identifying the contract with the customer,* of our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606)*, for an in-depth discussion of identifying the contract with the customer and section 7.2, *Control transferred at a point in time*, of that publication for a discussion of transferring control at a point in time.

ASC 842-40-25-2 through 3 also includes guidance for evaluating whether the transfer of an asset with a leaseback to the seller is a sale and purchase. Under this guidance, the existence of the leaseback, in and of itself, does not preclude a sale and purchase. However, a sale and purchase does not occur if the leaseback would be classified as a finance lease (seller-lessee) or a sales-type lease (buyer-lessor). In these types of leases, the FASB believes that the seller-lessee effectively retains control of the underlying asset. Therefore, the FASB indicated in the Basis for Conclusions (BC 352(b)) that it is inappropriate for a seller-lessee to account for the sale of an underlying asset that it concurrently repurchases. Instead, these transactions are accounted for as financings by both the buyer-lessor (lender) and the seller-lessee (borrower). If the leaseback is classified as an operating lease (seller-lessee) or a direct financing lease or an operating lease (buyer-lessor), such leaseback, in and of itself, does not preclude sale and purchase accounting, respectively.

While an option for a seller-lessee to repurchase the transferred asset would generally preclude sale accounting under ASC 606, ASC 842-40 specifies that an option for the seller-lessee to repurchase the asset does not preclude sale and purchase accounting when **both** of the following conditions are met:

1. The exercise price of the option is the fair value of the underlying asset at the time the option is exercised.

2. There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

In the Basis for Conclusions (BC 352(c)), the Board noted that "real estate assets would not meet criterion (2) — [There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace]. This is because real estate is, by nature, 'unique' (that is, no two pieces of land occupy the same space on this planet) such that no other similar real estate asset is 'substantially the same.'" Therefore, we believe a sale and leaseback of real estate, including a sale and leaseback of integral equipment as defined in ASC 978 (i.e., any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost), when the seller-lessee retains any form of a repurchase option will result in a financing for both the seller-lessee and buyer-lessor.

7.2.1 Lease renewals

Certain leaseback transactions provide the seller-lessee with the right to continue to extend the lease, at a fixed-price rental or at fair value at the date of exercise, for substantially all (e.g., 90% or more) of the underlying asset's remaining economic life. ASC 842-40 does not address whether a lessee's renewal options (e.g., fixed price, fair value at the date of exercise) permitting the seller-lessee to extend the lease for substantially all of the remaining economic life of the underlying asset preclude sale accounting. However, the Board noted in the Basis for Conclusions (BC 218) that "a lessee that has an option to extend a lease for all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset." We believe that when the renewal price is not fair value determined at the time the renewal option is exercised, the renewal option would prohibit sale accounting under ASC 842 in the same way a purchase option priced at other than the fair value of the underlying asset at the time the option is exercised would preclude sale accounting under ASC 606.

7.2.2 Right of first refusal and first offer

A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. An agreement that allows the seller-lessee to repurchase the asset in the event no third-party offer is made is an option to repurchase. As a result, care must be taken so that the right of first refusal is predicated on a "real" offer from an unrelated third party with the ability and intention to purchase the asset.

In a related issue, certain sale and leaseback transactions provide that the seller-lessee has the right to make a first offer to buy the property at the end of the lease term. As long as the buyer-lessor is not compelled to accept this offer and the offer amount is not fixed, a right of first offer generally would not preclude sale accounting. If the buyer-lessor is compelled to accept the offer, the right of first offer is effectively a seller-lessee repurchase option, resulting in a failed sale if the two additional criteria for determining whether the transfer of an asset is accounted for as a sale under ASC 842-40-25-3 are not met (i.e., (i) the exercise price of the option is the fair value of the asset at the time the option is exercised, and (ii) there are alternative assets, that are substantially the same as the transferred asset, readily available in the marketplace). If the seller-lessee is compelled to make the offer (under a right of first offer), the right of first offer is effectively a buyer-lessor put. Refer to section 7.3.2, *Put option held by the customer*, of our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606)*, for an in-depth discussion of customer-held put options.

7.2.3 Seller-lessee guarantee of the residual value

Excerpt from Accounting Standards Codification

Leases — Sale-Leaseback Transactions

Implementation Guidance and Illustrations

842-40-55-20

The seller-lessee may guarantee to the **lessor** that the residual value will be a stipulated amount at the end of the **lease term**. If the transfer of the asset is a sale in accordance with paragraphs 842-40-25-1 through 25-3, the seller-lessee **residual value guarantee** should be accounted for in the same manner as any other residual value guarantee provided by a **lessee**.

842-40-55-21

The residual value guarantee does not, on its own, preclude accounting for the transaction as a sale and leaseback, but should be considered in evaluating whether control of the asset has transferred to the buyer-lessor in accordance with paragraph 606-10-25-30. For example, a significant residual value guarantee by the seller-lessee may affect an entity's consideration of the transfer of control indicator in paragraph 606-10-25-30(d).

Under ASC 842-40, the existence of the seller-lessee guarantee of the residual value in a sale and leaseback transaction does not automatically preclude the application of sale and leaseback accounting. Such guarantee would impact the evaluation of whether the transfer of an asset is a sale and purchase under ASC 606-10-25-30. If a significant residual value guarantee is provided in a sale and leaseback transaction by the seller-lessee, it would impact the evaluation of whether the buyer-lessor obtains control of the leased asset (e.g., it may indicate that the significant risks and rewards of ownership of the leased asset have not yet transferred to the buyer-lessor). Further, with the significant residual value guarantee, the leaseback may likely be classified as a finance lease (seller-lessee) or a sales-type lease (buyer-lessor) as any residual value guaranteed by the seller-lessee is included in the fair value criteria testing (i.e., the present value of the sum of lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all the fair value of the underlying asset) for lease classification. The classification of the lease as a finance lease (seller-lessee) or a sales-type lease (buyer-lessor) would preclude sales accounting under ASC 842-40-25-2. Refer to section 3.2, *Criteria for lease classification — lessors*, for further detail.

7.3 Transactions in which the transfer of an asset is a sale

Excerpt from Accounting Standards Codification

Leases — Sale and Leaseback Transactions

Recognition

842-40-25-4

If the transfer of the asset is a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:

a. The seller-lessee shall:

    1. Recognize the transaction price for the sale at the point in time the buyer-lessor obtains control of the asset in accordance with paragraph 606-10-25-30 in accordance with the guidance on determining the transaction price in paragraphs 606-10-32-2 through 32-27

    2. Derecognize the carrying amount of the **underlying asset**

    3. Account for the **lease** in accordance with Subtopic 842-20.

b. The buyer-lessor shall account for the purchase in accordance with other Topics and for the lease in accordance with Subtopic 842-30.

Initial Measurement

842-40-30-1

An entity shall determine whether a sale and leaseback transaction is at **fair value** on the basis of the difference between either of the following, whichever is more readily determinable:

a. The sale price of the asset and the fair value of the asset

b. The present value of the **lease payments** and the present value of market rental payments.

842-40-30-2

If the sale and leaseback transaction is not at fair value, the entity shall adjust the sale price of the asset on the same basis the entity used to determine that the transaction was not at fair value in accordance with paragraph 842-40-30-1. The entity shall account for both of the following:

a. Any increase to the sale price of the asset as a prepayment of rent

b. Any reduction of the sale price of the asset as additional financing provided by the buyer-lessor to the seller-lessee. The seller-lessee and the buyer-lessor shall account for the additional financing in accordance with other Topics.

842-40-30-3

A sale and leaseback transaction is not off market solely because the sale price or the lease payments include a variable component. In determining whether the sale and leaseback transaction is at fair value, the entity should consider those variable payments it reasonably expects to be entitled to (or to make) on the basis of all of the information (historical, current, and forecast) that is reasonably available to the entity. For a seller-lessee, this would include estimating any variable consideration to which it expects to be entitled in accordance with paragraphs 606-10-32-5 through 32-9.

842-40-30-4

If the transaction is a related party **lease**, an entity shall not make the adjustments required in paragraph 842-40-30-2, but shall provide the required disclosures as discussed in paragraphs 842-20-50-7 and 842-30-50-4.

If the transfer of the asset is a sale, the seller-lessee does each of the following:

- Recognizes the transaction price for the sale in accordance with the guidance on determining the transaction price in ASC 606-10-32-2 through 32-27 at the point in time that the buyer-lessor obtains control of the asset (refer to chapter 5, *Determine the transaction price*, of our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606)*, for an in-depth discussion of determining the transaction price)
- Derecognizes the carrying amount of the underlying asset
- Recognizes any gain or loss, adjusted for off-market terms, immediately (refer to section 7.3.2, *Adjustment for off-market terms*)
- A buyer-lessor accounts for the purchase of the asset in accordance with ASC 360.

7.3.1 Accounting for the leaseback

When a sale occurs, both the seller-lessee and the buyer-lessor account for the leaseback in the same manner as any other lease (i.e., in accordance with the lessee and lessor guidance, respectively), with adjustments for any off-market terms.

7.3.2 Adjustment for off-market terms

A sale transaction and the ensuing lease are generally interdependent and negotiated as a package. Consequently, some transactions could be structured with a negotiated sale price that is above or below the asset's fair value and with lease payments for the ensuing lease that are above or below the then-current market rates. These off-market terms could distort the gain or loss on the sale and the recognition of lease expense and lease income for the lease. To make sure that the gain or loss on the sale and the lease-related assets and liabilities associated with such transactions are not understated or overstated, ASC 842-40 requires adjustments for any off-market terms of sale and leaseback transactions, except for sale and leaseback transactions among related parties (refer to section 7.3.2.2, *Related party leasing transactions*, below).

The off-market adjustments are based on the difference between (1) the sale price of the asset and its fair value or (2) the present value of the lease payments and the present value of market rental payments, whichever is more readily determinable. The FASB indicated in the Basis for Conclusions (BC 364) that entities are expected to maximize the use of observable prices and information when determining which measure is the most appropriate to use.

When the sale price is less than the underlying asset's fair value or the present value of the lease payments is less than the present value of market rental payments, a seller-lessee recognizes the difference as an increase to the sales price and the initial measurement of the right-of-use asset as a lease prepayment. When the sale price is greater than the underlying asset's fair value or the present value of the lease payments is greater than the present value of market rental payments, a seller-lessee recognizes the difference as a reduction to the sales price and an additional financing received from the buyer-lessor separately from the lease liability. The seller-lessee accounts for the additional financing in accordance with other US GAAP.

Buyer-lessors are also required to adjust the purchase price of the underlying asset for any off-market terms. Such adjustments are recognized as lease prepayments made by the seller-lessee or as additional financing provided to the seller-lessee. The buyer-lessor accounts for any additional financing in accordance with other US GAAP.

7.3.2.1 Variable lease payments

The terms of a sale and leaseback transaction are not off market solely because the sale price or the lease payments include a variable component. In determining whether the sale and leaseback transaction is at fair value, an entity should consider variable payments it reasonably expects to be entitled to (or to make) on the basis of all of the information (i.e., historical, current and forecasted) that is reasonably available. For a seller-lessee, this includes estimating any variable consideration it expects to be entitled to in accordance with ASC 606-10-32-5 through 32-9. Refer to section 5.2, *Variable consideration*, of our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606)*, for an in-depth discussion of estimating variable consideration.

7.3.2.2 Related party leasing transactions

Adjustments are not made to reflect either the fair value of the purchase and sale or the current market rates for a lease in sale and leaseback transactions among related parties. Refer to section 9.1, *Related party leasing transactions*.

7.3.3 Example

ASC 842-40 provides the following example of the accounting for a sale and leaseback transaction.

Excerpt from Accounting Standards Codification

Leases — Sale and Leaseback Transactions

Implementation Guidance and Illustrations

Example 1 — Sale and Leaseback Transaction

842-40-55-23

An entity (Seller) sells a piece of land to an unrelated entity (Buyer) for cash of $2 million. Immediately before the transaction, the land has a carrying amount of $1 million. At the same time, Seller enters into a contract with Buyer for the right to use the land for 10 years (the leaseback), with annual payments of $120,000 payable in arrears. This Example ignores any initial direct costs associated with the transaction. The terms and conditions of the transaction are such that Buyer obtains substantially all the remaining benefits of the land on the basis of the combination of the cash flows it will receive from Seller during the leaseback and the benefits that will be derived from the land at the end of the lease term. In determining that a sale occurs at commencement of the leaseback, Seller considers that, at that date, all of the following apply:

a. Seller has a present right to payment of the sales price of $2 million.

b. Buyer obtains legal title to the land.

c. Buyer has the significant risks and rewards of ownership of the land because, for example, Buyer has the ability to sell the land if the property value increases and also must absorb any losses, realized or unrealized, if the property value declines.

842-40-55-24

The observable fair value of the land at the date of sale is $1.4 million. Because the fair value of the land is observable, both Seller and Buyer utilize that benchmark in evaluating whether the sale is at market term. Because the sale is not at fair value (that is, the sales price is significantly in excess of the fair value of the land), both Seller and Buyer adjust for the off-market terms in accounting for the transaction. Seller recognizes a gain of $400,000 ($1.4 million − $1 million) on the sale of the land. The amount of the excess sale price of $600,000 ($2 million − $1.4 million) is recognized as additional financing from Buyer to Seller (that is, Seller is receiving the additional benefit of financing from Buyer). Seller's incremental borrowing rate is 6 percent. The leaseback is classified as an operating lease.

842-40-55-25

At the commencement date, Seller derecognizes the land with a carrying amount of $1 million. Seller recognizes the cash received of $2 million, a financial liability for the additional financing obtained from Buyer of $600,000, and a gain on sale of the land of $400,000. Seller also recognizes a lease liability for the leaseback at the present value of the portion of the 10 contractual leaseback payments attributable to the lease of $38,479 ($120,000 contractual lease payment − $81,521 of that lease payment that is attributable to the additional Buyer financing), discounted at the rate of 6 percent, which is $283,210, and a corresponding right-of-use asset of $283,210. The amount of $81,521 is the amount of each $120,000 annual payment that must be attributed to repayment of the principal of the financial liability for that financial liability to reduce to zero by the end of the lease term.

842-40-55-26

After initial recognition and measurement, at each period of the lease term, Seller will do both of the following:

a. Decrease the financing obligation for the amount of each lease payment allocated to that obligation (that is, $81,521) and increase the carrying amount of the obligation for interest accrued using Seller's incremental borrowing rate of 6 percent. For example, at the end of Year 1, the balance of the financial obligation is $554,479 ($600,000 − $81,521 + $36,000).

b. Recognize the interest expense on the financing obligation (for example, $36,000 in Year 1) and $38,479 in operating lease expense.

842-40-55-27

At the end of the lease term, the financing obligation and the lease liability equal $0.

842-40-55-28

Also, at the commencement date, Buyer recognizes the land at a cost of $1.4 million and a financial asset for the additional financing provided to Seller of $600,000. Because the lease is an operating lease, at the date of sale Buyer does not do any accounting for the lease.

842-40-55-29

In accounting for the additional financing to Seller, Buyer uses 6 percent as the applicable discount rate, which it determined in accordance with paragraphs 835-30-25-12 through 25-13. Therefore, Buyer will allocate $81,521 of each lease payment to Buyer's financial asset and allocate the remaining $38,479 to lease income. After initial recognition and measurement at each period of the lease term, Buyer will do both of the following:

a. Decrease the financial asset for the amount of each lease payment received that is allocated to that obligation (that is, $81,521) and increase the carrying amount of the obligation for interest accrued on the financial asset using Seller's incremental borrowing rate of 6 percent. Consistent with Seller's accounting, at the end of Year 1, the carrying amount of the financial asset is $554,479 ($600,000 − $81,521 + $36,000).

b. Recognize the interest income on the financing obligation (for example, $33,269 in Year 2) and $38,479 in operating lease income.

842-40-55-30

At the end of the lease term, the carrying amount of the financial asset is $0, and Buyer continues to recognize the land.

7.4 Transactions in which the transfer of an asset is not a sale

Excerpt from Accounting Standards Codification

Leases — Sale and Leaseback Transactions

Recognition

842-40-25-5

If the transfer of the asset is not a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:

a. The seller-lessee shall not derecognize the transferred asset and shall account for any amounts received as a financial liability in accordance with other Topics.

b. The buyer-lessor shall not recognize the transferred asset and shall account for the amounts paid as a receivable in accordance with other Topics.

Initial Measurement

842-40-30-6

The guidance in paragraph 842-40-25-5 notwithstanding, the seller-lessee shall adjust the interest rate on its financial liability as necessary to ensure that both of the following apply:

a. Interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the **lease term** and the term of the financing. The term of the financing may be shorter than the lease term because the transfer of an asset that does not qualify as a sale initially may qualify as a sale at a point in time before the end of the lease term.

b. The carrying amount of the asset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term or the date at which control of the asset will transfer to the buyer-lessor (for example, the date at which a repurchase option expires if that date is earlier than the end of the lease term).

If the transfer of an asset is not a sale, the seller-lessee and the buyer-lessor account for the transaction as a financing. The seller-lessee keeps the asset subject to the sale and leaseback transaction on its balance sheet and accounts for amounts received as a financial liability in accordance with other US GAAP. The seller-lessee decreases the financial liability by lease payments made, less the portion considered interest expense.

The seller-lessee adjusts the interest rate on its financial liability as necessary to make sure that both:

- Interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the lease term or the term of the financing (i.e., there should be no negative amortization of the liability)
- The carrying amount of the asset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term or the date at which control of the asset will transfer to the buyer-lessor (i.e., there should be no built-in loss)

If the transfer of the asset is not a sale, the buyer-lessor does not recognize the transferred asset and instead accounts for the amounts paid as a loan receivable in accordance with other US GAAP.

If a sale and leaseback transaction that is accounted for as a financing subsequently qualifies for sales recognition under ASC 606 and ASC 842-40 (e.g., expiration of the repurchase option), the transaction would, at that time, be accounted for using sale and leaseback accounting by both the seller-lessee and the buyer-lessor. The seller-lessee would derecognize the carrying amounts of the financial liability and the underlying assets and recognize the difference between the carrying amounts of the financial liability and the underlying assets as gain or loss. The buyer-lessor would recognize the purchase of the underlying asset by derecognizing the carrying amount of its loan receivable and recognizing the transferred asset at that same amount. In addition, the leaseback would be classified and accounted for as any new leases as of the commencement date of the leaseback, which is the date of the transaction qualifies for sale recognition under ASC 842, and the lease has commenced. The above discussion presumes there have been no additional changes in terms or conditions at the time of sale. Any such changes would affect the accounting at that time.

7.4.1 Impairment of assets subject to a sale-leaseback

An entity enters into a sale and leaseback transaction as the seller-lessee that does not qualify as a sale under ASC 842 is treated as a financing of the existing asset, which is not removed from the entity's balance sheet. A question arises as to whether any excess of carrying amount over fair market value at the date of the sale should be recognized as a loss.

It is our view that an asset that does not qualify for sale and leaseback accounting would continue to be subject to impairment under ASC 360 as a held for use asset. An excess of carrying value over fair market value at the date of sale would indicate that the recoverability of the carrying amount of an asset should be assessed under the guidelines of ASC 360. See our Financial reporting developments publication, *Impairment or disposal of long-lived assets*, for further information on applying the provisions of ASC 360.

7.4.2 Example

ASC 842-40 provides the following example of the accounting for a failed sale and leaseback transaction.

Excerpt from Accounting Standards Codification

Leases — Sale and Leaseback Transactions

Implementation Guidance and Illustrations

Example 2 — Accounting for Failed Sale and Leaseback Transaction

842-40-55-31

An entity (Seller) sells an asset to an unrelated entity (Buyer) for cash of $2 million. Immediately before the transaction, the asset has a carrying amount of $1.8 million and has a remaining useful life of 21 years. At the same time, Seller enters into a contract with Buyer for the right to use the asset for 8 years with annual payments of $200,000 payable at the end of each year and no renewal options. Seller's incremental borrowing rate at the date of the transaction is 4 percent. The contract includes an option to repurchase the asset at the end of Year 5 for $800,000.

842-40-55-32

The exercise price of the repurchase option is fixed and, therefore, is not the fair value of the asset on the exercise date of the option. Consequently, the repurchase option precludes accounting for the transfer of the asset as a sale. Absent the repurchase option, there are no other factors that would preclude accounting for the transfer of the asset as a sale.

842-40-55-33

Therefore, at the commencement date, Seller accounts for the proceeds of $2 million as a financial liability and continues to account for the asset. Buyer accounts for the payment of $2 million as a financial asset and does not recognize the transferred asset. Seller accounts for its financing obligation, and Buyer accounts for its financial asset in accordance with other Topics, except that, in accordance with paragraph 842-40-30-6, Seller imputes an interest rate (4.23 percent) to ensure that interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the lease term and the term of the financing and that the carrying amount of the asset will not exceed the financial liability at the point in time the repurchase option expires (that is, at the point in time Buyer will obtain control of the asset in accordance with the guidance on satisfying performance obligations in Topic 606). Paragraph 842-40-30-6 does not apply to the buyer-lessor; therefore, Buyer recognizes interest income on its financial asset on the basis of the imputed interest rate determined in accordance with paragraphs 835-30-25-12 through 25-13, which in this case Buyer determines to be 4 percent.

842-40-55-34

During Year 1, Seller recognizes interest expense of $84,600 (4.23% × $2 million) and recognizes the payment of $200,000 as a reduction of the financial liability. Seller also recognizes depreciation expense of $85,714 ($1.8 million ÷ 21 years). Buyer recognizes interest income of $80,000 (4% × $2 million) and recognizes the payment of $200,000 as a reduction of its financial asset.

842-40-55-35

At the end of Year 1, the carrying amount of Seller's financial liability is $1,884,600 ($2 million + $84,600 — $200,000), and the carrying amount of the underlying asset is $1,714,286 ($1.8 million — $85,714). The carrying amount of Buyer's financial asset is $1,880,000 ($2 million + $80,000 — $200,000).

842-40-55-36

At the end of Year 5, the option to repurchase the asset expires, unexercised by Seller. The repurchase option was the only feature of the arrangement that precluded accounting for the transfer of the asset as a sale. Therefore, upon expiration of the repurchase option, Seller recognizes the sale of the asset by derecognizing the carrying amount of the financial liability of $1,372,077, derecognizing the carrying amount of the underlying asset of $1,371,429, and recognizing a gain of $648. Buyer recognizes the purchase of the asset by derecognizing the carrying amount of its financial asset of $1,350,041 and recognizes the transferred asset at that same amount. The date of sale also is the commencement date of the leaseback for accounting purposes. The lease term is 3 years (8 year contractual leaseback term — 5 years already passed at the commencement date). Therefore, Seller recognizes a lease liability at the present value of the 3 remaining contractual leaseback payments of $200,000, discounted at Seller's incremental borrowing rate at the contractually stated commencement date of 4 percent, which is $555,018, and a corresponding right-of-use asset of $555,018. Seller uses the incremental borrowing rate as of the contractual commencement date because that rate more closely reflects the interest rate that would have been considered by Buyer in pricing the lease.

842-40-55-37

The lease is classified as an operating lease by both Seller and Buyer. Consequently, in Year 6 and each year thereafter, Seller recognizes a single lease cost of $200,000, while Buyer recognizes lease income of $200,000 and depreciation expense of $84,378 on the underlying asset ($1,350,041 ÷ 16 years remaining useful life).

842-40-55-38

At the end of Year 6 and at each reporting date thereafter, Seller calculates the lease liability at the present value of the remaining lease payments of $200,000, discounted at Seller's incremental borrowing rate of 4 percent. Because Seller does not incur any initial direct costs and there are no prepaid or accrued lease payments, Seller measures the right-of-use asset at an amount equal to the lease liability at each reporting date for the remainder of the lease term.

7.5 Other transactions subject to sale and leaseback accounting

Sale and leaseback accounting guidance also may be applicable to transactions that are structured other than as a typical sale and leaseback. Entities may structure transactions differently from a typical sale and leaseback to achieve certain tax treatments, for financing or for other reasons. Examples of these transactions are contribution-leaseback, spin-off-leaseback and exchange-leaseback.

Contribution-leaseback

Under a contribution-leaseback arrangement, an entity contributes (i.e., transfers) an asset to another entity in exchange for a noncontrolling interest in that entity. Concurrent with the contribution of the asset, the contributor/transferor enters into an arrangement to lease back the contributed asset. We believe that a contribution-leaseback transaction represents a partial sale and leaseback that should be accounted for in accordance with the provisions for sale and leaseback transactions under ASC 842-40. As discussed in section 7.1.2, *Partial sale and leaseback*, partial sale transactions do not automatically preclude the use of sale and leaseback accounting. The contribution-leaseback transactions should be accounted for in accordance with the provisions for sale and leaseback transactions under ASC 842-40. However, if the entity contributes (i.e., transfers) an asset to another entity in exchange for a controlling interest in that entity, the investee/transferee would be consolidated by the contributor/transferor. Therefore, the contribution-leaseback transaction would not subject to the lease accounting under ASC 842.

Spin-off-leaseback

Under a spin-off-leaseback arrangement, an entity distributes the stock of a subsidiary that owns an underlying asset (the underlying asset may or may not also be leased by other entities in the consolidated group) to the shareholders of the parent entity. Concurrent with the spin-off, the parent entity enters into an arrangement to lease back all or a portion of the underlying asset that were spun off. We also believe that a spin-off-leaseback transaction should be accounted for in accordance with the provisions for sale and leaseback transactions under ASC 842-40.

Exchange-leaseback

Under an exchange-leaseback arrangement, an entity (seller-lessee) typically exchanges an underlying asset with another entity (buyer-lessor) in a nonmonetary exchange and leases the underlying asset back from the buyer-lessor. Similar to contribution and spin-off leaseback transactions, we believe that exchange-leaseback transactions should also be accounted for in accordance with the provisions for sale and leaseback transactions under ASC 842-40.

7.6 Sale and leasebacks by entities with regulated operations

Excerpt from Accounting Standards Codification

Regulated Operations — Leases

Overview and Background

980-842-05-1

This Subtopic provides guidance on accounting for leases for entities with regulated operations.

Recognition

980-842-25-1

Accounting for sale and leaseback transactions in accordance with the guidance in Subtopic 842-40 may result in a difference between the timing of income and expense recognition required by that Subtopic and the timing of income and expense recognition for rate-making purposes.

980-842-25-2

That difference shall be accounted for as follows:

a. If the difference in timing of income and expense recognition constitutes all or a part of a **phase-in plan**, it shall be accounted for in accordance with Subtopic 980-340.

b. Otherwise, the timing of income and expense recognition related to the sale and leaseback transaction shall be modified as necessary to conform to the Regulated Operations Topic. That modification required for a transaction that is accounted for as a financing is further described in the following paragraph and paragraphs 980-840-35-1 through 35-2.

980-842-25-3

The difference between the amount of income or expense recognized for a transaction that is not part of a phase-in plan and that is accounted for as a financing under Subtopic 842-40 and the amount of income or expense included in allowable cost for rate-making purposes shall be capitalized or accrued as a separate regulatory-created asset or liability, as appropriate, if that difference meets the criteria of the Regulated Operations Topic.

Subsequent Measurement

980-842-35-1

If the sale and leaseback transaction is accounted for as a financing and the sale is recognized for rate-making purposes, the total of interest imputed under the interest method for the financing and the depreciation of the underlying asset shall be modified to equal the total lease expense and the gain or loss allowable for rate-making purposes.

The provisions of ASC 842-40 apply to sale and leaseback transactions of an entity with regulated operations subject to ASC 980, *Regulated Operations*. Sale and leaseback accounting under ASC 842-40 may result in a difference between the timing of income and expense recognition for accounting purposes and the timing of income and expense recognition for rate-making purposes.

7.7 Lessee involvement in asset construction ('build-to-suit' transactions)

Excerpt from Accounting Standards Codification

Leases — Sale and Leaseback Transactions

Implementation Guidance and Illustrations

842-40-55-3

An entity may negotiate a **lease** before the **underlying asset** is available for use by the **lessee**. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. Depending on the terms and conditions of the **contract**, a lessee may be required to make payments relating to the construction or design of the asset.

842-40-55-4

If a lessee incurs costs relating to the construction or design of an underlying asset before the **commencement date**, the lessee should account for those costs in accordance with other Topics, for example, Topic 330 on inventory or Topic 360 on property, plant, and equipment. Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset. Payments for the right to use the underlying asset are **lease payments**, regardless of the timing of those payments or the form of those payments (for example, a lessee might contribute construction materials for the asset under construction).

842-40-55-5

If the lessee controls the underlying asset being constructed before the commencement date, the transaction is accounted for in accordance with this Subtopic. Any one (or more) of the following would demonstrate that the lessee controls an underlying asset that is under construction before the commencement date:

a. The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (for example, by making a payment to the **lessor**).

b. The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use (see paragraph 842-10-55-7) to the owner-lessor. In evaluating whether the asset has an alternative use to the owner-lessor, an entity should consider the characteristics of the asset that will ultimately be leased.

c. The lessee legally owns either:

   1. Both the land and the property improvements (for example, a building) that are under construction

   2. The non-real-estate asset (for example, a ship or an airplane) that is under construction.

d. The lessee controls the land that property improvements will be constructed upon (this includes where the lessee enters into a transaction to transfer the land to the lessor, but the transfer does not qualify as a sale in accordance with paragraphs 842-40-25-1 through 25-3) and does not enter into a lease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the property improvements.

e. The lessee is leasing the land that property improvements will be constructed upon, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements, and does not enter into a **sublease** of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements.

The list of circumstances above in which a lessee controls an underlying asset that is under construction before the commencement date is not all inclusive. There may be other circumstances that individually or in combination demonstrate that a lessee controls an underlying asset that is under construction before the commencement date.

The following flowchart summarizes how lessees evaluate and account for a build-to-suit transaction.

Does the lessee control the underlying asset being constructed before the commencement date? [ASC 842-40-55-1 through 55-2 and ASC 842-40-55-5] (refer to section 7.7.2, *Determining whether the lessee controls the underlying asset being constructed*)

Yes

- ASC 842 does not provide specific recognition and measurement guidance
- We believe an entity:
  - Recognizes the asset as costs are incurred
  - Recognizes a liability in an amount equal to the capitalized costs not paid for by the lessee
  - When lease commences, evaluates the sale and leaseback guidance in ASC 842

(refer to section 7.7.4, *Accounting when the lessee controls the underlying asset being constructed*)

No

- An entity evaluates the nature of the payments made or costs incurred prior to the commencement date

[ASC 842-40-55-4] (refer to section 7.7.3, *Accounting when the lessee does not control the underlying asset being constructed*)

ASC 842 guidance of lessee involvement in asset construction focuses on whether the lessee controls the asset being constructed. In build-to-suit lease transactions, various forms of lessee involvement during the construction period raise questions about whether the lessee has control of the underlying asset being constructed. In some asset construction arrangements, the prospective lessee participates in the asset construction process. For example, a prospective lessee may act as a construction agent, general contractor or as principal for the owner-lessor during the asset construction period.

Lessee involvement in projects where a long-lived asset is constructed may result in a sale and leaseback transaction subject to the provisions of ASC 842-40. There is no requirement that the prospective lessee entity serve as a construction agent, general contractor or principal for the owner-lessor in the project for sale and leaseback accounting to be applicable. In addition, the provisions that result in a lessee controlling the underlying asset being constructed before commencement date of a lease, and thus subject to the sale and leaseback provisions of ASC 842-40, are applicable to all assets that are within the scope of ASC 842, for example, the construction of a vessel whereby the lessee has control of the asset being constructed.

7.7.1 Lessee indemnification of environmental contamination

Excerpt from Accounting Standards Codification

Leases — Sale-Leaseback Transactions

Implementation Guidance and Illustrations

842-40-55-7

A provision that requires **lessee** indemnifications for preexisting environmental contamination does not, on its own, mean that the lessee controlled the **underlying asset** before the **lease** commenced regardless of the likelihood of loss resulting from the indemnity. Consequently, the presence of such a provision does not mean the transaction is in the scope of this Subtopic.

A provision that requires lessee indemnifications for preexisting environmental contamination during its use of the underlying asset over the term of the lease would not, on its own, result in the lessee obtaining control over the underlying asset during the construction period regardless of the likelihood of loss resulting from the indemnity. Refer to section 3.4.8, *Lessee indemnifications for environmental contamination*, for a discussion of the accounting for indemnifications of preexisting environmental contamination in a lease.

7.7.2 Determining whether the lessee controls the underlying asset being constructed

The FASB indicated in the Basis for Conclusions (BC 400(b)) that the evaluation on whether a lessee controls the underlying asset being constructed is similar to the evaluation undertaken in the revenue recognition guidance in accordance with ASC 606-10-25-27 to determine whether a performance obligation is satisfied over time. In some cases, it is clear that the lessee controls the underlying asset being constructed (e.g., when the lessee legally owns the asset during the construction period and has the right to direct its use and obtain substantively all of its economic benefit). In other cases, it is clear the lessee does not control the underlying asset being constructed (e.g., when the lessee has little or no substantive involvement during construction). However, in many cases, judgment will be required to determine whether the lessee's involvement, in substance, gives it control of the underlying asset.

ASC 842-40 includes the following examples of circumstances that individually (or in the aggregate) demonstrate that the lessee controls an underlying asset that is under construction before the commencement date of a lease:

- The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (e.g., by making a payment to the lessor). This right may be in the form of an option or obligation to purchase the asset from the lessor. ASC 842 does not provide additional guidance to demonstrate how to evaluate the term "any" in this example. Our view is that the reference to "any" in this example means the right to obtain the partially constructed underlying assets would need to exist at any single point in time and would not have to exist throughout the construction period. Also, if the right to obtain the partially constructed underlying assets is contingent upon an event within the lessee's control (e.g., a default provision, a call option), then the lessee would have such right at any point in time.

- The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessor. In evaluating whether the asset has an alternative use to the owner-lessor, an entity should consider the characteristics of the asset that will ultimately be leased.
- The lessee legally owns either: 1) both the land and the property improvements (e.g., a building), or 2) the non-real estate asset (e.g., a ship or an airplane) that is under construction.
- The lessee controls the land that property improvements will be constructed upon (this includes where the lessee enters into a transaction to transfer the land to the lessor, but the transfer does not qualify as a sale in accordance with ASC 842-40-25-1 through 25-3) and does not enter into a lease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the property improvements. The lessee may control the land via legal ownership or, if it has transferred the land, in a transaction that does not qualify as a sale in accordance with ASC 842 (refer to section 7.4, *Transactions in which the transfer of an asset is not a sale*).
- The lessee is leasing the land that the property improvements will be constructed upon, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements, and does not enter into a sublease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated party to sublease the land for substantially all of the economic life of the property improvements.

Judgment will be required to determine whether a lessee controls an asset under construction because this list is not all inclusive. For example, we believe that a lessee also controls an asset that is under construction if it funds substantially all of the costs of the materials needed for the construction project.

ASC 842-40 provides the following examples of how to determine whether a lessee controls an underlying asset that is under construction.

Excerpt from Accounting Standards Codification

Leases — Sale and Leaseback Transactions

Implementation Guidance and Illustrations

Example 3 — Lessee Control over an Asset under Construction

842-40-55-40

Lessee and Lessor enter into a contract whereby Lessor will construct (whether itself or using subcontractors) a building to Lessee's specifications and lease that building to Lessee for a period of 20 years once construction is completed for an annual lease payment of $1,000,000, increasing by 5 percent per year, plus a percentage of any overruns above the budgeted cost to construct the building. The building is expected to have an economic life of 50 years once it is constructed. Lessee does not legally own the building and does not have a right under the contract to obtain the building while it is under construction (for example, a right to purchase the construction in process from Lessor). In addition, while the building is being developed to Lessee's specifications, those specifications are not so specialized that the asset does not have an alternative use to Lessor.

Case A — Lessee Does Not Control the Asset under Construction

842-40-55-41

Assume Lessee controls (that is, Lessee is the owner for accounting purposes) the land upon which the building will be constructed and, as part of the contract, Lessee agrees to lease the underlying land to Lessor for an initial period of 25 years. Lessor also is granted a series of six 5-year renewal options for the land lease.

842-40-55-42

None of the circumstances in paragraph 842-40-55-5 exist. Even though Lessee owns the land (whether legally or for accounting purposes only) upon which the building will be constructed, Lessor legally owns the property improvements and has rights to use the underlying land for at least substantially all of the economic life of the building. Lessee does not own the building and does not have a right under the contract to obtain the building (for example, a right to purchase the building from Lessor). In addition, the building has an alternative use to Lessor. Therefore, Lessee does not control the building under construction. Consequently, the arrangement is not within the scope of this Subtopic. Lessee and Lessor will account for the lease of the building in accordance with Subtopics 842-20 and 842-30, respectively. If Lessee incurs costs related to the construction or design of the building (for example, architectural services in developing the specifications of the building), it will account for those costs as lease payments unless the costs are for goods or services provided to Lessee, in which case Lessee will account for those costs in accordance with other Topics.

Case B — Lessee Controls the Asset under Construction

842-40-55-43

Assume Lessee leases, rather than owns, the land upon which the building will be constructed. Lessee has a 20-year lease of the underlying land and five 10-year renewal options. Therefore, Lessee's lease of the underlying land, together with the renewal options, is for at least substantially all of the economic life of the building under construction. Lessee enters into a sublease with Lessor for the right to use the underlying land for 20 years that commences upon completion of the building. The sublease has a single 10-year renewal option available to Lessor.

842-40-55-44

Lessee controls the building during the construction period and, therefore, the arrangement is within the scope of this Subtopic. Lessee and Lessor will apply the guidance in this Subtopic to determine whether this arrangement qualifies as a sale and a leaseback or whether this arrangement is, instead, a financing arrangement. Lessee controls the building during the construction period because, in accordance with paragraph 842-40-55-5(e), Lessee controls the use of the land upon which the building will be constructed for a period that is at least substantially all of the economic life of the building and the sublease entered into with Lessor does not both (a) grant Lessor the right to use the land before the beginning of construction and (b) permit Lessor to use the land for substantially all the economic life of the building (that is, the sublease, including Lessor renewal options, only is for 30 years as compared with the 50-year economic life of the building).

7.7.3 Accounting when the lessee does not control the underlying asset being constructed

If the lessee does not control the underlying asset being constructed, any payments made (or other consideration provided) for the right to use the underlying asset are lease payments, regardless of the timing or form of those payments (e.g., the lessee could provide some of the raw materials for use in construction). Lease payments made prior to lease commencement are recognized as a prepaid asset and evaluated in the lease classification test. Costs incurred by the lessee that relate specifically to construction or design of an asset that are not payments for the use of an asset to be leased are recognized in accordance with other US GAAP (e.g., ASC 330, *Inventory*, ASC 360) depending on the facts and circumstances. For example, those costs may be accounted for as nonmonetary prepaid lease, leasehold improvement or sales of a good (e.g., inventory or property, plant and equipment).

7.7.4 Accounting when the lessee controls the underlying asset being constructed

ASC 842 does not provide specific recognition and measurement guidance for a lessee that controls an asset being constructed. In that case, we believe that the asset is recognized during the construction period as costs are incurred to construct the asset. A liability also should be recognized in an amount equal to the capitalized costs that are not paid for by the lessee (e.g., paid for by the lessor). If the lessee controls the asset during the construction period, a sale and leaseback of the asset occurs at the commencement date of the lease (generally at the completion of construction). The sale and leaseback guidance in ASC 842 is evaluated to determine whether the underlying asset is derecognized. If the application of the sale and leaseback guidance results in a failed sale, the asset remains on the lessee's balance sheet, and the liability is subsequently accounted for as a financing obligation. Refer to section 7.4.2, *Example*, for an example of accounting of the accounting for a failed sale and leaseback transaction.

7.8 Disclosure

Excerpt from Accounting Standards Codification

Leases — Sale and Leaseback Transactions

Disclosure

842-40-50-1

If a seller-lessee or a buyer-lessor enters into a sale and leaseback transaction that is accounted for in accordance with paragraphs 842-40-25-4 and 842-40-30-1 through 30-3, it shall provide the disclosures required in paragraphs 842-20-50-1 through 50-9 for a seller-lessee or paragraphs 842-30-50-1 through 50-13 for a buyer-lessor.

842-40-50-2

In addition to the disclosures required by paragraphs 842-20-50-1 through 50-9, a seller-lessee that enters into a sale and leaseback transaction shall disclose both of the following:

a. The main terms and conditions of that transaction

b. Any gains or losses arising from the transaction separately from gains or losses on disposal of other assets.

A seller-lessee that enters into a sale and leaseback transaction in which the transfer of the asset is a sale is required to provide disclosures applicable to lessees (refer to section 4.10, *Disclosure*). Similarly, a buyer-lessor that enters into a sale and leaseback transaction in which the transfer of the asset is a purchase is required to provide disclosures applicable to lessors (refer to section 5.9, *Disclosure*).

A seller-lessee in a sale and leaseback transaction is also required to disclose:

- The main terms and conditions of the transaction
- Any gains or losses arising from the transaction separately from gains or losses on the disposal of other assets

ASC 842 does not include specific disclosure requirements for transactions that are accounted for as financings. We believe that entities would apply other US GAAP (e.g., ASC 820) to make the appropriate disclosures.

7.9 Transfer of tax benefits

Excerpt from Accounting Standards Codification

Leases — Sale-Leaseback Transactions

Implementation Guidance and Illustrations

842-40-55-11

A U.S. entity purchases an asset and enters into a **contract** with a foreign investor that provides that foreign investor with an ownership right in, but not necessarily title to, the asset. That ownership right enables the foreign investor to claim certain benefits of ownership of the asset for tax purposes in the foreign tax jurisdiction.

842-40-55-12

The U.S. entity also enters into a contract in the form of a leaseback for the ownership right with the foreign investor. The contract contains a purchase option for the U.S. entity to acquire the foreign investor's ownership right in the asset at the end of the **lease term**.

842-40-55-13

The foreign investor pays the U.S. entity an amount of cash on the basis of an appraised value of the asset. The U.S. entity immediately transfers a portion of that cash to a third party, and that third party assumes the U.S. entity's obligation to make the future **lease payments**, including the purchase option payment. The cash retained by the U.S. entity is consideration for the tax benefits to be obtained by the foreign investor in the foreign tax jurisdiction. The U.S. entity may agree to indemnify the foreign investor against certain future events that would reduce the availability of tax benefits to the foreign investor. The U.S. entity also may agree to indemnify the third-party trustee against certain future events.

842-40-55-14

The result of the transaction is that both the U.S. entity and the foreign investor have a tax basis in the same depreciable asset.

842-40-55-15

An entity should determine whether the transfer of the ownership right is a sale based on the guidance in paragraphs 842-40-25-1 through 25-3. Consistent with paragraphs 842-40-25-2 through 25-3, if the leaseback for the ownership right is a **finance lease** or if the U.S. entity has an option to repurchase the ownership right at any exercise price other than the **fair value** of that right on the exercise date, there is no sale. If the transfer of the ownership right is not a sale, consistent with the guidance in paragraph 842-40-25-5, the entity should account for the cash received from the foreign investor as a financial liability in accordance with other Topics

842-40-55-16

If the transfer of the ownership right is a sale, income recognition for the cash received should be determined on the basis of individual facts and circumstances. Immediate income recognition is not appropriate if there is more than a remote possibility of loss of the cash consideration received because of indemnification or other contingencies.

842-40-55-17

The total consideration received by the U.S. entity is compensation for both the tax benefits and the indemnification of the foreign investor or other third-party trustee. The recognition of a liability for the indemnification agreement at inception in accordance with the guidance in Topic 460 on guarantees would reduce the amount of income related to the tax benefits that the seller-lessee would recognize immediately when the possibility of loss is remote.

Periodically, an entity enters into transactions that are, in substance, transfers of tax benefits through tax leases. These transactions are commonly referred to as "double-dip" transactions as their objective is to provide to more than one entity a deduction in separate tax jurisdictions (e.g., Switzerland and the US). The transaction generally involves the sale of a depreciable asset or transfers an ownership right in an asset to an investor in a foreign jurisdiction in consideration for cash proceeds and an obligation by the seller to lease back the asset under a finance lease and an operating lease with a fixed-price purchase option.

The foreign investor is typically provided with an ownership right in, but not necessarily with title to, the asset. That ownership right enables the foreign investor to claim certain tax benefits associated with the ownership of the asset such as accelerated depreciation deductions or tax credits. The US entity generally maintains a purchase option to acquire the foreign investor's rights in the asset at the end of the lease term.

Typically, most of the cash proceeds upon execution of the transaction are required to be deposited into an essentially risk-free investment trust account, generally managed by a third party. The earnings and principal of the account are used solely for, and are sufficient to, satisfy the seller-lessee obligation, including payment of the purchase option. The free cash (the difference between the sales proceeds and the deposit to the trust account) represents the consideration paid by the investor for the tax benefits. The arrangement often contains indemnification provisions by the seller-lessee, indemnifying the foreign investor against certain future events that would reduce the availability of tax benefits to the investor and/or the third-party trustee against certain future events.

To determine whether the transfer of the ownership right of the underlying asset is a sale, both the seller-lessee and the buyer-lessor apply the guidance in accordance with ASC 842-40-25-1 through 25-3. In addition to meeting certain revenue recognition provisions in ASC 606 (i.e., control transfers to the buyer in accordance with ASC 606-10-25-30), the ownership right of the underlying asset is considered a sale if all of the following conditions are met:

- The leaseback is classified as an operating lease for the seller-lessee and either a direct financing lease or an operating lease for the buyer-lessor.
- The exercise price of the purchase option on the leaseback is the fair value of the underlying asset at the time the option is exercised.
- There are alternative assets, substantially the same as the leased asset, readily available in the marketplace. Refer to section 7.2, *Determining whether the transfer of an asset is a sale*, for specific considerations for transactions involving real estate.

If the transfer of the ownership right of the underlying asset as well as the transfer of tax benefits is not a sale, the seller-lessee and the buyer-lessor account for the transaction as a financing (refer to section 7.4, *Transactions in which the transfer of an asset is not a sale*). The seller-lessee retains the underlying asset on its balance sheet and accounts for amounts received from the foreign investor as a financial liability in accordance with other US GAAP. Refer to section 7.4, *Transactions in which the transfer of an asset is not a sale*, for further detail.

If the transfer of the ownership right of the underlying asset as well as the transfer of tax benefits is a sale (which often is not the case in double-dip tax structured transactions), the seller-lessee and the buyer-lessor account for the transaction as a sale and leaseback transaction. Refer to section 7.3, *Transactions in which the transfer of an asset is a sale*, for the accounting of the transaction. Further, a determination should be made whether the consideration received by the US entity for the sale of the tax benefits (net of related costs) should be recognized currently in income or deferred (this determination applies only to the portion of the gain associated with the sale of tax benefits).

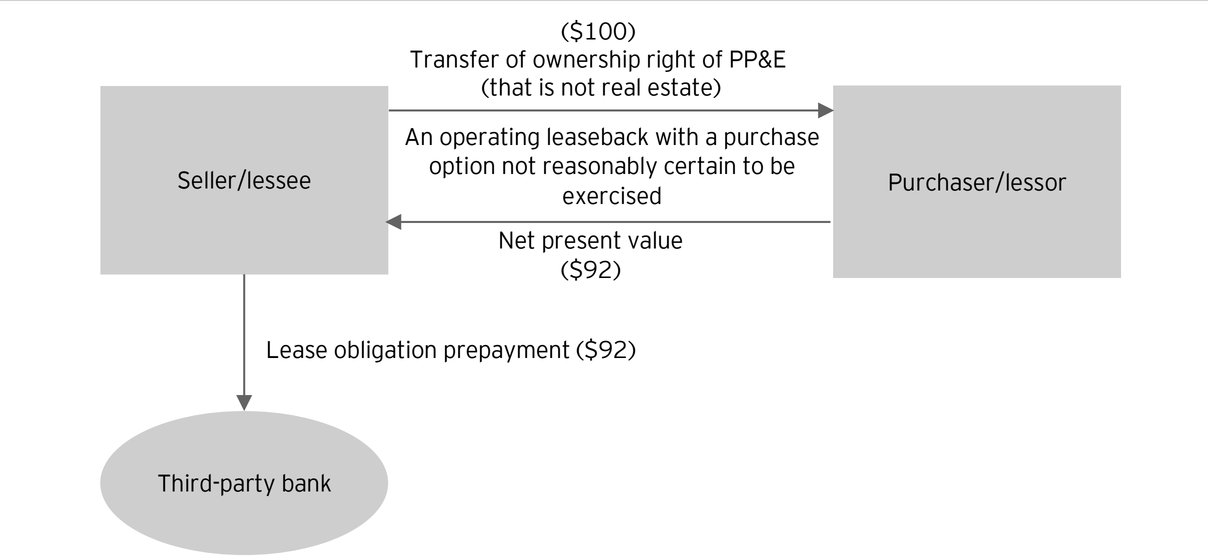
The timing of income recognition of the compensation paid to the seller-lessee for the sale of income tax benefits should be determined based on individual facts and circumstances. Immediate income recognition (assuming the transaction meets sale and leaseback requirements) is not appropriate if there is more than a remote possibility of loss of the cash consideration received by the seller (e.g., due to indemnification or other contingencies that could require the seller of the tax benefits to make payment to the purchaser or to the third party trustee).

The total consideration received by the seller-lessee (i.e., US entity) is compensation for both the tax benefits and the indemnification of the foreign investor or other third-party trustee. The recognition of a liability for the indemnification agreement at inception in accordance with the guidance in ASC 460 on guarantees would reduce the amount of income related to the tax benefits that the seller-lessee would recognize immediately when the possibility of loss is remote.

Regarding the lease liability or the financial liability recognized by the seller-lessee in a sale or a financing transaction, the seller-lessee should consider the extinguishment requirements under ASC 405-20, *Liabilities — Extinguishments of Liabilities*, to determine the accounting for any payment made to the third-party trustee to service future lease and purchase option payments due under the leaseback. To meet the extinguishment requirements of ASC 405-20, the seller-lessee must be legally released as the primary obligor under the lease or financial obligation. As a result of failure to meet the debt extinguishment requirements of ASC 405-20 (i.e. the seller-lessee continues to owe future lease and purchase option payments when they become due), the deposit made with the a third-party trustee (not consolidated with seller-lessee) is recorded on the balance sheet of the seller-lessee as a prepaid asset, and does not reduce the lease or financial liability.

The following is a graphic depiction of a typical structure:

Illustration 33 — Transfer of tax benefits through tax leases — typical transaction structure



7.9.1 Disclosure of a transfer of tax benefits through tax leases

The following is a summary of the disclosure requirements for a transfer of tax benefits through tax leases:

- **Significant accounting policies —** The accounting policies or practices followed should include the method of accounting for the transfer of tax benefits transactions and the methods of recognizing revenue and allocating income tax benefits and asset costs to current and future periods.
- **Income taxes —** The reported amount of income tax expense attributable to continuing operations should be reconciled to the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations, and the estimated amount and the nature of each significant reconciling item should be disclosed (ASC 740-10-50). Transactions involving the transfer of tax benefits through tax leases may give rise to a significant reconciling item that should be disclosed pursuant to these requirements.
- **Material transactions —** If material and unusual or infrequent to the enterprise, the nature and financial effects of transactions involving the transfer of tax benefits through tax leases should be disclosed on the face of the income statement or, alternatively, in notes to the financial statements in accordance with ASC 225-20, *Income Statement — Extraordinary and Unusual Items*.

  Note: *In January 2015, the FASB issued ASU 2015-01, Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items, which eliminates extraordinary items from US GAAP. The ASU is effective in annual periods, and interim periods within those annual periods, beginning after 15 December 2015. Early adoption is permitted; however, adoption must occur at the beginning of an annual period. An entity can elect to apply the guidance prospectively or retrospectively*.
- **Contingencies —** If significant contingencies exist with respect to the transfer of tax benefits, disclosures in accordance with ASC 450, *Contingencies*, may be warranted.
- **Comparability —** If comparative financial statements are presented, disclosure should be made of any change in practice that significantly affects comparability.

8 Business combinations

8.1 Classification of acquired leases

Excerpt from Accounting Standards Codification

Master Glossary

Acquiree

The **business** or **businesses** that the **acquirer** obtains control of in a **business combination**. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an **acquisition by a not-for-profit entity**.

Acquirer

The entity that obtains control of the **acquiree**. However, in a **business combination** in which a **variable interest entity** (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

Acquisition by a Not-for-Profit Entity

A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. When applicable guidance in Topic 805 is applied by a **not-for-profit entity**, the term **business combination** has the same meaning as this term has for a for-profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities.

Business Combination

A transaction or other event in which an **acquirer** obtains control of one or more **businesses**. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also **Acquisition by a Not-for-Profit Entity**.

Implementation Guidance and Illustrations

Lease of an Acquiree

842-10-55-11

In a **business combination** or an **acquisition by a not-for-profit entity**, the acquiring entity should retain the previous **lease** classification in accordance with this Subtopic unless there is a **lease modification** and that modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8.

Under ASC 842, the acquiring entity in a business combination (or acquisition by a not-for-profit entity) does not change the acquiree's existing lease classification unless the lease is modified and the modification is not accounted for as a separate contract. Refer to section 4.6, *Lease modifications*, and section 5.6, *Lease modifications*, for a discussion of lessee and lessor modifications, respectively. If a lease is modified, and the modified lease is accounted for as a separate contract, the acquirer classifies the new lease based on ASC 842's lease classification guidance.

If a lease is modified in connection with the business combination and is not accounted for as a separate contract, the acquirer remeasures and reallocates the remaining consideration in the contract and reassesses the lease classification using the modified terms and conditions and facts and circumstances as of the effective date of the lease modification as discussed in section 4.6.3, *Lessee accounting for a modification that is not accounted for a separate contract*, and section 5.6.3, *Lessor accounting for a modification that is not accounted for a separate contract*, for lessees and lessors, respectively. After determining the classification of the modified lease, the acquirer accounts for the modified lease in accordance with the guidance in ASC 805 discussed in the remainder of this chapter.

An unmodified lease is accounted for in accordance with the guidance in the remainder of this chapter. If the only change in a lease as a result of the business combination is a change in the identity of the parties, the change would not represent a lease modification because there is no change to the terms and conditions of the contract that results in a change in the scope of or consideration for the lease. As such, the classification of the lease does not change.

The provisions of ASC 842-10-55-11 apply to both lessees and lessors in a business combination.

The accounting for a lease in an asset acquisition is discussed in section 8.6, *Asset acquisition — lessor,* for lessors and section 8.7, *Asset acquisition — lessee,* for lessees.

8.2 Recognition and measurement of acquired leases

Excerpt from Accounting Standards Codification

Business combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Recognition

805-20-25-10

The acquirer shall recognize separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. Additional guidance on applying that definition is provided in paragraphs 805-20-25-14 through 25-15, 805-20-55-2 through 55-45, and Example 1 (see paragraph 805-20-55-52). For guidance on the recognition and subsequent measurement of a **defensive intangible asset**, see Subtopic 350-30.

805-20-25-10A

An identifiable intangible asset may be associated with a **lease**, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with paragraph 805-20-25-10.

805-20-25-11

The acquirer shall recognize assets or liabilities related to an **operating lease** in which the acquiree is the **lessee** as required by paragraphs 805-20-25-10A and 805-20-25-28A.

805-20-25-12

Regardless of whether the acquiree is the lessee or the **lessor**, the acquirer shall determine whether the terms of each of an acquiree's operating leases are favorable or unfavorable compared with the market terms of leases of the same or similar items at the acquisition date. If the acquiree is a lessor, the acquirer shall recognize an intangible asset if the terms of an operating lease are favorable relative to market terms and a liability if the terms are unfavorable relative to market terms. If the acquiree is a lessee, the acquirer shall adjust the measurement of the acquired **right-of-use asset** for any favorable or unfavorable terms in accordance with paragraph 805-20-30-24.

805-20-25-28A

The acquirer shall recognize assets and liabilities arising from leases of an acquiree in accordance with Topic 842 on leases (taking into account the requirements in paragraph 805-20-25-8(a)).

805-20-25-28B

For leases for which the acquiree is a lessee, the acquirer may elect, as an accounting policy election by class of underlying asset and applicable to all of the entity's acquisitions, not to recognize assets or liabilities at the acquisition date for leases that, at the acquisition date, have a remaining lease term of 12 months or less. This includes not recognizing an intangible asset if the terms of an operating lease are favorable relative to market terms or a liability if the terms are unfavorable relative to market terms.

The acquirer separately recognizes identifiable intangible assets associated with the inherent value of the lease (i.e., the price market participants are willing to pay for an at-market lease). The inherent value may relate to the economic benefit of acquiring a lessor acquiree and an asset with an in-place lease versus one that is not leased. Refer to section 8.3, *Considerations for valuing in-place leases*. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion as described further in section 4.2.5, *Intangible assets*, of our Financial reporting developments publication, *Business combinations*.

ASC 805 requires all assets acquired, liabilities assumed and any noncontrolling interests to be recognized and measured at fair value on the acquisition date, with limited exceptions. Certain lease-related assets and liabilities are an exception to the general recognition and measurement principles under ASC 805. Instead, the acquirer in a business combination applies ASC 842's initial recognition and measurement provisions to recognize those lease-related assets and lease liabilities when the acquiree is a lessee or a lessor.

The following table summarizes the items in an acquired lease that typically give rise to an asset or liability in a business combination.

	Lease classification	Asset	Liability	Section reference
Acquiree is a lessee	Finance or operating lease	▸ Right-of-use asset** ▸ Leasehold improvements* ▸ In-place lease value*	▸ Lease liability**	8.2.1, *Acquiree in a business combination is a lessee in a finance or operating lease*
Acquiree is a lessor	Sales-type or direct finance lease	▸ Net investment in lease which is the sum of lease receivable and unguaranteed residual asset** ▸ In-place lease value* ▸ Customer relationship intangible asset*	▸ Not applicable	8.2.2, *Acquiree in a business combination is a lessor in a sales-type or direct financing lease*
Acquiree is a lessor	Operating lease	▸ Favorable lease terms relative to market* ▸ Leased asset (including lessor-owned tenant improvements)* ▸ In-place lease value* ▸ Customer relationship intangible asset*	▸ Unfavorable lease terms relative to market*	8.2.3, *Acquiree in a business combination is a lessor in an operating lease*

* Recognized and measured at fair value in accordance with the general principles of ASC 805

** Recognized and measured in accordance with ASC 842

Leases with a remaining lease term of 12 months or less

If the acquiree is a lessee, the acquirer can elect to apply the same accounting policy election by class of underlying asset for all business combinations to not recognize assets and liabilities for leases that at the acquisition date have a remaining lease term of 12 months or less. ASC 805-20-25-28B states that such an election includes not recognizing an intangible asset if the terms of an operating lease are favorable relative to market terms or a liability if the terms are unfavorable relative to market terms.

8.2.1 Acquiree in a business combination is a lessee in a finance or operating lease

Excerpt from Accounting Standards Codification

Business combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-24

For **leases** in which the acquiree is a **lessee**, the acquirer shall measure the **lease liability** at the present value of the remaining **lease payments**, as if the acquired lease were a new lease of the acquirer at the acquisition date. The acquirer shall measure the **right-of-use asset** at the same amount as the lease liability as adjusted to reflect favorable or unfavorable terms of the lease when compared with market terms.

Subsequent Measurement

805-20-35-6

Leasehold improvements acquired in a business combination shall be amortized over the shorter of the useful life of the assets and the remaining **lease term** at the date of the acquisition. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the leasehold improvements to the end of their useful life.

When the acquiree in a business combination is a lessee, the acquirer initially measures the lease liability and right-of-use asset for acquired finance and operating leases as if the leases are new at the acquisition date. That is, ASC 805's governing principle to recognize assets and liabilities at fair value is not applied to these assets and liabilities. As a reminder, in a business combination or acquisition by a not-for-profit, the acquiring entity does not change the acquiree's existing lease classification unless the lease is modified and the modified lease is not accounted for as a separate contract as discussed in section 8.1, *Classification of acquired leases*. The FASB indicated in the Basis for Conclusions (BC 415) that measuring the acquired lease as if it were a new lease includes assessing the following:

- The lease term
- Any lessee options to purchase the underlying asset
- Lease payments
- The discount rate for the lease

The lease liability is initially measured at the present value of the remaining lease payments using the concepts described in chapter 2, *Key concepts*, to determine the lease term, lease payments and discount rate as of the acquisition date. The right-of-use asset is initially measured at an amount equal to the lease liability, adjusted for favorable or unfavorable terms of the lease (including favorable and unfavorable purchase or renewal options) when compared with market terms. Therefore, the acquirer does not separately recognize an intangible asset or liability for favorable or unfavorable lease terms relative to market terms.

An acquirer does not recognize (separately or as part of the lease liability and right-of-use asset) any prepaid or accrued rent previously recognized by the acquired entity for the lease payments that are uneven throughout the lease term because the acquiree's prepaid or accrued rent does not meet the definition of an asset or liability.

However, the acquirer separately recognizes, at fair value, any other identifiable intangible assets associated with the lease, which may be evidenced by market participants' willingness to pay for the lease even if it is at market terms. For example, ASC 805-20-25-10A indicates that a lease of gates at an airport or a lease of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as an identifiable intangible asset. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion as described further in section 4.2.5, *Intangible assets*, of our Financial reporting developments publication, *Business combinations*.

The subsequent measurement of an acquired lease liability and right-of-use asset is determined using the lessee subsequent measurement guidance under ASC 842. Refer to chapter 4, *Lessee accounting*.

The acquirer also recognizes leasehold improvements acquired in a business combination at fair value in accordance with ASC 805 and amortizes the assets over the shorter of the useful life of the assets or the remaining lease term at the date of acquisition. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee amortizes the leasehold improvements to the end of their useful life.

8.2.2 Acquiree in a business combination is a lessor in a sales-type or direct financing lease

Excerpt from Accounting Standards Codification

Business combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-25

For leases in which the acquiree is a lessor of a **sales-type lease** or a **direct financing lease**, the acquirer shall measure its **net investment in the lease** as the sum of both of the following (which will equal the fair value of the **underlying asset** at the acquisition date):

a. The **lease receivable** at the present value, discounted using the rate implicit in the lease, of the following, as if the acquired lease were a new lease at the acquisition date:

   1. The remaining lease payments

   2. The amount the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor.

b. The **unguaranteed residual asset** as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable, as determined in accordance with (a), at that date.

The acquirer shall take into account the terms and conditions of the lease in calculating the acquisition-date fair value of an underlying asset that is subject to a sales-type lease or a direct financing lease by the acquiree-lessor.

When the acquiree in a business combination is a lessor in a sales-type or direct financing lease, the acquirer recognizes and measures the net investment in the lease, which includes the lease receivable and the unguaranteed residual asset at the acquisition date. As a reminder, in a business combination or acquisition by a not-for-profit entity, the acquiring entity does not change the acquiree's existing lease classification unless the lease is modified and the modified lease is not accounted for as a separate contract as discussed in section 8.1, *Classification of acquired leases*.

The lease receivable is measured assuming the lease is a new lease at the acquisition date. This includes assessing the lease term, any lessee options to purchase the underlying asset, lease payments and the discount rate for the lease. The acquirer measures the lease receivable at the present value of the remaining lease payments and any guaranteed residual asset, using the concepts described in chapter 2, *Key concepts*, to determine the lease term, lease payments and rate implicit in the lease.

The unguaranteed residual asset is initially measured as the difference between the acquisition-date fair value of the underlying asset (as defined in section 4.1.1, *Short-term leases*) and the lease receivable (as determined above) on the acquisition date. The acquirer takes into consideration the terms and conditions of the lease (e.g., off-market terms, purchase options, renewal options, termination penalties, residual value guarantees) when calculating the acquisition-date fair value of the underlying asset. Consequently, any lease terms that are favorable or unfavorable relative to market terms result in adjustments to the measurement of the acquisition-date fair value of the underlying asset that is used to measure the unguaranteed residual asset. Further, an acquirer does not separately recognize an intangible asset for off-market terms for sales-type or direct financing leases of a lessor.

However, an acquirer does separately recognize identifiable intangible assets associated with the inherent value of the lease (i.e., the price market participants are willing to pay for an at-market lease). The inherent value may relate to the economic benefit of acquiring an asset with an in-place lease versus one that is not leased. Refer to section 8.3, *Considerations for valuing in-place leases*.

The subsequent measurement of the net investment in a sales-type or direct financing lease is determined using the lessor subsequent measurement guidance under ASC 842. Refer to chapter 5, *Lessor accounting*.

8.2.3 Acquiree in a business combination is a lessor in an operating lease

Underlying assets subject to operating leases remain on the lessor's balance sheet. Therefore, when an acquiree is a lessor, an underlying asset subject to an operating lease is recognized on the acquirer's balance sheet and initially measured at its acquisition-date fair value in accordance with ASC 805. The subsequent measurement of the underlying asset subject to an operating lease is determined under ASC 360.

The acquirer separately recognizes an intangible asset if the terms of an operating lease are favorable compared with market terms and a liability if the terms are unfavorable compared with market terms. The acquiree also separately recognizes any identifiable intangible assets, such as an identifiable intangible asset associated with the inherent value of the lease (i.e., the price market participants are willing to pay for an at-market lease) or a customer-related intangible asset for its contractual relationship with any lessees.

Any lease-related intangible asset or liability (e.g., favorable/unfavorable lease terms relative to market, in-place lease value, customer relationship) that is recognized as part of the business combination is generally amortized to rental income over the term of the lease so that level rental income is recorded over the lease term. An asset recognized for the inherent value of a lease typically also is amortized over the term of the lease.

After the business combination, the acquirer follows the accounting for any operating lease as described in section 5.4, *Operating leases*.

8.3 Considerations for valuing in-place leases

When assets are acquired with in-place leases, some lease contracts may have value for reasons other than terms that are favorable relative to market prices.

In valuing in-place leases, various methods may be used to determine the fair value of the lease. These include the income method, the cost method and the market method. However, when valuing in-place leases, the following components should be considered in the valuation.

- **The fair value measurement framework in ASC 820 —** See our Financial reporting developments, *Fair value measurement*, further discussion on applying the provisions of ASC 820.
- **Direct costs associated with obtaining a new lessee** — The value of an in-place lease would include the direct costs that are avoided by acquiring the lease instead of originating the lease. For example, these costs could include commissions, tenant improvements and other direct costs associated with obtaining a new lessee.
- **Opportunity costs associated with lost rentals** — In general, obtaining a new lessee will take some period of time, and during that period of time the asset owner may not be receiving lease payments. This period, often referred to as the absorption period, represents an opportunity cost to the owner that is avoided if the asset is acquired with an in-place lease.
- **Additional customer relationship intangible assets** — Consideration should be given as to whether the lease arrangements create a customer relationship asset under ASC 805. Examples of customer relationship assets might include the value, as a result of a current lease arrangement, associated with the expected renewal of the lease or the increased likelihood of obtaining the lessee as a lessee for other locations owned by the lessor.

In-place leases acquired with an asset (e.g., tenant leases associated with an acquired building) would also meet the recognition criteria under ASC 805, and therefore must be recognized apart from the acquired asset. As the useful life of an in-place lease is normally shorter than the remaining life of the underlying asset, separate recognition and amortization will affect the net earnings of the acquiring entity.

8.4 Lease of property from a third party entered into as part of a business combination

In certain business combinations, a third party unrelated to the acquiree or acquirer is inserted into the transaction to acquire certain assets of the business directly from the acquiree that will in turn be leased by the third party to the acquirer of the business. The question has arisen as to whether such transactions should be accounted for as the acquisition, sale and leaseback of the assets or simply as a lease transaction by the acquirer. In our view, although the transaction may in form be a lease of assets, it is in substance a sale-leaseback and should be accounted for as such if the assets to be leased are acquired by the third party in contemplation of, or contingent upon, the acquisition of a business by the acquirer-lessee.

8.5 Leveraged lease acquired in a business combination or by a not-for-profit entity

Excerpt from Accounting Standards Codification

Leases—Leveraged Lease Arrangements

Recognition

842-50-25-2

In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall retain the classification of the acquired entity's investment as a **lessor** in a **leveraged lease** at the date of the combination. The net investment of the acquired leveraged lease shall be disaggregated into its component parts, namely net rentals receivable, **estimated residual value**, and unearned income including discount to adjust other components to present value.

Initial Measurement

842-50-30-2

In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall assign an amount to the acquired net investment in the **leveraged lease** in accordance with the general guidance in Topic 805 on business combinations, based on the remaining future cash flows and giving appropriate recognition to the estimated future tax effects of those cash flows.

Subsequent Measurement

842-50-35-1

In a business combination or an **acquisition by a not-for-profit entity**, the acquiring entity shall subsequently account for its acquired investment as a **lessor** in a **leveraged lease** in accordance with the guidance in this Subtopic as it would for any other leveraged lease.

ASU 2016-02 eliminates leveraged lease accounting for new leases on its effective date. That is, after the effective date, lessors account for all new leases, including those that would have qualified as leveraged leases under ASC 840, using the classification guidance in ASC 842.

A leveraged lease acquired after the effective date in a business combination or by a not-for-profit entity, that existed and was classified as a leveraged lease before the effective date, is grandfathered, and the acquirer continues to follow the recognition, measurement, presentation and disclosure guidance for leveraged leases that was carried forward to ASC 842-50. If the acquired leveraged lease is modified by the acquirer on or after the effective date of the new guidance, the acquired leveraged lease would be reclassified using the lease classification guidance in ASC 842. Refer to section 3.2, *Criteria for lease classification — lessors*, and section 11.4.5, *Leases previously classified as leveraged leases under ASC 840*.

If the only change in a leveraged lease as a result of the business combination is a change in the identity of the lessor (i.e., change from the name of the acquiree to the name of the acquirer), the change would not represent a lease modification because there is no change to the terms and conditions of a contract that results in a change in the scope of or consideration for the lease. As such, the classification of the leveraged lease would not change.

If the acquiree in a business combination is a lessor in a leveraged lease that was classified and accounted for under ASC 840 prior to the effective date of ASC 842, and the business combination occurred after the acquirer's effective date of ASC 842, the general guidance of ASC 805 also must be applied in assigning amounts to the net investment in the leveraged lease. The acquirer must determine the remaining net future cash flows and give appropriate recognition to the estimated future tax effects of such cash flows. Once this amount is determined, the net investment is broken down into its component parts (net rentals receivable, estimated residual value and unearned income, including the discount to adjust the other components to present value). Each component is then allocated a purchase price adjustment. Subsequent to the acquisition, the investment in the leveraged lease is accounted for by the acquirer in accordance with ASC 842-50 (refer to chapter 10, *Leveraged* leases, for further discussion on accounting for leveraged leases).

A detailed illustration of the accounting for a leveraged lease acquired in a business combination follows:

Excerpt from Accounting Standards Codification

Leases—Leveraged Lease Arrangements

Implementation Guidance and Illustrations

842-50-55-27

This Example illustrates one way that a lessor's investment in a leveraged lease might be valued by the acquiring entity in a business combination or an acquisition by a not-for-profit entity and the subsequent accounting for the investment in accordance with the guidance in this Subtopic. The elements of accounting and reporting illustrated for this Example are as follows:

a. Acquiring entity's cash flow analysis by years (see paragraph 842-50-55-29)

b. Acquiring entity's valuation of investment in the leveraged lease (see paragraph 842-50-55-30)

c. Acquiring entity's allocation of annual cash flow to investment and income (see paragraph 842-50-55-31)

d. Journal entry for recording allocation of purchase price to net investment in the leveraged lease (see paragraph 842-50-55-32)

e. Journal entries for the year ending December 31, 1984 (Year 10 of the lease) (see paragraph 842-50-55-33).

842-50-55-28

This Example has the following terms and assumptions.

Cost of leased asset (equipment)	$1,000,000
Lease term	15 years, dating from January 1, 1975
Lease rental payments	$90,000 per year (payable last day of each year)
Residual value	$200,000 estimated to be realized 1 year after lease termination
Financing:	
Equity investment by lessor	$400,000
Long-term non-recourse debt	$600,000, bearing interest at 9% and repayable in annual installments (on last day of each year) of $74,435.30
Depreciation allowable to lessor for income tax purposes	7-year asset depreciation range life using double-declining-balance method for the first 2 years (with the half-year convention election applied in the first year) and sum-of-years digits method for remaining life, depreciated to $100,000 salvage value
Lessor's income tax rate (federal and state)	50.4% (assumed to continue in existence throughout the term of the lease)
Investment tax credit	10% of equipment cost or $100,000 (realized by the lessor on last day of first year of lease)
Initial direct costs	For simplicity, initial direct costs have not been included in the illustration
Date of business combination	January 1, 1982
Tax status of business combination	Non-taxable transaction
Appropriate interest rate for valuing net-of-tax return on investment	4 ½%

842-50-55-29

Acquiring entity's cash flow analysis by years follows.

Year	(1) Gross Lease Rentals and Residual Value	(2) Depreciation (for Income Tax Purposes)	(3) Loan Interest Payments	(4) Taxable Income (Col. 1-2-3)	(5) Income Tax (Charges) (Col. 4 x 50.4%)	(6) Loan Principal Payments	(7) Annual Cash Flow (Col. 1-3+5-6)
8	$ 90,000	$ –	$ 37,079	$ 52,921	$ (26,672)	$ 37,357	$ (11,108)
9	90,000	–	33,717	56,283	(28,367)	40,719	(12,803)
10	90,000	–	30,052	59,948	(30,214)	44,383	(14,649)
11	90,000	–	26,058	63,942	(32,227)	48,378	(16,663)
12	90,000	–	21,704	68,296	(34,421)	52,732	(18,857)
13	90,000	–	16,957	73,043	(36,813)	57,478	(21,248)
14	90,000	–	11,785	78,215	(39,420)	62,651	(23,856)
15	90,000	–	6,145	83,855	(42,263)	68,290	(26,698)
16	200,000	100,000	–	100,000	(50,400)	–	149,600
Total	$ 920,000	$ 100,000	$ 183,497	$ 636,503	$ (320,797)	$ 411,988	$ 3,718

842-50-55-30

Acquiring entity's valuation of investment in the leveraged lease follows.

Cash Flow	Present Value at 4 ½% Net-of-Tax Rate
1. Rentals receivable (net of principal and interest on the nonrecourse debt) ($15,564.70 at the end of each year for 8 years)	$ 102,663
2. Estimated residual value ($200,000 realizable at the end of 9 years)	134,581
3. Future tax payments (various amounts payable over 9 years — see the table in paragraph 842-50-55-29)	(253,489)
Net present value	$ (16,245)

842-50-55-31

Acquiring entity's allocation of annual cash flow to investment and income follows (see footnote (a)).

	1	2	3	4	5	6
		Annual Cash Flow			Components of Income[b]	
Year	Net Investment at Beginning of Year	Total from Col. 7 of the Table in Paragraph 842-50-55-29	Allocated to Investment	Allocated to Income[a]	Pretax Income	Tax Effect of Pretax Income
8	$ (16,245)	$ (11,108)	$ (11,108)	$ –	$ –	$ –
9	(5,137)	(12,803)	(12,803)	–	–	–
10	7,666	(14,649)	(14,973)	324	5,530	(5,206)
11	22,639	(16,663)	(17,621)	958	16,353	(15,395)
12	40,260	(18,857)	(20,561)	1,704	29,087	(27,383)
13	60,821	(21,248)	(23,822)	2,574	43,937	(41,363)
14	84,643	(23,856)	(27,439)	3,583	61,160	(57,577)
15	112,082	(26,698)	(31,443)	4,745	80,995	(76,250)
16	143,525	149,600	143,525	6,075	103,698	(97,623)
Totals		$ 3,718	$ (16,245)	$ 19,963	$ 340,760	$ (320,797)

(a) Lease income is recognized as 4.233% of the unrecovered investment at the beginning of each year in which the net investment is positive. The rate is that rate which, if applied to the net investment in the years in which the net investment is positive, will distribute the net income (net cash flow) to those years.

(b) Each component is allocated among the years of positive net investment in proportion to the allocation of net income in column 4. Journal Entry 2 in paragraph 842-50-55-33 includes an example of this computation.

842-50-55-32

Illustrative journal entry for recording allocation of purchase price to net investment in the leveraged lease follows.

Rentals receivable (table in paragraph 842-50-55-29, total of column 1 minus residual value, minus totals of columns 3 and 6)	$ 124,515	
Estimated residual value (paragraph 842-50-55-28)	200,000	
Purchase price allocation clearing account (paragraph 840-50-55-30, present value)	16,245	
Unearned and deferred income (paragraph 842-50-55-30, present value, minus total of rentals receivable and estimated residual value)		$ 340,760

842-50-55-33

Illustrative journal entries for year ending December 31,19Y4 follows.

Third Year of Operation after the Business Combination
(Year 10 of the Lease)

Journal Entry 1		
Cash	$ 15,565	
Rentals receivable (table in paragraph 842-50-55-29, column 1 minus columns 3 and 6)		$ 15,565
Collection of year's net rental		
Journal Entry 2		
Unearned and deferred income	$ 5,530	
Income from leveraged leases (table in paragraph 842-50-55-31, column 5)		$ 5,530
Recognition of pretax income for the year allocated in the same proportion as the allocation of total income computed as follows:		
([$324 ÷ $19,963] × $340,760 = $5,530)		
Journal Entry 3		
Deferred taxes (table in paragraph 842-50-55-29, column 5, minus table in paragraph 842-50-55-31, column 6)	$ 25,008	
Income tax expense (table in paragraph 842-50-55-31, column 6)	5,206	
Cash (table in paragraph 842-50-55-29, column 5)		$ 30,214
To record payment of tax for the year		

8.6 Asset acquisition — lessor

The assessment of whether a purchase of a lease portfolio is a business combination (possibly resulting in goodwill) or an asset acquisition where the consideration paid is ascribed entirely to the acquired assets is based on the guidance in ASC 805. In an asset acquisition, the guidance in ASC 350-30-25 should be followed. Further discussion on determining whether an acquisition of a group of assets and activities should be accounted for as an asset acquisition or a business combination is included in section 2.1.3, *Definition of a business*, of our Financial reporting developments publication, *Business combinations*. Discussion of accounting for an asset acquisition is also included in Appendix A, *Accounting for asset acquisitions*, of our Financial reporting developments publication, *Business combinations*.

An entity that becomes a lessor as a result of an asset acquisition must reassess the assumed lease and classify the lease as an operating or a sales-type or direct finance lease in accordance with ASC 842-10-25-3 (refer to section 3.2, *Criteria for lease classification — lessors*). That is, a lessor that acquires an interest in a lease in an asset acquisition does not automatically retain the prior lease classification as is generally the case in a business combination.

If an entity acquires an asset and leases it back to the seller, the entity will apply the sale and leaseback guidance discussed in chapter 7, *Sale and leaseback transaction*, to determine whether the transaction is a purchase or a financing of the asset.

Note: *As part of its project to clarify certain aspects of the definition of a business, the FASB issued a proposal in November 2015 that would provide a more robust framework for analyzing when a set of transferred assets and activities (set) is a business. The proposal would (1) require that a business include at least one substantive process, (2) clarify that an acquisition in which substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets is not a business and (3) narrow the definition of outputs. In practice today, if revenues are generated immediately before and after a transaction (e.g., through a lease), the set is typically presumed to be a business. Requiring entities in this situation to further assess the substance of the processes they acquire likely would reduce the number of transactions accounted for as business combinations but may require entities to exercise more judgment than they do today. Readers should monitor developments on this proposal.*

8.7 Asset acquisition — lessee

As discussed in section 8.6, *Asset acquisition — lessor*, an entity would need to determine whether the group of assets and activities it acquired should be accounted for as a business combination or an asset acquisition, based on the definition of a business in ASC 805. In an asset acquisition, the guidance in ASC 350-30-25 should be followed. Further discussion on determining whether an acquisition of a group of assets and activities should be accounted for as an asset acquisition or a business combination is included in section 2.1.3, *Definition of a business*, of our Financial reporting developments publication, *Business combinations*. Discussion of accounting for an asset acquisition is also included in Appendix A, *Accounting for asset acquisitions*, of our Financial reporting developments publication, *Business combinations*.

An entity that becomes a lessee as a consequence of an asset acquisition must reassess the assumed lease and classify the lease as a finance or operating lease in accordance with ASC 842-10-25-2 (refer to section 3.1, *Criteria for lease classification — lessees*). That is, a lessee that acquires an interest in a lease (lessee) in an asset acquisition does not automatically retain the prior lease classification as generally is the case in a business combination.

9 Other considerations

9.1 Related party leasing transactions

Excerpts from Accounting Standards Codification

Master Glossary

Related Parties

Related parties include:

a. Affiliates of the entity

b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management

d. Principal owners of the entity and members of their immediate families

e. Management of the entity and members of their immediate families

f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests

g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Leases — Overall

Implementation Guidance and Illustrations

842-10-55-12

Leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases on the basis of the legally enforceable terms and conditions of the lease. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties.

Leases—Lessee

Disclosure

842-20-50-7

A lessee shall disclose lease transactions between related parties in accordance with paragraphs 850-10-50-1 through 50-6.

Leases—Lessor

Disclosure

842-30-50-4

A lessor shall disclose any lease transactions between related parties (see Topic 850 on related party disclosures).

ASC 842 requires lessees and lessors to classify and account for leases between related parties on the basis of the legally enforceable terms and conditions of the lease (i.e., in the same manner as leases between unrelated parties).

Under ASC 842, lessees and lessors are required to apply the disclosure requirements for related party transactions in accordance with ASC 850, *Related Party Disclosures*. These requirements include disclosing the nature of the relationships and a description of the transactions, including information deemed necessary to understand the effects of the transactions on the financial statements. Additionally, these disclosures should not imply that a transaction is at arm's length unless such an assertion can be substantiated.

9.2 Leases involving variable interest entities

ASC 810 includes provisions related to the consolidation of certain entities that have (1) an insufficient amount of equity for the entity to finance its activities without additional subordinated financial support provided by any parties, (2) a group of equity owners that do not have the power to direct the entity's activities that most significantly impact the entity's economic performance or (3) equity that does not absorb the entity's losses or receive the entity's benefits.

Examples of arrangements that may involve variable interest entities and, accordingly, may require the application of the Variable Interest Model's provisions in ASC 810 include:

- Build-to-suit arrangements
- Leases that include lessee guarantees of asset values
- Leases that include lessee purchase options
- Sale and leaseback transactions
- Enhanced Equipment Trust Certificates
- Sales of property subject to operating leases

To determine whether a lease arrangement involves a variable interest entity, refer to our Financial reporting developments publication, *Consolidation and the Variable Interest Model — Determination of a controlling financial interest*, for further guidance.

10 Leveraged leases

10.1 Introduction and grandfathering

Excerpt from Accounting Standards Codification

Master Glossary

Leveraged Lease

From the perspective of a **lessor**, a **lease** that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the **commencement date** is before the effective date.

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

Leases previously classified as **leveraged leases** under Topic 840

z. For leases that were classified as **leveraged leases** in accordance with Topic 840, and for which the commencement date is before the effective date, a lessor shall apply the requirements in Subtopic 842-50. If a leveraged lease is modified on or after the effective date, it shall be accounted for as a new lease as of the effective date of the modification in accordance with the guidance in Subtopics 842-10 and 842-30.

  1. A lessor shall apply the pending content that links to this paragraph to a leveraged lease that meets the criteria in (z) that is acquired in a business combination or an **acquisition by a not-for-profit entity** on or after the effective date.

Leases — Leveraged Lease Arrangements

Scope and Scope Exceptions

842-50-15-1

This Subtopic addresses accounting for **leases** that meet the criteria in transition paragraph 842-10-65-1(z). If a **lessee** exercises an option to extend a lease that meets the criteria in transition paragraph 842-10-65-1(z) that it was not previously reasonably assured of exercising, the exercise of that option shall be considered a **lease modification** as described in paragraph 842-10-65-1(z).

ASU 2016-02 eliminates leveraged lease accounting for new leases on its effective date. That is, subsequent to the effective date, lessors account for all new leases, including those that would have qualified as leveraged leases under ASC 840, using the classification criteria discussed in section 3.2, *Criteria for lease classification — lessors*, (i.e., sales-type, direct financing or operating). For such leases, entities apply other relevant US GAAP (e.g., ASC 740, *Income Taxes*, ASC 470) to account for the non-lease components of such transactions.

Leveraged lease arrangements that exist before the effective date (i.e., the lease has commenced before the effective date) are grandfathered and therefore continue to follow the existing recognition, measurement, presentation and disclosure guidance for leveraged leases that was carried forward to ASC 842-50. Leases of to-be-constructed assets that qualified to be leveraged leases at lease inception prior to the effective date under ASC 840 but are not completed (i.e., the lease has not commenced) prior to the effective date would not be grandfathered.

If an existing leveraged lease is modified on or after the effective date of ASC 842, the existing leveraged lease is required to be reclassified as a sales-type, direct financing or operating lease, as applicable, using the lease classification guidance in ASC 842. Refer to section 3.2, *Criteria for lease classification — lessors*, and section 11.2, *Transition*. In that case, there would be no basis to net the remaining non-recourse debt balance with the lease receivable (if any), and any deferred tax balances would need to be adjusted as required under ASC 740 to comply with that guidance.

In addition, if a lessee exercises an option to extend a leveraged lease on or after the effective date of ASC 842 that it was not previously reasonably assured of exercising (i.e., under ASC 840, the renewal option was not included in the original accounting lease term for purposes of classifying the lease at inception), the exercise of that option is accounted for as a lease modification, and the lease no longer qualifies for leveraged lease accounting and is instead accounted for under ASC 842. Refer to section 5.6, *Lease modifications*.

10.1.1 Leveraged lease acquired in a business combination or by a not-for-profit entity

Refer to section 8.5, *Leveraged lease acquired in a business combination or by a not-for-profit entity*, for the discussion of a leveraged lease acquired in a business combination or by a not-for-profit entity that exists before the effective date of ASC 842.

10.2 Definition of a leveraged lease

Excerpt from Accounting Standards Codification

Leases — Leveraged Lease Arrangements

Recognition

842-50-25-1

A **lessor** shall record its investment in a **leveraged lease**. The net of the balances of the following accounts as measured in accordance with this Subtopic shall represent the lessor's initial and continuing investment in leveraged leases:

a. Rentals receivable

b. Investment-tax-credit receivable

c. **Estimated residual value** of the leased asset

d. Unearned and deferred income.

Prior to the effective date of ASC 842 (e.g., 1 January 2019 for a calendar-year entity that did not early adopt ASU 2016-02), a lease was a leveraged lease if it had all of the following characteristics, at the inception of the lease:

- It met the criteria for a direct financing lease in ASC 840-10-25-43(b).
- It involved at least three parties: a lessee, a long-term creditor and a lessor (commonly referred to as the equity participant).
- The financing provided by the long-term creditor was non-recourse as to the general credit of the lessor. The amount of the financing was sufficient to provide the lessor with "substantial leverage" in the transaction. ASC 840 did not provide specific guidance on what is "substantial leverage," but the illustration of leveraged lease accounting in ASC 842-50-55-11 (formerly ASC 840-30-55-14) assumes 60% non-recourse financing by the third-party lenders and 40% investment by the equity participant (lessor).

- The lessor's net investment declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination.

If all of these characteristics existed, the lease would be accounted for by the lessor as a leveraged lease. All other leases were accounted for as sales-type, direct financing or operating leases by the lessor, as appropriate. Leveraged lease treatment is not relevant to the lessee and prohibited subsequent to the effective date of ASC 842 for the lessor except for the grandfathered leveraged leases, which were discussed in section 10.1, *Introduction and grandfathering*.

Special accounting rules were provided for leveraged leases using the "investment with separate phases method" (refer to section 10.3.2, *Recording income on a leveraged lease*) because of the unique combination of characteristics of such leases that produces an overall economic effect that is distinct from that of other transactions.

In a typical leveraged lease, lessee rental payments may be equal to or exceed the non-recourse debt service payments in all periods. Those typical leveraged lease transactions generate depreciation deductions for income tax purposes that exceed the net of rental income and interest expense and result in tax savings to lessors that have other taxable income during the early periods of the lease term. Those tax savings allow the lessor to recover its equity investment quickly, leaving excess cash in the middle periods but requiring reinvestment of cash in the later periods to pay deferred taxes as they become due.

10.2.1 Leveraged lease involving an existing asset of a regulated entity

Excerpt from Accounting Standards Codification

Leases — Leveraged Lease Arrangements

Implementation Guidance and Illustrations

842-50-55-1

Although the carrying amount of an asset acquired previously may not differ significantly from its **fair value**, it is unlikely that the two will be the same. However, regulated utilities have argued that the carrying amounts of certain of their assets always equal the fair value based on the utility's ability to recover that cost in conjunction with a franchise to sell a related service in a specified area. That argument is not valid when considering the value of the asset to a third-party purchaser that does not own that franchise.

Although the FASB retained this implementation guidance in ASC 842, it relates to the initial classification of a leveraged lease at its inception under ASC 840 with a commencement date prior to the effective date and has no impact on new leases entered into by regulated or non-regulated entities subsequent to the effective date. All leveraged leases previously classified under ASC 840 whether regulated or non-regulated entities required that the carrying value and fair value of the asset at inception be equal to qualify as direct finance leases and, therefore, a leveraged lease.

10.3 Accounting for leveraged leases

Excerpt from Accounting Standards Codification

Leases — Leveraged Lease Arrangements

Initial Measurement

842-50-30-1

A **lessor** shall initially measure its investment in a **leveraged lease** net of the nonrecourse debt (as discussed in paragraph 842-50-25-1). The net of the balances of the following accounts shall represent the initial and continuing investment in leveraged leases:

a. Rentals receivable, net of that portion of the rental applicable to principal and interest on the nonrecourse debt.

b. A receivable for the amount of the investment tax credit to be realized on the transaction.

c. The **estimated residual value** of the leased asset. The estimated residual value shall not exceed the amount estimated at **lease inception** except if the **lease** agreement includes a provision to escalate **minimum lease payments** either for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value (such as general price levels) during the construction or preacquisition period. In that case, the effect of any increases that have occurred shall be considered in the determination of the estimated residual value of the **underlying asset** at lease inception.

d. Unearned and deferred income consisting of both of the following:

   1. The estimated pretax lease income (or loss), after deducting initial direct costs, remaining to be allocated to income over the **lease term**.

   2. The investment tax credit remaining to be allocated to income over the lease term.

Subsequent Measurement

842-50-35-2

The investment in **leveraged leases** minus deferred taxes arising from differences between pretax accounting income and taxable income shall represent the **lessor's** net investment in leveraged leases for purposes of computing periodic net income from the leveraged lease. Given the original investment and using the projected cash receipts and disbursements over the term of the **lease**, the rate of return on the net investment in the years in which it is positive shall be computed. The rate is that rate that, when applied to the net investment in the years in which the net investment is positive, will distribute the net income to those years and is distinct from the interest rate implicit in the lease. In each year, whether positive or not, the difference between the net cash flow and the amount of income recognized, if any, shall serve to increase or reduce the net investment balance. The use of the term *years* is not intended to preclude application of the accounting prescribed in this paragraph to shorter accounting periods.

842-50-35-3

The net income (or loss) that a lessor recognizes on a leveraged lease shall be composed of the following three elements:

a. Pretax lease income (or loss)

b. Investment tax credit

c. Tax effect of pretax lease income (or loss).

842-50-35-4

The pretax lease income (or loss) and investment tax credit elements shall be allocated in proportionate amounts from the unearned and deferred income included in the lessor's net investment (as described in paragraph 842-50- 30-1(d)). The tax effect of the pretax lease income (or loss) recognized shall be reflected in tax expense for the year. The tax effect of the difference between pretax accounting income (or loss) and taxable income (or loss) for the year shall be charged or credited to deferred taxes.

842-50-35-5

If, at any time during the **lease term** the application of the method prescribed in this Subtopic would result in a loss being allocated to future years, that loss shall be recognized immediately. This situation might arise in circumstances in which one of the important assumptions affecting net income is revised (see paragraphs 842-50-35-6 through 35-15).

10.3.1 Determining the leveraged lease investment

The net investment reflected in the lessor's balance sheet, which increases or decreases by the amount of the difference between each period's net cash flow and the income recognized, consists of:

- Rentals receivable, net of the portion applicable to principal and interest on the related non-recourse debt
- A receivable for the investment tax credit until it is realized (the investment tax credit was repealed by the Tax Reform Act of 1986)
- The estimated residual value of the leased asset
- Unearned income (the remaining amount of estimated pretax lease income or loss and investment tax credit to be allocated to income over the lease term, after deducting initial direct costs) (refer to section 2.6, *Initial direct costs*, for entities that do not elect the package of practical expedients described in section 11.2.2, *Transition practical expedients*)

The accounting for deferred taxes in a leveraged lease is specifically excluded from the general accounting for income taxes in ASC 740 and computed in accordance with guidance provided in ASC 842 (specifically ASC 842-50-30-1, and ASC 842-50-35-2 through 35-4). Although deferred taxes are included in the net investment in the leveraged lease for purposes of computing income (refer to section 10.3.2, *Recording income on a leveraged lease*), deferred taxes relating to leveraged leases are shown on the balance sheet with other deferred tax items (i.e., deferred taxes computed in accordance with ASC 740) and not netted against the lease investment on the face of the balance sheet.

10.3.2 Recording income on a leveraged lease

The "investment with separate phases method," which is required to be used to account for leveraged leases, recognizes lease income at a level rate of return on the net investment in those periods in which the net investment at the beginning of the period is a positive amount. This method and the FASB's rationale for requiring its use are described in the basis for conclusions for Statement 13 (paragraph 109(c) of Statement 13). Typically, the net investment in a leveraged lease follows this pattern:

Early periods	Positive, based on initial investment in leased property
Middle periods	Negative, due mainly to large income tax deductions from accelerated depreciation and high interest payments on the non-recourse debt
Later periods	Positive, as accelerated depreciation reverses and interest payments diminish
Final period	Zero, as residual value is realized on sale of the property

When the FASB originally deliberated Statement 13, it rejected the theory of accruing so-called "secondary earnings" (earnings on temporary funds to be reinvested) over the lease term. Instead, in its basis for conclusions, the FASB stated these earnings should be recorded in income only when they occur because this is the economic reality of the transaction and because anticipation of future interest on funds expected to be held temporarily has no support in present generally accepted accounting principles (paragraph 109(d) of Statement 13).

The determination of the net investment and the amount of income recognized are interdependent. Income is recognized using a rate calculated by a trial and error process, which is repeated until a rate is selected, which develops a total amount allocated to income that is equal to the net cash flow. As a practical matter, a computer program normally would be used to calculate this rate.

Income from a leveraged lease is segregated into three components: pretax lease income, tax effect of the pretax lease income and investment tax credit. The amount of each component to be recognized each accounting period is based on the ratio of the after-tax net income for the period (as computed based on a Multiple Investment Sinking Fund yield) to the total after-tax net income from the lease times the total pretax lease income, total tax effect and total investment tax credit. A loss would be recognized immediately for any projected excess of gross cash disbursements, excluding the initial investment, over the gross cash receipts from a leveraged lease.

Refer to section 2.9.2, *Lessor accounting for variable lease payments*, for discussion of lessor accounting for contingent rent.

10.3.3 Accounting for income taxes related to leveraged leases

Excerpt from Accounting Standards Codification

Leases — Leveraged Lease Arrangements

Other Presentation Matters

842-50-45-1

For purposes of presenting the investment in a **leveraged lease** in the **lessor's** balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment). In the income statement or the notes to that statement, separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period.

842-50-45-2

Integration of the results of income tax accounting for **leveraged leases** with the other results of accounting for income taxes under Topic 740 on income taxes is required if deferred tax credits related to leveraged leases are the only source (see paragraph 740-10-30-18) for recognition of a tax benefit for deductible temporary differences and carryforwards not related to leveraged leases. A valuation allowance is not necessary if deductible temporary differences and carryforwards will offset taxable amounts from future recovery of the net investment in the leveraged lease. However, to the extent that the amount of deferred tax credits for a leveraged lease as determined in accordance with this Subtopic differs from the amount of the deferred tax liability related to the leveraged lease that would otherwise result from applying the guidance in Topic 740, that difference is preserved and is not a source of taxable income for recognition of the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards.

842-50-45-3

This Subtopic requires that the tax effect of any difference between the assigned value and the tax basis of a leveraged lease at the date of a business combination or an **acquisition by a not-for-profit entity** shall not be accounted for as a deferred tax credit. Any tax effects included in unearned and deferred income as required by this Subtopic shall not be offset by the deferred tax consequences of other temporary differences or by the tax benefit of operating loss or tax credit carryforwards. However, deferred tax credits that arise after the date of a combination shall be accounted for in the same manner as for leveraged leases that were not acquired in a combination.

Implementation Guidance and Illustrations

842-50-55-4

The accounting for income taxes related to **leveraged leases** set forth in this Subtopic is not consistent with the guidance in Topic 740 on income taxes.

842-50-55-5

The integration of the results of accounting for income taxes related to leveraged leases with the other results of accounting for income taxes as required by Topic 740 is an issue if all of the following exist:

a. The accounting for a leveraged lease requires recognition of deferred tax credits.

b. The guidance in Topic 740 limit the recognition of a tax benefit for deductible temporary differences and carryforwards not related to the leveraged lease.

c. Unrecognized tax benefits in this paragraph could offset taxable amounts that result from future recovery of the net investment in the leveraged lease.

Deferred income taxes in leveraged lease transactions are accounted for under specific guidance provided in ASC 842-50 and not the general guidance related to accounting for income taxes provided in ASC 740. Income tax rates and the projected timing of income tax cash flows are important assumptions in determining the rate of return on a leveraged lease. If tax rates change and that change has an impact on the total net income from the lease or if the projected timing of income tax cash flows is revised, lessors must recalculate the allocation of income on the leveraged lease (refer to section 10.3.4, *Change in leveraged lease assumptions*). In addition, ASC 842-50-30-2 provides specific guidance for allocating consideration in a business combination to acquired leveraged leases (refer to section 8.5, *Leveraged lease acquired in a business combination or by a not-for-profit entity*, for further discussion). Although the accounting for income taxes related to leveraged leases in ASC 842 is not consistent with the guidance related to accounting for income taxes in ASC 740, as indicated in the Basis for Conclusions for Statement 109, when deliberating the general guidance related to accounting for income taxes, the FASB decided not to re-open the subject of leveraged lease accounting (paragraph 126 of Statement 109).

Integration of leveraged lease income tax accounting and accounting for other temporary differences is required when deferred tax credits related to leveraged leases are the only source of taxable income when assessing the need for a valuation allowance for deferred tax assets not related to leveraged leases. A valuation allowance is not required when the deductible temporary differences and carryforwards will offset taxable amounts from the future recovery of the net investment in the leveraged lease. However, to the extent the amount of leveraged-lease deferred tax credits as determined in accordance with the methods prescribed by the leveraged lease guidance found in ASC 842 differs from the amount of the deferred tax liability that would result from applying the general guidance for income taxes in ASC 740, that difference is preserved and is not considered a source of taxable income for purposes of recognizing the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards. In other words, the taxable temporary difference that would result from applying the general guidance for deferred income taxes in ASC 740 is all that can be considered in evaluating the need for a valuation allowance.

The following illustration, although somewhat simplified, depicts the requirement to preserve the difference between deferred tax balances that result from applying the special guidance for accounting for deferred income taxes in ASC 842 applicable to leveraged leases and those that would result from applying the general provisions for accounting for income taxes in ASC 740.

Illustration 34 — Integration of leveraged lease income tax accounting and accounting for other temporary differences

Assume that a company entered a leveraged lease prior to the effective date of ASC 842 and when tax rates were 45%, and tax rates are subsequently reduced to 35% (at the end of year 2). At the end of year 2, deferred tax effects related to the leveraged lease are computed as follows:

	ASC 842	ASC 740
Net rentals receivable	$ 2,000	$ 2,000
Tax basis	(1,500)	(1,500)
Taxable temporary difference	500	500
Tax rate	40%[1]	35%
Deferred tax liability	$ 200	$ 175

Also assume that at the end of year 2, the company has a deductible temporary difference of $1,500 scheduled to reverse in year 6 arising from a warranty accrual. Absent consideration of the deferred tax credits related to the leveraged lease, the weight of available evidence indicates that a valuation allowance is required for the entire $525 deferred tax asset ($1,500 x 35%). In this case, a valuation allowance would be required for $350 ($525 — $175), and a net deferred tax benefit of $175 is recognized. Although the recorded deferred tax credit is $200, $25 of that credit relates to special tax recognition provisions related to leveraged lease transactions, and that difference should be preserved and is not available for offsetting.

[1] Derived. Deferred tax effects computed under ASC 842, adjusting for the change in total net income from the lease as a result of the decrease in tax rates from 45% to 35%.

10.3.4 Change in leveraged lease assumptions

Excerpt from Accounting Standards Codification

Leases — Leveraged Lease Arrangements

Subsequent Measurement

842-50-35-6

Any **estimated residual value** and all other important assumptions affecting estimated total net income from the **leveraged lease** shall be reviewed at least annually. The rate of return and the allocation of income to positive investment years shall be recalculated from **lease inception** following the method described in paragraphs 842-50-35-2 through 35-4 and using the revised assumption if, during the **lease term**, any of the following conditions occur:

a. The estimate of the residual value is determined to be excessive and the decline in the residual value is judged to be other than temporary.

b. The revision of another important assumption changes the estimated total net income from the **lease**.

c. The projected timing of the income tax cash flows is revised.

842-50-35-7

The **lessor** shall update all assumptions used to calculate total and periodic income if the lessor is performing a recalculation of the leveraged lease. That recalculation shall include actual cash flows up to the date of the recalculation and projected cash flows following the date of recalculation.

842-50-35-8

The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed. The gain or loss shall be recognized as follows:

a. The pretax gain or loss shall be included in income from continuing operations before income taxes in the same line item in which leveraged lease income is recognized.

b. The tax effect of the gain or loss shall be included in the income tax line item.

c. An upward adjustment of the estimated residual value (including any guaranteed portion) shall not be made.

842-50-35-9

The projected timing of income tax cash flows generated by the leveraged lease is an important assumption and shall be reviewed annually, or more frequently, if events or changes in circumstances indicate that a change in timing has occurred or is projected to occur. The income effect of a change in the income tax rate shall be recognized in the first accounting period ending on or after the date on which the legislation effecting a rate change becomes law.

842-50-35-10

A revision of the projected timing of the income tax cash flows applies only to changes or projected changes in the timing of income taxes that are directly related to the leveraged lease transaction. For example, a change in timing or projected timing of the tax benefits generated by a leveraged lease as a result of any of the following circumstances would require a recalculation because that change in timing is directly related to that lease:

a. An interpretation of the tax law

b. A change in the lessor's assessment of the likelihood of prevailing in a challenge by the taxing authority

c. A change in the lessor's expectations about settlement with the taxing authority.

842-50-35-11

In contrast, as discussed in paragraph 842-50-35-20, a change in timing of income taxes solely as a result of an alternative minimum tax credit or insufficient taxable income of the lessor would not require a recalculation of a leveraged lease because that change in timing is not directly related to that lease. A recalculation would not be required unless there is an indication that the previous assumptions about total after-tax net income from the leveraged lease were no longer valid.

842-50-35-12

Tax positions shall be reflected in the lessor's initial calculation or subsequent recalculation on the recognition, measurement, and derecognition criteria in paragraphs 740-10-25-6, 740-10-30-7, and 740-10-40-2. The determination of when a tax position no longer meets those criteria is a matter of individual facts and circumstances evaluated in light of all available evidence.

842-50-35-13

If the lessor expects to enter into a settlement of a tax position relating to a leveraged lease with a taxing authority, the cash flows following the date of recalculation shall include projected cash flows between the date of the recalculation and the date of any projected settlement and a projected settlement amount at the date of the projected settlement.

842-50-35-14

The recalculation of income from the leveraged lease shall not include interest or penalties in the cash flows from the leveraged lease.

842-50-35-15

Advance payments and deposits made with a taxing authority shall not be considered an actual cash flow of the leveraged lease; rather, those payments and deposits shall be included in the projected settlement amount.

When important assumptions are changed that affect estimated total net income from the lease, including any other than temporary decline in the estimated residual value or the projected timing of income tax cash flows is revised, the allocation of income to periods in which the net investment is positive is recomputed from the inception of the lease. The net investment is then adjusted to equal the recalculated balance and a gain or loss is recognized. Upward adjustments in estimated residual value are prohibited. Sections 10.3.4.1 through 10.3.4.6 provide an overview of common changes in assumptions impacting leveraged leases.

As a reminder, a change in leveraged lease assumptions (i.e., assumptions affecting estimated total net income from the leveraged lease) only is not a modification to a leveraged lease. Therefore, the lessor would continue to apply leveraged lease accounting. Only a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (e.g., a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term) is considered as a modification. If an existing leveraged lease is modified on or after the effective date of ASC 842, the lessor is required to reassess the contract (e.g., whether the arrangement contains a lease, lease classification) using the lease classification guidance in ASC 842. Refer to section 5.6, *Lease modifications*. As a result of the modification, leveraged lease accounting is no longer applicable, and the lessor would prospectively apply sales-type, direct financing or operating lease accounting as applicable (assuming after the modification, the arrangement still contains a lease). Upon modification, there would be no basis to net the remaining non-recourse debt balance with a lease receivable, and any deferred tax balances would need to be adjusted as required under ASC 740 to comply with that guidance.

As discussed in section 10.1, *Introduction and grandfathering*, if a lessee exercises an option to extend a leveraged lease on or after the effective date of ASC 842 that it was not previously reasonably assured of exercising (i.e., under ASC 840, the renewal option was not included in the original accounting lease term for purposes of classifying the lease at inception), the exercise of that option is accounted for as a lease modification, and the lease no longer qualifies for leveraged lease accounting and is instead accounted for under ASC 842. Refer to section 5.6, *Lease modifications*.

10.3.4.1 Impact of change in effective tax rate

The lessor's income tax rate is an important assumption in accounting for a leveraged lease. Accordingly, the income effect of a change in the income tax rate should be recognized in the first accounting period ending on or after the date on which the legislation effecting a rate change becomes law. If accounting for the effect on leveraged leases of the change in tax rates results in a significant variation from the customary relationship between income tax expense and pretax accounting income and the reason for that variation is not otherwise apparent, the reason for that variation should be disclosed as required by ASC 842-50-50-3 (refer to section 10.4, *Disclosures*).

All components of a leveraged lease must be recalculated from inception of the lease based on the revised after-tax cash flows arising from the change in the tax law, including revised tax rates (including the impact of alternative minimum tax (AMT), refer to section 10.3.4.2, *Impact of AMT on leveraged* *lease accounting*) and repeal of the investment tax credit. The difference between the amounts originally recorded and the recalculated amount would be included as a cumulative catch-up in income of the period in which the tax law is enacted.

10.3.4.2 Impact of AMT on leveraged lease accounting

Excerpt from Accounting Standards Codification

Leases — Leveraged Lease Arrangements

Subsequent Measurement

842-50-35-16

An entity shall include assumptions about the effect of the alternative minimum tax, considering its consolidated tax position, in **leveraged lease** computations.

842-50-35-17

Any difference between alternative minimum tax depreciation and the tax depreciation assumed in the leveraged lease or between income recognition for financial reporting purposes and alternative minimum tax income could, depending on the **lessor's** overall tax situation, result in alternative minimum tax or the utilization of alternative minimum tax credits.

842-50-35-18

If alternative minimum tax is paid or an alternative minimum tax credit is utilized, the total cash flows from the leveraged lease could be changed and the lessor's net investment in the leveraged lease and income recognition would be affected.

842-50-35-19

If a change to the tax assumptions changes total estimated after-tax net income, the rate of return on the leveraged lease shall be recalculated from inception, the accounts constituting the lessor's net investment shall be adjusted, and a gain or loss shall be recognized in the year in which the assumption is changed.

842-50-35-20

However, an entity whose tax position frequently varies between alternative minimum tax and regular tax shall not be required to recalculate the rate of return on the leveraged lease each year unless there is an indication that the original assumptions regarding total after-tax net income from the **lease** are no longer valid. In that circumstance, the entity shall be required to revise the leveraged lease computations in any period in which total net income from the leveraged lease changes because of the effect of the alternative minimum tax on cash flows for the lease.

The lessor's income tax rate and the amount of taxes paid or tax benefits received are important assumptions in a leveraged lease calculation. Any difference between AMT depreciation and the tax depreciation assumed in the leveraged lease or between income recognition for financial reporting purposes and AMT income could, depending on the lessor's overall tax situation, result in AMT or the utilization of AMT credits. In the circumstances in which AMT is paid or an AMT credit is utilized, the total cash flows from the leveraged lease could be changed, and the lessor's net investment in the leveraged lease and income recognition would be affected.

An entity should include assumptions regarding the effect of the AMT, considering its consolidated tax position, in leveraged lease computations. An entity whose tax position frequently varies between AMT and regular tax would not be required to recompute each year, unless there was an indication that the original assumptions regarding total after-tax net income from the lease were no longer valid. In that circumstance, the entity would be required to revise the leveraged lease computations in any period in which management believes that total net income from the leveraged lease will be affected due to the effect of the AMT on cash flows for the lease. In addition, if the lessor is required to recompute its leveraged lease income for a change in assumption other than solely AMT, that recalculation shall include actual cash flows up to the date of the recalculation and projected cash flows following the date of recalculation, including consideration of projected AMT impact.

10.3.4.3 Impact of change or projected change in the timing of cash flows relating to income taxes generated by a leveraged lease transaction

The timing of the cash flows relating to income taxes generated by a leveraged lease is an important assumption that affects the periodic income recognized by the lessor for that lease. Because tax benefits in a leveraged lease are often realized in the early periods of the lease, disproportionately more income from the lease is typically allocated to earlier periods. For certain leveraged lease transactions, the Internal Revenue Service (IRS) has challenged both the ability to accelerate the timing of tax deductions and the amounts of those deductions. The settlement in a challenge from the IRS may result in a significant change in the timing of the realization of tax benefits, which changes the timing of the estimated after-tax cash flows from the leveraged lease (and therefore the timing of income recognition from the lease) and reduces the overall expected rate of return, although it does not change the estimated total net income. The settlement may also result in interest and penalties that would change the estimated total net income from the lease.

Lessors are required to review the projected timing of income tax cash flows generated by a leveraged lease annually, or more frequently if events or changes in circumstances indicate that a change in timing has occurred or is projected to occur. If the projected timing of the income tax cash flows is revised, the rate of return and the allocation of income to positive investment years should be recalculated from the inception of the lease based on the revised projected cash flows, including any projected settlements and an update of all assumptions used. The recalculation should include the actual or expected changes and an update of all assumptions in timing of all cash flows, including those due to AMT credits or net operating loss carryforwards, if significant. The recalculation should not include interest or penalties in the cash flows from the leveraged lease. Any advance payments or deposits made with a taxing authority should not be considered an actual cash flow of the leveraged lease; rather, those payments and deposits should be included in the projected settlement amount. The difference between the amounts originally recorded and the recalculated amount should be recognized as a gain or loss in income from continuing operations in the year in which the assumption is changed in the same line item in which leveraged lease income is recognized. The tax effect of the recognized gain or loss should be included in the income tax line item (ASC 842-50-35-9 through 35-15).

The following example illustrates how a lessor would include advance payments in a recalculation of a leveraged lease:

Excerpt from Accounting Standards Codification

Leases — Leveraged Lease Arrangements

Implementation Guidance and Illustrations

842-50-55-24

This Example illustrates how (in accordance with the guidance in paragraph 842-50-35-13 and other paragraphs) a lessor would include advance payments and deposits in a recalculation of a leveraged lease resulting from a determination by the lessor that it would enter into a settlement of a tax position arising from a leveraged lease.

842-50-55-25

This Example assumes that the lessor has concluded that the position originally taken on the tax return would meet the more-likely-than-not threshold in Subtopic 740-10 on income taxes. It also assumes that the lessor would conclude that the estimate of $50 for the projected lease-in, lease-out settlement is consistent with the measurement guidance in that Subtopic.

842-50-55-26

A lessor makes an advance payment of $25 on July 1, 2007, $10 of which is estimated to be associated with issues arising from a lease-in, lease-out transaction. On July 1, 2007, the lessor changes its assumption about the timing of the tax cash flows and projects a settlement with the Internal Revenue Service on September 1, 2009. The projected settlement would result in a payment to the taxing authority of $125 of which $50 is associated with the lease-in, lease-out transaction. On July 1, 2007, when the lessor recalculates the leveraged lease, the lessor would include a $50 cash flow on September 1, 2009, as a projected outflow in the leveraged lease recalculation.

Tax positions should be reflected in a lessor's initial calculation and/or subsequent recalculation based on the recognition, derecognition and measurement criteria in ASC 740-10 (refer to our Financial reporting developments publication, *Income taxes,* for further discussion).

10.3.4.4 Impact of a change in estimated residual value

As noted in ASC 842-50-35-8(c), an upward adjustment of the estimated residual value is prohibited. Transactions in which a lessor has sold an interest in any appreciation in the residual value to a third-party investor have raised the question as to whether reflecting such a sale is essentially recognizing appreciation in the residual value. The following example illustrates.

Lessor X is the equity participant in a leveraged lease. When the leveraged lease was originally recorded, the residual value was determined to be $100. A group of speculators now pays $30 for an option for any excess of the residual value over $100. Either the speculators would pay the $100 to Lessor X at the end of the lease and sell the asset itself, or Lessor X would sell the asset and all proceeds in excess of $100 would be paid to the speculators. The question concerns how to account for the $30 when it is received. The following three alternatives have been identified:

1. Treat the $30 cash inflow as a change in lease assumptions in accordance with ASC 842-50-35-6 through 35-8 and recalculate the cash flows from the leveraged lease since inception by including the $30 received in the current year with no change in the $100 residual reflected at the end of the lease. Any income tax expense related to the $30 option premium should also be reflected in the revised cash flow in the period in which it is subject to income tax. A cumulative catch-up adjustment would be recorded in the current year resulting from the difference between cumulative income to date under the revised calculation and the old calculation.

2. Revise the leveraged lease calculations as in alternative 1 above with the exception that the calculation would reflect a $70 residual at the end of the lease term and $30 of proceeds received when paid by the speculators.

3. Record the $30 as a deferred credit to be taken into income at the end of the lease as additional sales proceeds for the residual.

Although merits exist for each of the three alternatives, assuming that the equity participant has no new obligations with respect to the disposition of the residual at the end of the lease (i.e., merely providing speculator with any upside benefit when it is realized), we believe that alternative 1 most closely follows the leveraged lease model. The sale of the upward appreciation of the residual does not represent an upward adjustment of the residual value. Instead, it represents the monetization of a previously unvalued and unrecorded asset.

If, in the above example, the lessor had sold the residual value, alternative 2 would best approximate the accounting for such a revision in the timing of cash flows associated with that transaction within the leveraged lease model.

10.3.4.5 Refinancing of non-recourse debt

The interest rate of the non-recourse debt in a leveraged lease transaction is an important assumption in the leveraged lease model. If, as a result of refinancing non-recourse debt (in a lease that is currently classified as a leveraged lease), the lessor's cash flow assumptions change, the revised cash flows under the refinanced debt should be reflected and a cumulative catch-up adjustment recorded as noted in section 10.3.4, *Change in leveraged lease assumptions*.

If the lessor refinances the non-recourse debt subsequent to the inception of the lease and either borrowed an amount greater than the original non-recourse loan principal at the inception of the lease or greater than the existing non-recourse loan principal at the time of the refinancing, we believe it would be inappropriate to treat the borrowings in excess of the outstanding principal at the time of the refinancing as part of the leveraged lease. Instead, such additional borrowings should be recorded separately in the financial statements as opposed to being offset in the net investment in leveraged lease.

10.3.4.6 Changes in terms and conditions of a leveraged lease

As discussed in section 10.1, *Introduction and grandfathering*, a lessor and a lessee may enter into an amendment to modify the terms and conditions of an existing leveraged lease, or the lessee may exercise an option to extend a leveraged lease that it was not previously reasonably assured of exercising. As indicated in ASC 842-10-65-1(z), once an existing leveraged lease is modified on or after the effective date of ASC 842, the existing leveraged lease is accounted for as a new lease as of the effective date of the modification in accordance with the guidance in ASC 842-10 and ASC 842-30. As a result, the leveraged lease classification and accounting is no longer applicable to the modified lease.

10.3.5 Impact of delayed equity investment on leveraged lease accounting

Excerpt from Accounting Standards Codification

Master Glossary

Delayed Equity Investment

In **leveraged lease** transactions that have been structured with terms such that the **lessee's** rent payments begin one to two years after **lease inception**, equity contributions the **lessor** agrees to make (in the lease agreement or a separate binding **contract**) that are used to service the nonrecourse debt during this brief period. The total amount of the lessor's contributions is specifically limited by the agreements.

Leases — Leveraged Lease Arrangements

Implementation Guidance and Illustrations

842-50-55-2

A **delayed equity investment** frequently obligates the **lessor** to make up the shortfall between rent and debt service in the first several years of the transaction. The type of recourse debt resulting from the delayed equity investment does not contradict the notion of nonrecourse and, therefore, does not preclude **leveraged lease** accounting as long as other requirements of leveraged lease accounting are met. The lessor's related obligation should be recorded as a liability at present value at **lease inception**.

842-50-55-3

Recognition of the liability would increase the lessor's net investment on which the lessor bases its pattern of income recognition. While the increase to the net investment results in an increase in income, it may be offset by the accrual of interest on the liability.

Leveraged lease transactions are sometimes structured with terms such that the lessee's rent payments begin one to two years after inception of the lease. In these transactions, the lessor normally is required to make up the shortfall between rent and debt service in the first several years of the transaction by agreeing, in the lease agreement or a separate binding contract, to make equity contributions that are used to service the non-recourse debt during this brief period. This arrangement is commonly referred to as a delayed equity investment, which typically is limited to the amounts specified, and is measurable at the inception of the lease. The debt is non-recourse to the lessor; however, the creditor frequently has recourse to the lessor's general credit for the debt service contributions. As discussed in section 10.1, *Introduction and grandfathering*, one of the required characteristics of a leveraged lease is that the financing provided by the long-term creditor must be non-recourse as to the general credit of the lessor.

The type of recourse debt resulting from the delayed equity investment does not contradict the notion of non-recourse for purposes of qualifying for leveraged lease. As such, recourse debt resulting from the delayed equity investment does not preclude leveraged lease accounting as long as other requirements of leveraged lease accounting are met. The lessor's obligation for the delayed equity investment should be recorded as a liability at present value at the inception of the lease. The lessor's net investment on which the lessor bases its pattern of income recognition would reflect the delayed equity investment (i.e., the net investment would increase due to the recognition of the liability). While the increase to the net investment results in an increase in income, it tends to be offset by the accrual of interest on the liability.

10.3.6 Leveraged lease — comprehensive illustration

ASC 842-50-55-6 through 55-15 provides an illustration of accounting and financial statement presentation for leveraged leases. The illustration begins with a set of assumptions and uses them to prepare an analysis of cash flows by years. This analysis provides the basis for the calculation of the net investment in the leased property. Below is a summarized version of the illustration.

Illustration 35 — Accounting for leveraged leases

In the illustration, a $1,000,000 asset is financed by a $600,000 non-recourse borrowing and $400,000 of equity investment by the lessor (it is assumed there are no initial direct costs). The components of total income to be earned follows:

Total rentals, including residual value	$ 1,550,000	$ 1,550,000
Tax depreciation	(1,000,000)	
Loan interest	(516,530)	(516,530)
Taxable income	33,470	
Assumed tax rate/tax effect	X 50.4%	(16,869)
Loan principal		(600,000)
Investment tax credit		100,000
Initial investment		(400,000)
Total lease income		$ 116,601

The net investment at the beginning of the first year is $400,000, and the net investment and related deferred taxes at the end of the first year are calculated as follows:

Net investment:	
Initial investment	$ 400,000
Annual rental	(90,000)
Loan interest and principal payment	74,435
Investment tax credit realized	(100,000)
Income realized (see below):	
Pretax lease income	9,929
Investment tax credit	29,663
	$ 324,027

Deferred taxes:

First year tax loss:		
Annual rental	$	90,000
Tax depreciation		(142,857)
Loan interest		(54,000)
		(106,857)
Assumed tax rate	X	50.4%
	$	(53,856)
Tax effect of pretax lease income recognized (see below)		(5,004)
	$	(58,860)

The net investment at the beginning of the second year for purposes of computing income is $265,167 ($324,027 net investment less $58,860, the deferred taxes).

The rate that is applied to each year's beginning net investment in calculating annual income is the sum of the net investment in positive years divided into the total income to be earned on the lease. In the illustration, the total income ($116,601) is divided by the sum of the positive net investment amounts ($1,348,477) to produce a rate of 8.647%. This rate is applied to the initial net investment of $400,000 and results in $34,588 as the amount of income to be recognized for the first year. The first year's income is allocated to its components based on the relationship of the components of total income to be earned as follows:

Component	Total income	Percentage of total		First year income Total	First year income Components
Pretax lease income	$ 33,470	28.705%	x	$ 34,588	$ 9,929
Tax effect of pretax lease income	(16,869)	(14.467)	x	34,588	(5,004)
Investment tax credit	100,000	85.762	x	34,588	29,663
	$116,601	100.000%			$ 34,588

10.4 Disclosures

Excerpt from Accounting Standards Codification

Leases — Leveraged Lease Arrangements

Disclosure

842-50-50-1

If leveraged leasing is a significant part of the **lessor's** business activities in terms of revenue, net income, or assets, the components of the net investment balance in **leveraged leases** as set forth in paragraph 842-50-25-1 shall be disclosed in the notes to financial statements.

842-50-50-2

For guidance on disclosures about financing receivables, which include receivables relating to a lessor's rights to payments from leveraged leases, see the guidance beginning in paragraphs 310-10-50-5A, 310-10-50-27, and 310- 10-50-31.

Pending Content:

Transition Date: (P) December 16, 2019; (N) December 16, 2020 | Transition Guidance: 326-10-65-1

Editor's note: The content of paragraph 842-50-50-2 will change upon the adoption of ASU 2016-13:

For guidance on disclosures about financing receivables, which include receivables relating to a lessor's rights to payments from leveraged leases, see the guidance beginning in Subtopic 326-20 on financial instruments measured at amortized cost and paragraph 310-10-50-31.

842-50-50-3

If accounting for the effect on leveraged leases of the change in tax rates results in a significant variation from the customary relationship between income tax expense and pretax accounting income and the reason for that variation is not otherwise apparent, the lessor shall disclose the reason for that variation.

840-30-S99-2

The following is the text of SEC Observer Comment: Effect of a Change in Tax Law or Rates on Leveraged Leases.

EY's note: This SAB Topic has not been updated to reflect the content of ASU 2016-02

Section 840-30-35 requires that all components of a leveraged lease be recalculated from inception of the lease based on the revised after-tax cash flows arising from the change in the tax law, including revised tax rates. The difference between the amounts originally recorded and the recalculated amounts would be included in income of the year in which the tax law is enacted.

This accounting may have distortive effects on the ratio of earnings to fixed charges ("the ratio") as calculated. For example, a favorable after-tax effect might consist of an unfavorable adjustment to pretax income that is more than offset by a favorable adjustment to income tax expense. In those circumstances, despite the overall favorable effect, the ratio as calculated pursuant to the applicable instructions to Item 503(d) of Regulation S-K would be affected negatively because the "earnings" component of the ratio is based on pretax income.

In filings with the Commission the SEC staff will expect the cumulative effect on pretax income and income tax expense, if material, to be reported as separate line items in the income statement. SEC staff will not object to exclusion of an unfavorable pretax adjustment from the "earnings" component of the ratio, in cases in which the after-tax effect is favorable, provided that (1) such exclusion is adequately identified and explained in connection with all disclosures and discussions relating to the ratio and (2) supplemental disclosure is made of the ratio as calculated in accordance with the applicable instructions.

11 Effective date and transition

11.1 Effective date

Excerpts from Accounting Standards Codification

Master Glossary

Not-for-Profit Entity

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return

b. Operating purposes other than to provide goods or services at a profit

c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities

b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

The following represents the transition and effective date information related to Accounting Standards Update No. 2016-02, Leases (Topic 842):

a. A **public business entity**, a **not-for-profit entity** that has issued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the U.S. Securities and Exchange Commission shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Earlier application is permitted.

b. All other entities shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Earlier application is permitted.

ASU 2016-02 is effective for annual periods beginning after 15 December 2018 (i.e., 1 January 2019 for a calendar-year entity), and interim periods within those years, for PBEs and both of the following:

- Not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market
- Employee benefit plans that file or furnish financial statements with or to the SEC

For all other entities, ASU 2016-02 is effective for annual periods beginning after 15 December 2019 (i.e., 1 January 2020 for a calendar-year entity), and interim periods beginning after 15 December 2020 (i.e., 1 January 2021 for a calendar-year entity).

Interim adoption

Early adoption is permitted for all entities. ASU 2016-02 neither specifically addresses nor prohibits early adoption in an interim period other than the first interim period. We believe an entity can early adopt the standard in an interim period other than the first interim period; however, the adoption would be reflected as of the beginning of the annual period in accordance with ASC 250. For example, if a calendar-year entity early adopts in the second quarter of 2017, it should reflect the adoption of ASU 2016-02 as if it had adopted the standard on 1 January 2017. The next time an entity presents its financial statements for the first quarter of 2017 (i.e., in the first quarter of 2018), it would adjust them to reflect the adoption of ASU 2016-02.

11.1.1 Disclosure prior to adoption

Entities subject to SEC reporting requirements should provide disclosures about the effects of ASU 2016-02 in registration statements and periodic reports filed with the SEC. As noted in SEC Staff Accounting Bulletin (SAB) Topic 11.M, the SEC staff expects disclosure of the potential effects of new standards if they are known. These entities should make the following disclosures within MD&A and the financial statements:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier
- A discussion of the method of adoption allowed, including whether the optional practical expedients will be applied (refer to section 11.2.2, *Transition practical expedients)*

- A discussion of the effect the standard is expected to have on the financial statements or, if the effect isn't known or reasonably estimable, a statement to that effect
- Disclosure of other significant matters that the entity believes might result from adopting the standard (e.g., planned or intended changes in business practices, effect on debt covenants, etc.)

For example, a company may disclose the following:

- In February 2016, the FASB issued guidance codified in ASC 842, *Leases*, which supersedes the guidance in ASC 840, *Leases*. ASC 842 will be effective for the Company on 1 January 2019, and the Company expects to apply the transition practical expedients allowed by the standard. Footnote XX provides details on the Company's current lease arrangements. While the Company continues to evaluate the provisions of ASC 842 to determine how it will be affected, the primary effect of adopting the new standard will be to record assets and obligations for current operating leases. Upon adoption, based on leases in place as of 31 December 2016, the Company expects to recognize assets and liabilities of approximately $X million related to our operating leases. The adoption of ASC 842 is not expected to have a material impact on the Company's results of operations or cash flows.

Consistent with SAB Topic 11.M, at a September 2016 Emerging Issues Task Force Meeting, the SEC Observer said that if a registrant does not know or cannot reasonably estimate the effect that the adoption of a new standard will have on its financial statements, it should make a statement to that effect and consider providing qualitative disclosures to help the reader assess the significance of the effect on the registrant's financial statements. These qualitative disclosures should include a description of the new standard's effect on the registrant's accounting policies and provide a comparison to the registrant's current accounting policies. The SEC Observer also said that registrants should describe the status of their processes to implement the new standards and the significance of any implementation matters yet to be addressed in those processes. The SEC staff expects an entity's disclosures to evolve in each reporting period as more information about the effects of a new standard becomes available. Members of the SEC staff have said that disclosure of the probable outcomes of applying new accounting standards, including ASC 842, will be a focus in reviews of registrants' 10-K filings.

11.1.2 Adoption of ASU 2016-02 before the adoption of the new revenue recognition standard

Because early adoption is permitted, an entity may adopt ASU 2016-02 before it adopts the new revenue recognition standard (ASC 606). The FASB aligned several concepts in ASC 842 with concepts in ASC 606 (e.g., determining whether the transfer of an asset is a sale in a sale and leaseback transaction) and in some cases required lessors to apply specific guidance in ASC 606 to their leasing transactions (e.g., for a lessor's allocation of the consideration in the contract). Therefore, an entity that adopts the new leasing guidance before it adopts the new revenue guidance may need to apply certain concepts in ASC 606 when accounting for leases.

11.2 Transition

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

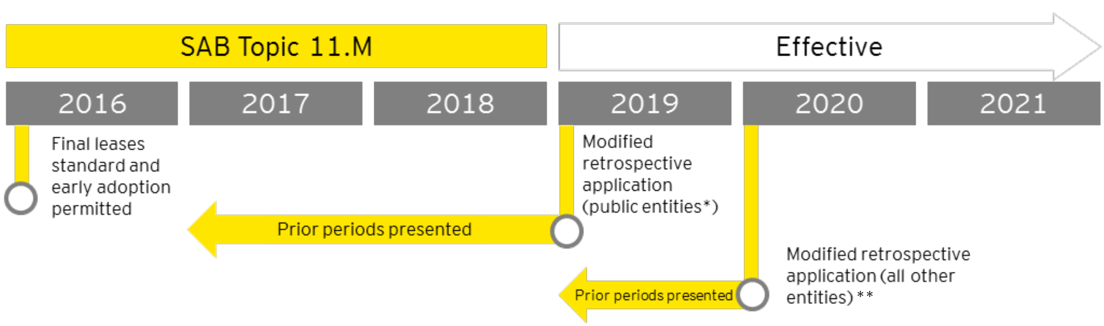
c. In the financial statements in which an entity first applies the pending content that links to this paragraph, the entity shall recognize and measure **leases** within the scope of the pending content that links to this paragraph that exist at the beginning of the earliest comparative period presented, using the approach described in (i) through (ee).

d. An entity shall adjust equity at the beginning of the earliest comparative period presented, and the other comparative amounts disclosed for each prior period presented in the financial statements, as if the pending content that links to this paragraph had always been applied, subject to the requirements in (h) through (ee).

e. If a **lessee** elects not to apply the recognition and measurement requirements in the pending content that links to this paragraph to **short-term leases**, the lessee shall not apply the approach described in (k) through (t) to short-term leases.

See Examples 28 through 29 (paragraphs 842-10-55-243 through 55-254) for illustrations of the transition requirements.

ASU 2016-02's transition provisions are applied as of the beginning of the earliest comparative period presented in the financial statements. As illustrated below, a calendar-year entity that adopts ASU 2016-02 on 1 January 2019 and presents three-year comparative financial statements applies the transition provisions on 1 January 2017 (i.e., the beginning of the earliest comparative period presented).



* Public entities include PBEs and certain not-for-profit entities and employee benefit plans.

** Assumes two years of comparative financial statements are presented.

Lessees that make an accounting policy election (by class of underlying asset to which the right of use relates) to apply the short-term lease exception do not apply the lessee transition provisions discussed in section 11.3, *Lessee transition*, to qualifying leases. Refer to section 4.1.1, *Short-term leases,* for a discussion of identifying a short-term lease.

Lessees and lessors are required to adopt ASU 2016-02 using a modified retrospective approach for all leases that exist at or commence after the beginning of the earliest comparative period presented, and they have an option to use certain practical expedients (refer to section 11.2.2, *Transition practical expedients*). Lessees and lessors are prohibited from using a full retrospective transition approach.

The FASB indicated in the Basis for Conclusions (BC 391) that applying a modified retrospective transition approach will not produce the same accounting result as a full retrospective approach, but the results will be similar, and the benefits of a more precise transition approach would not justify the costs.

11.2.1 SEC reporting considerations

At the 21 March 2016 SEC Regulations Committee Joint Meeting with SEC staff, the staff indicated that the selected financial data table (Item 301 of Regulation S-K) should follow the transition provisions of ASU 2016-02 (i.e., the new leasing standard will be applied as of the beginning of the earliest comparative period presented in the financial statements). For example, an SEC registrant's Form 10-K for the year ending 31 December 2019 will include financial statements for each of the three years in the period ending 31 December 2019. In this example, 1 January 2017 would be the beginning of the earliest comparative period presented in the financial statements. The registrant will not be required to apply the new leasing standard in the selected financial data table for periods prior to 1 January 2017 (i.e., 2016 and 2015). Consistent with Instruction 2 to S-K Item 301, the registrant should disclose the lack of comparability of the data presented in the financial data table (if material).

The SEC staff in the Division of Corporation Finance also updated its Financial Reporting Manual to add its view that the date of initial application for purposes of the new leases standard would not change if a registrant is required to provide financial statements for earlier periods when issuing retrospectively revised financial statements for a registration statement filed in the year of adoption. For example, assume an entity adopts ASC 842 effective 1 January 2019, resulting in an initial application date of 1 January 2017 and files its 10-Q for the first quarter in April 2019. The entity then files a registration statement in May 2019 that includes the financial statements for the years ended 31 December 2016, 2017 and 2018. The SEC staff's Financial Reporting Manual clarifies that the entity would not be required to adjust its date of initial application to 1 January 2016 as a result of reissuing its 2016 financial statements in its registration statement following adoption of the new guidance.

11.2.2 Transition practical expedients

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

f. An entity may elect the following practical expedients, which must be elected as a package and applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a **lessor**), when applying the pending content that links to this paragraph to leases that commenced before the effective date:

1. An entity need not reassess whether any expired or existing **contracts** are or contain leases.
2. An entity need not reassess the lease classification for any expired or existing leases (that is, all existing leases that were classified as **operating leases** in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as **finance leases**).
3. An entity need not reassess **initial direct costs** for any existing leases.

g. An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the **lease term** (that is, when considering lessee options to extend or terminate the lease and to purchase the **underlying asset**) and in assessing impairment of the entity's **right-of-use assets**. This practical expedient may be elected separately or in conjunction with the practical expedients in (f).

The package of practical expedients

Lessees and lessors are permitted to make an election to apply a package of practical expedients that allow them not to reassess:

1. Whether any expired or existing contracts are or contain leases. Because ASC 840's accounting for operating leases and service contracts is similar, entities may not have always focused on determining whether an arrangement is a lease or a service contract. Some entities may need to revisit assessments made under ASC 840 because, under ASC 842, most operating leases are recognized on lessees' balance sheets, and the effects of accounting for an arrangement as a service instead of a lease may be material. The FASB noted in the Basis for Conclusions (BC 393 (a)) that the practical expedient that permits entities not to reassess whether any expired or existing contracts contain leases does not grandfather incorrect assessments made under ASC 840 (i.e., the practical expedient applies only to arrangements that were appropriately assessed under ASC 840).
2. Lease classification for any expired or existing leases.
3. Initial direct costs for any expired or existing leases (i.e., whether those costs qualify for capitalization under ASC 842).

These three practical expedients must be elected as a package and must be consistently applied to all leases. An entity cannot choose which of the individual practical expedients to apply or which leases to apply them to (i.e., an entity must apply all three of these practical expedients to all leases or apply none of them).

The hindsight practical expedient

Entities are also permitted to make an election to use hindsight when determining lease term (i.e., evaluating a lessee's option to renew or terminate the lease or to purchase the underlying asset) and assessing impairment of right-of-use assets (lessees only). Entities would consider all facts and circumstances that have changed, through to the effective date, in applying hindsight. However, entities would not consider events that occurred after the effective date, but prior to the first time it issues its financial statements reflecting the adoption of ASC 842 (i.e., hindsight only extends to the effective date). The hindsight practical expedient may be elected separately or in conjunction with the package of practical expedients described above. An entity must apply this practical expedient to all leases or apply it to none of them.

If the entity does not elect the package of practical expedients, the assessment of lease classification could be impacted by a change in lease term if the entity elects to apply the hindsight practical expedient. The use of the hindsight practical expedient only impacts lease classification if the package of practical expedients is not elected.

11.2.3 Reassessment of lease classification

An entity that does not elect to apply the package of practical expedients to all of its leases, as discussed in section 11.2.2, Transition *practical expedients*, reassesses lease classification at the later of the commencement date of the lease or the effective date of the most recent lease modification as if the entity had always applied ASC 842. However, an entity may separately elect to apply the hindsight practical expedient to all leases (also discussed in 11.2.2., *Transition practical expedients)*. In that circumstance, an entity would use hindsight to reassess the lease term for both lease classification and measurement.

If the entity does not elect the package of practical expedients, the assessment of lease classification could be impacted by a change in the lease term if the entity elects to apply the hindsight practical expedient.

11.2.4 Impairment of right-of-use assets prior to the effective date

The guidance in ASC 842-10-65-1(g) and 842-20-35-3(b) requires a lessee to consider whether a right-of-use asset was impaired prior to the effective date. Questions have been raised about whether the lessee should reevaluate the asset group that includes the operating lease or simply the newly recognized right-of-use asset as a single unit of account. Based on a 2016 FASB Technical Inquiry, the FASB staff believes that prior to the effective date, a lessee's impairment analysis would consider the right-of-use asset as its own unit of account rather than part of an ASC 360 asset group. In contrast, after the effective date, the FASB staff confirmed that a right-of-use asset would be evaluated for impairment as part of an asset group, following the principles of ASC 360. Refer to our Financial reporting developments publication, *Impairment or disposal of long-lived assets*, for discussion of grouping assets when performing impairment evaluations.

Given the unit of account, before the effective date, is the right-of-use asset, the FASB staff also believes that lessees should not reassess the measurement and allocation of impairment losses recognized prior to the effective date when a right-of-use asset is recognized upon adoption of ASC 842. That is, the amount of loss recognized within an asset group and the loss allocated to individual long-lived assets within the group would not change as a result of adopting ASC 842, even if the loss occurred after the beginning of the earliest comparative period presented. Any incremental impairment loss resulting from the recognition of the right-of-use asset (as a single unit of account) would not be allocated amongst any other assets in the asset group. The FASB staff noted that the Board intended to limit the need for dual record keeping during the transition period.

11.2.5 Arrangements agreed to or committed to before the reporting period beginning after 28 May 2003

Under EITF 01-8, *Determining whether an arrangement contains a lease*, arrangements that were agreed to or committed to before the beginning of the reporting period beginning after 28 May 2003 (and not subsequently modified or acquired in a business combination) were grandfathered from determining whether the arrangement contains a lease in the context of ASC 840. Although ASC 842 does not specifically retain this exception, we believe if an entity elects to apply the package of practical expedients to all leases as discussed in section 11.2.2, *Transition practical expedients*, the entity would not reassess whether those grandfathered arrangements are or contain leases. If an entity does not elect to apply the package of practical expedients, it is required to reassess all contracts using the provisions of ASC 842, including those grandfathered by EITF 01-8, to determine if they are or contain leases.

11.3 Lessee transition

A lessee that elects the package of practical expedients (discussed in section 11.2.2, *Transition practical expedients*) applies the transition guidance described in the following sections of this publication.

Classification prior to adoption	Classification subsequent to adoption	Section
Capital lease	Finance lease	11.3.1
Operating lease	Operating lease	11.3.3

A lessee that does not elect the package of practical expedients (discussed in section 11.2.2, *Transition practical expedients*) applies the transition guidance described in the following sections of this publication.

Classification prior to adoption	Classification subsequent to adoption	Section
Capital lease	Finance lease	11.3.1
Capital lease	Operating lease	11.3.2
Operating lease	Finance lease	11.3.3
Operating lease	Operating lease	11.3.3

11.3.1 Leases previously classified as capital leases under ASC 840 that are classified as finance leases under ASC 842

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

r. For each lease classified as a finance lease in accordance with this Topic, a lessee shall do all of the following:

1. Recognize a right-of-use asset and a lease liability at the carrying amount of the lease asset and the capital lease obligation in accordance with Topic 840 at the later of the beginning of the earliest comparative period presented or the commencement date of the lease.
2. Include any unamortized initial direct costs that meet the definition of initial direct costs in this Topic in the measurement of the right-of-use asset established in (r)(1).
3. Write off, as an adjustment to equity, any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic and that are not included in the measurement of the capital lease asset under Topic 840 (unless the lessee elects the practical expedients described in (f)).
4. Subsequently measure the right-of-use asset and the lease liability in accordance with Section 840-20-35 before the effective date.
5. Apply the subsequent measurement guidance in paragraphs 842-20-35-4 through 35-5 and 842-20-35-8 after the effective date. However, when applying the pending content in paragraph 842-20-35-4, a lessee shall not remeasure the lease payments for amounts probable of being owed under residual value guarantees in accordance with paragraph 842-10-35-4(c)(3).
6. Classify the assets and liabilities held under capital leases as right-of-use assets and lease liabilities arising from finance leases for the purposes of presentation and disclosure.

t. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not result in a separate contract in accordance with paragraph 842-10-25-8, or the lessee is required to remeasure the lease liability in accordance with paragraph 842-20-35-4, the lessee shall subsequently account for the lease in accordance with the requirements in this Topic beginning on the effective date of the modification or the remeasurement date.

If an entity elects to apply the package of practical expedients, as described in section 11.2.2, *Transition practical expedients*, capital leases under ASC 840 become finance leases under ASC 842 (i.e., lease classification is not reassessed in transition). An entity that does not elect the package of practical expedients reassesses whether the arrangement is or contains a lease, lease classification and whether previously capitalized costs continue to qualify as initial direct costs. If lease classification changes from a capital lease to an operating lease, refer to section 11.3.2, *Leases previously classified as capital leases under ASC 840 that are classified as operating leases under ASC 842*.

If the entity does not elect the package of practical expedients, the assessment of lease classification could be impacted by a change in lease term if the entity elects to apply the hindsight practical expedient to all leases (described in 11.2.2, *Transition practical expedients)*. If lease classification changes from a capital lease to an operating lease, refer to section 11.3.2, *Leases previously classified as capital leases under ASC 840 that are classified as operating leases under ASC 842*. The use of the hindsight practical expedient might impact lease classification only if the package of practical expedients is not elected.

For a capital lease that exists at the beginning of the earliest comparative period presented or commences before the effective date and is classified as a finance lease under ASC 842:

- The lessee initially recognizes a finance lease right-of-use asset and lease liability at the later of (1) the beginning of the earliest comparative period presented and (2) the commencement date of the lease, measured at the carrying amount of the capital lease asset and capital lease obligation under ASC 840.
- The lessee recognizes, as part of the finance lease right-of-use asset, unamortized initial direct costs. If the entity has not elected to apply the package of practical expedients (refer to section 11.2.2, *Transition practical expedients*), any initial direct costs that do not qualify for capitalization under ASC 842 would be written off as an adjustment to equity.
- During the periods prior to the effective date, the lessee accounts for the finance lease right-of-use asset and lease liability in accordance with the subsequent measurement guidance for capital leases in ASC 840.

If the entity elects to apply the hindsight practical expedient (refer to section 11.2.2, *Transition practical expedients*) and concludes the lease term should change, we believe the entity would adjust the initial recognition of the carrying amount of the capital lease asset and capital lease obligation to reflect the amounts that would have been recorded under ASC 840 had the revised lease term always been assumed.

Beginning on the effective date, a lessee accounts for the finance lease right-of-use asset and lease liability in accordance with the subsequent measurement guidance in ASC 842 (refer to section 4.3.2, *Subsequent measurement*), except that a lessee does not remeasure the finance lease right-of-use asset or lease liability for changes in the amount that it is probable it will owe under a residual value guarantee.

If the lease is modified (i.e., the terms and conditions of the contract are changed in a way that results in a change in the scope of or the consideration for the lease) on or after the effective date and the modified lease is not accounted for as a separate contract, or if the lessee is required to remeasure the lease liability in accordance with ASC 842-20-35-4, the lessee applies the subsequent measurement guidance in ASC 842 from the date of modification or remeasurement.

11.3.2 Leases previously classified as capital leases under ASC 840 that are classified as operating leases under ASC 842

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

s. For each lease classified as an operating lease in accordance with this Topic, a lessee shall do the following:

   1. Derecognize the carrying amount of any capital lease asset and capital lease obligation in accordance with Topic 840 at the later of the beginning of the earliest comparative period presented or the commencement date of the lease. Any difference between the carrying amount of the capital lease asset and the capital lease obligation shall be accounted for in the same manner as prepaid or accrued rent.

2. Recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-35-3 if the lease commenced before the beginning of the earliest period presented in the financial statements.
3. Recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-30-1 at the commencement date of the lease if the lease commenced after the beginning of the earliest period presented in the financial statements.
4. Account for the operating lease in accordance with the guidance in Subtopic 842-20 after initial recognition in accordance with (s)(2) or (s)(3).
5. Write off, as an adjustment to equity, any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic.

t. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not result in a separate contract in accordance with paragraph 842-10-25-8, or the lessee is required to remeasure the lease liability in accordance with paragraph 842-20-35-4, the lessee shall subsequently account for the lease in accordance with the requirements in this Topic beginning on the effective date of the modification or the remeasurement date.

If an entity elects to apply the package of practical expedients described in section 11.2.2, *Transition practical expedients*, leases classified as capital leases under ASC 840 become finance leases under ASC 842 (i.e., lease classification is not reassessed in transition), and the guidance in this section is not applicable. In that case, the guidance in section 11.3.1, *Leases previously classified as capital leases under ASC 840 that are classified as finance leases under ASC 842*, is applicable.

If an entity does not elect to apply the package of practical expedients but does apply the hindsight practical expedient (refer to section 11.2.2, *Transition practical expedients*) and concludes the lease term should change, the effect of that change could impact both the classification and measurement of a lease existing in the comparative periods. If the lessee concludes the lease is now an operating lease, the change in lease term (and corresponding change in lease payments and assessment of previous impairments of the right-of-use asset) would affect the initial measurement of the operating lease right-of-use asset and lease liability recognized. If the lease becomes a finance lease, refer to section 11.3.1, *Leases previously classified as capital leases under ASC 840 that are classified as finance leases under ASC 842*.

For a capital lease that exists at the beginning of the earliest comparative period presented or commences before the effective date that is classified as an operating lease under ASC 842, a lessee:

- Derecognizes the carrying amount of the capital lease asset and capital lease obligation at the later of (1) beginning of the earliest comparative period presented or (2) the commencement date of the lease (prior to the effective date), and accounts for any difference between the carrying amount of the capital lease asset and the capital lease obligation as prepaid or accrued rent
- Recognizes an operating lease right-of-use asset and lease liability in accordance with ASC 842's subsequent measurement guidance if the lease commenced before the beginning of the earliest comparative period presented or in accordance with ASC 842's initial measurement guidance if the lease commenced after the beginning of the earliest comparative period presented (refer to section 4.2.1, *Initial measurement*, and 4.2.2, *Subsequent measurement*)
- Writes off any unamortized initial direct costs that do not qualify for capitalization under ASC 842 as an adjustment to equity at the later of (1) the beginning of the earliest comparative period presented and (2) the commencement date of the lease

After initial recognition, a lessee accounts for the operating lease in accordance with ASC 842's guidance on operating leases.

11.3.3 Leases previously classified as operating leases under ASC 840 that are classified as operating or finance leases under ASC 842

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

k. A lessee should initially recognize a right-of-use asset and a **lease liability** at the later of the beginning of the earliest period presented in the financial statements and the **commencement date of the lease**.

l. Unless, on or after the effective date, the lease is modified (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8) or the lease liability is required to be remeasured in accordance with paragraph 842-20-35-4, a lessee shall measure the lease liability at the present value of the sum of the following, using a **discount rate for the lease** (which, for entities that are not public business entities, can be a risk-free rate determined in accordance with paragraph 842-20-30-3) established at the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease:

    1. The remaining minimum rental payments (as defined under Topic 840).

    2. Any amounts **probable** of being owed by the lessee under a **residual value guarantee**.

m. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall initially measure the right-of-use asset at the initial measurement of the lease liability adjusted for both of the following:

    1. The items in paragraph 842-20-35-3(b), as applicable.

    2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease.

n. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall subsequently measure the right-of-use asset throughout the remaining lease term in accordance with paragraph 842-20-35-3(b). If the initial measurement of the right-of-use asset in (m) is adjusted for the carrying amount of a liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease, the lessee shall apply the recognition and subsequent measurement guidance in Sections 842-20-25 and 842-20-35, respectively, when the right-of-use asset has been impaired.

o. For each lease classified as a finance lease in accordance with paragraph 842-10-25-2, a lessee shall measure the right-of-use asset as the applicable proportion of the lease liability at the commencement date, which can be imputed from the lease liability determined in accordance with (l). The applicable proportion is the remaining lease term at the beginning of the earliest comparative period presented relative to the total lease term. A lessee shall adjust the right-of-use asset recognized by the carrying amount of any prepaid or accrued **lease payments** and the carrying amount of any liability recognized in accordance with Topic 420 for the lease.

p. Any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic shall be written off as an adjustment to equity at the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease.

q. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not result in a separate contract in accordance with paragraph 842-10-25-8, or the lessee is required to remeasure the lease liability for any reason (see paragraphs 842-20-35-4 through 35-5), the lessee shall follow the requirements in this Topic from the **effective date of the modification** or the remeasurement date.

If an entity elects to apply the package of practical expedients (refer to section 11.2.2, *Transition practical expedients*), operating leases under ASC 840 become operating leases under ASC 842 (i.e., lease classification is not reassessed in transition). An entity that does not elect the package of practical expedients reassesses whether the arrangement is a lease, lease classification and whether previously capitalized lease costs continue to qualify as initial direct costs as discussed in section 11.2.3, *Reassessment of lease classification*. A change in lease classification will impact how the transition guidance described below is applied.

If the entity does not elect to apply the package of practical expedients, the assessment of lease classification could also be impacted by a change in lease term if the entity elects to apply the hindsight practical expedient (refer to section 11.2.2, *Transition practical expedients*). The use of the hindsight practical expedient may impact lease classification only if the entity does not elect to apply the package of practical expedients.

For an operating lease that exists at the beginning of the earliest comparative period presented or commences before the effective date, a lessee does the following:

- Initially recognizes a right-of-use asset and lease liability at the later of (1) the beginning of the earliest comparative period presented or (2) the commencement date of the lease (prior to the effective date)
- Initially and subsequently measures the lease liability at the present value of the sum of the following items using the discount rate for the lease (refer to section 2.5, *Discount rates*) established at the later of (1) the beginning of the earliest comparative period presented or (2) the commencement date of the lease:
  - The remaining minimum rental payments as described under ASC 840-10-25-6. The definition of minimum rental payments excludes amounts paid to the lessor for executory costs. The remaining original lease term determined under ASC 840 is used unless the lessee elects to use hindsight to determine the lease term (refer to section 11.2.2, *Transition practical expedients*).
  - Any amount it is probable a lessee will owe under a residual value guarantee.
- Writes off, as an adjustment to equity, any unamortized initial direct costs that would not have qualified for capitalization under ASC 842, unless the entity elects to apply the package of practical expedients described in section 11.2.2, *Transition practical expedients*

For an operating lease that continues to be classified as an operating lease under ASC 842 and has no associated liability recognized in accordance with ASC 420, *Exit or Disposal Cost Obligations*, a lessee initially and subsequently measures the right-of-use asset at an amount equal to the lease liability, adjusted for (1) cumulative prepaid or accrued lease payments, (2) the remaining balance of any lease incentives received, (3) any unamortized initial direct costs (the balance of which may depend on whether the lessee elects to apply the package of practical expedients) and (4) impairments (which may be impacted by whether the entity elects to use the hindsight practical expedient for all leases, as discussed in section 11.2.2, *Transition practical expedients,* when evaluating the right-of-use asset for impairment).

When an operating lease that continues to be classified as an operating lease under ASC 842 has an associated liability recognized in accordance with ASC 420, the lessee includes the carrying value of the ASC 420 liability in the initial measurement of the right-of-use asset, and subsequently measures the right-of-use asset as if it had been impaired (refer to section 4.2.5, *Impairment of right-of-use assets after the effective date*). As a result, the expense recognized following adoption of ASC 842 will include amortization of the right-of-use asset, generally on a straight-line basis, as well as accretion of the lease liability, similar to expense recognized for a finance lease.

For an operating lease that is classified as a finance lease under ASC 842, a lessee does the following at the later of (1) the beginning of the earliest comparative period presented or (2) the commencement date of the lease:

- Measures the right-of-use asset as the applicable proportion of the lease liability at the commencement date (which could precede the beginning of the earliest comparative period presented) that can be imputed (i.e., calculated) from the lease liability determined based on the guidance above
- Adjusts the right-of-use asset by the amount of any previously recognized prepaid or accrued lease payments and the carrying amount of any liability recognized in accordance with ASC 420 for the lease

We believe the applicable proportion of the lease liability is the amount that would have been recognized at commencement of the lease if ASC 842 had always been applied, multiplied by the proportion of the remaining lease term to the original lease term. For example, assume that a lease with an original term of 10 years has a remaining term of eight years at the beginning of the earliest comparative period presented. If the original lease liability would have been calculated as $100,000 at lease commencement (assuming the provisions of ASC 842 had always been applied), the right-of-use asset recognized would be $80,000 (calculated as $100,000 original lease liability divided by the 10-year lease term multiplied by eight years remaining at beginning of earliest comparative period presented). The right-of-use asset would then be adjusted for any prepaid or accrued rent.

If an entity elects the hindsight practical expedient for all leases, as described in section 11.2.2, *Transition practical expedients*, and concludes the lease term should change, the calculation of the lease liability and the applicable portion of the lease liability used to measure the right-of-use asset would change accordingly.

The lessee accounts for the lease in accordance with the subsequent measurement guidance in ASC 842 when either:

- The lease is modified (i.e., the terms and conditions of the contract are changed in a way that results in a change in the scope of or the consideration for the lease) on or after the effective date and the modified lease is not accounted for as a separate contract.
- The lessee is required to remeasure the lease liability in accordance with ASC 842-20-35-4.

11.3.4 Lessee transition — examples

11.3.4.1 Leases previously classified as capital leases under ASC 840

ASC 842 includes the following example to illustrate the application of ASC 842's lessee transition guidance for existing capital leases.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

Example 28 — Lessee Transition — Existing Capital Lease

842-10-55-244

The effective date of the guidance in this Topic for Lessee is January 1, 20X4. Lessee enters into a 7-year lease of an asset on January 1, 20X1, with annual lease payments of $25,000 payable at the end of each year. The lease includes a residual value guarantee by Lessee of $8,190. Lessee's incremental borrowing rate on the date of commencement was 6 percent. Lessee accounts for the lease as a capital lease. At lease commencement, Lessee defers initial direct costs of $2,800, which will be amortized over the lease term. On January 1, 20X2 (and before transition adjustments), Lessee has a lease liability of $128,707, a lease asset of $124,434, and unamortized initial direct costs of $2,400.

842-10-55-245

January 1, 20X2 is the beginning of the earliest comparative period presented in the financial statements in which Lessee first applies the guidance in this Topic. Lessee has elected the package of practical expedients in paragraph 842-10-65-1(f). As such, Lessee accounts for the lease as a finance lease, without reassessing whether the contract contains a lease or whether classification of the lease would be different in accordance with this Topic. Lessee also does not reassess whether the unamortized initial direct costs on January 1, 20X2, would have met the definition of initial direct costs in this Topic at lease commencement.

842-10-55-246

On January 1, 20X2, Lessee recognizes a lease liability at the carrying amount of the capital lease obligation on December 31, 20X1, of $128,707 and a right-of-use asset at the carrying amount of the capital lease asset of $126,834 (which includes unamortized initial direct costs of $2,400 that were included in the capital lease asset). Lessee subsequently measures the lease liability and the right-of-use asset in accordance with Subtopic 840-30 until the effective date.

842-10-55-247

Beginning on the effective date, Lessee applies the subsequent measurement guidance in Section 842-20-35, including the reassessment requirements, except for the requirement to reassess amounts probable of being owed under residual value guarantees. Such amounts will only be reassessed if there is a remeasurement of the lease liability for another reason, including as a result of a lease modification (that is, not accounted for as a separate contract).

11.3.4.2 Leases previously classified as operating leases under ASC 840

ASC 842 includes the following example to illustrate the application of ASC 842's lessee transition guidance for existing operating leases.

Excerpt from Accounting Standards Codification

Leases — Overall

Implementation Guidance and Illustrations

Example 29 — Lessee Transition — Existing Operating Lease

842-10-55-249

The effective date of the guidance in this Topic for Lessee is January 1, 20X4. Lessee enters into a five-year lease of an asset on January 1, 20X1, with annual lease payments payable at the end of each year. Lessee accounts for the lease as an operating lease. At lease commencement, Lessee defers initial direct costs of $500, which will be amortized over the lease term. On January 1, 20X2 (and before transition adjustments), Lessee has an accrued rent liability of $1,200 for the lease, reflecting rent that was previously recognized as an expense but was not yet paid as of that date. Four lease payments (1 payment of $31,000 followed by 3 payments of $33,000) and unamortized initial direct costs of $400 remain.

842-10-55-250

January 1, 20X2 is the beginning of the earliest comparative period presented in the financial statements in which Lessee first applies the guidance in this Topic. On January 1, 20X2, Lessee's incremental borrowing rate is 6 percent. Lessee has elected the package of practical expedients in paragraph 842-10-65-1(f). As such, Lessee accounts for the lease as an operating lease, without reassessing whether the contract contains a lease or whether classification of the lease would be different in accordance with this Topic. Lessee also does not reassess whether the unamortized initial direct costs on January 1, 20X2, would have met the definition of initial direct costs in this Topic at lease commencement.

842-10-55-251

On January 1, 20X2, Lessee measures the lease liability at $112,462, which is the present value of 1 payment of $31,000 and 3 payments of $33,000 discounted using the rate of 6 percent. The right-of-use asset is equal to the lease liability before adjustment for accrued rent and unamortized initial direct costs, which were not reassessed because Lessee elected the practical expedients in paragraph 842-10-65-1(f).

842-10-55-252

On January 1, 20X2, Lessee recognizes a lease liability of $112,462 and a right-of-use asset of $111,662 ($112,462 − $1,200 + $400).

842-10-55-253

From the transition date (January 1, 20X2) on, Lessee will continue to measure and recognize the lease liability at the present value of the sum of the remaining minimum rental payments (as that term was applied under Topic 840) and the right-of-use asset in accordance with this Topic.

842-10-55-254

Beginning on the effective date of January 1, 20X4, Lessee applies the subsequent measurement guidance in Section 842-20-35, including the reassessment requirements.

11.3.5 Lessee involvement in asset construction ('build-to-suit' transactions)

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

u. A lessee shall apply a modified retrospective transition approach for leases accounted for as build-to-suit arrangements under Topic 840 that are existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements as follows:

1. If an entity has recognized assets and liabilities solely as a result of a transaction's build-to-suit designation in accordance with Topic 840, the entity should derecognize those assets and liabilities at the later of the beginning of the earliest comparative period presented in the financial statements and the date that the lessee is determined to be the accounting owner of the asset in accordance with Topic 840. Any difference should be recorded as an adjustment to equity at that date. The lessee shall apply the lessee transition requirements in (k) through (t) to the lease.

2. If the construction period of the build-to-suit lease concluded before the beginning of the earliest comparative period presented in the financial statements and the transaction qualified as a sale and leaseback transaction in accordance with Subtopic 840-40 before the date of initial application, the entity shall follow the general lessee transition requirements for the lease.

ASC 842 significantly changes the guidance for lessee involvement in asset construction. The guidance in ASC 842 focuses on whether the lessee controls the asset being constructed rather than whether the lessee has substantially all of the risks during the construction period. Refer to section 7.7, *Lessee involvement in asset construction ('build-to-suit' transactions),* for further discussion of the evaluation and accounting for build-to-suit transactions under ASC 842.

The accounting by entities that recognized assets and liabilities solely as a result of the build-to-suit guidance in ASC 840 will depend upon whether the construction project is complete as of the effective date.

Construction is completed before the effective date

If an entity recognized assets and liabilities solely as a result of the build-to-suit guidance in ASC 840 and the construction of the asset was completed prior to the effective date, the entity would derecognize the assets and liabilities at the later of (1) the beginning of the earliest period presented in the financial statements or (2) the date construction of the asset commenced. This approach would apply even if the entity would conclude it controls the asset being constructed applying the principles in ASC 842. This interpretation includes all transactions in which the lessee was the deemed owner of the asset following ASC 840's build-to-suit guidance, even if the company achieved sale-leaseback accounting after the completion of construction.

Following derecognition of the assets and liabilities, the entity will then recognize the lease in accordance with ASC 842 at the later of the beginning of the earliest comparative period presented or the completion of construction.

The transition guidance does not address how an entity that derecognizes assets and liabilities previously recognized solely as a result of the build-to-suit guidance in ASC 840 would classify its lease during the transition period. We believe that for purposes of applying ASC 842's transition provisions, an entity would first assess lease classification as if the entity had always applied ASC 840 and then apply ASC 842's transition provisions based on that conclusion.

Construction is ongoing at the effective date

If an entity previously determined it was the deemed owner of an asset during construction following the guidance in ASC 840 and the construction project is ongoing at the effective date, the entity would derecognize the assets and liabilities at the later of (1) the beginning of the earliest period presented in the financial statements or (2) the date construction of the assets commenced. At the effective date, the entity will evaluate ASC 842's guidance for lessee involvement in asset construction to determine if it controls the underlying asset. If the entity concludes it controls the asset, it will again recognize the asset under construction with a related financing obligation. Refer to section 7.7, *Lessee involvement in asset construction ('build-to-suit' transactions)*, for further discussion of determining whether a lessee controls an asset under construction and the accounting when the lessee is the deemed owner.

In some circumstances, an entity may have determined that it was not the deemed owner of the asset during construction applying ASC 840 (i.e., the entity did not bear substantially all of the construction period risk); however, applying the guidance in ASC 842, the entity determines that it controls the asset under construction at the effective date. In those cases, we believe the lessee would recognize the asset and financing obligation as of the effective date. A lessee could also choose to recognize that asset and financing obligation as of the beginning of construction (i.e., in the applicable comparative periods) with an adjustment to equity for the difference between the asset and liability.

11.4 Lessor transition

A lessor that elects to apply the package of practical expedients (discussed in section 11.2.2, *Transition practical expedients*) applies the transition guidance described in the following sections of this publication.

Classification prior to adoption	Classification subsequent to adoption	Section
Sales-type	Sales-type	11.4.1
Direct financing	Direct financing	11.4.1
Operating	Operating	11.4.3

A lessor that does not elect the package of practical expedients (discussed in section 11.2.2, *Transition practical expedients*) applies the transition guidance described in the following sections of this publication.

Classification prior to adoption	Classification subsequent to adoption	Section
Sales-type	Sales-type	11.4.1
Sales-type	Direct financing	11.4.1
Sales-type	Operating	11.4.2
Direct financing	Direct financing	11.4.1
Direct financing	Sales-type	11.4.1
Direct financing	Operating	11.4.2
Operating	Operating	11.4.3
Operating	Sales-type	11.4.4
Operating	Direct financing	11.4.4

11.4.1 Leases previously classified as sales-type or direct financing leases under ASC 840 that continue to be classified as sales-type or direct financing leases under ASC 842

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

x. For each lease classified as a direct financing lease or a sales-type lease in accordance with this Topic, do all of the following:
   1. Continue to recognize a net investment in the lease at the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, at the carrying amount of the net investment at that date. This would include any unamortized initial direct costs capitalized as part of the lessor's net investment in the lease in accordance with Topic 840.
   2. Before the effective date, a lessor shall account for the lease in accordance with Topic 840.
   3. Beginning on the effective date, a lessor shall account for the lease in accordance with the recognition, subsequent measurement, presentation, and disclosure guidance in Subtopic 842-30.
   4. Beginning on the effective date, if a lessor modifies the lease (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8), it shall account for the modified lease in accordance with paragraph 842-10-25-16 if the modified lease is classified as a direct financing lease after the modification or paragraph 842-10-25-17 if the modified lease is classified as a sales-type lease after the modification. A lessor shall not remeasure the net investment in the lease on or after the effective date unless the lease is modified (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8).

If an entity elects to apply the package of practical expedients, as described in section 11.2.2, *Transition practical expedients*, sales-type leases and direct financing leases under ASC 840 remain sales-type leases and direct financing leases, respectively, under ASC 842 (i.e., lease classification is not reassessed in transition). An entity that does not elect to apply the practical expedients reassesses whether the arrangement is a lease, lease classification and whether previously deferred costs continue to qualify as initial direct costs applying the definition in ASC 842. If lease classification changes from a sales-type or direct financing lease to an operating lease, refer to section 11.4.2, *Leases previously classified as sales-type or direct financing under ASC 840 that are classified as operating leases under ASC 842*.

If the entity does not elect to apply the package of practical expedients, reassessment of lease classification could also be impacted by a change in lease term if the entity elects to apply the hindsight practical expedient (described in 11.2.2, *Transition practical expedients).* The use of the hindsight practical expedient may impact lease classification only if the package of practical expedients is not elected.

For sales-type and direct financing leases that exist at the beginning of the earliest comparative period presented or commence after the beginning of the earliest comparative period presented but before the effective date that continue to be classified as sales-type leases or direct financing leases, a lessor:

- Continues to recognize a net investment in the lease at the later of (1) the beginning of the earliest comparative period presented or (2) the commencement date of the lease, measured at the carrying amount of the net investment in the lease under ASC 840, including any unamortized initial direct costs capitalized as part of the lessor's net investment in the lease under ASC 840
- Subsequently accounts for the net investment in the lease under ASC 840 in the periods prior to the effective date

If the entity elects to apply the hindsight practical expedient, as discussed in section 11.2.2, *Transition practical expedients*, and does not elect to apply the package of practical expedients and concludes the lease term should change, we believe the entity would adjust the carrying amount of the initial measurement of the net investment in the lease measured under ASC 840 for the change in the lease term to reflect how the lease would have been recorded under ASC 840 had the revised lease term always been applied. As discussed above, use of the hindsight practical expedient can only impact lease classification if the package of practical expedients is not elected.

Neither ASC 230 nor ASC 840 addresses the presentation of lease payments received from a direct financing or sales-type lease in the statement of cash flows. Some entities currently present principal payments received as an operating activity because the lease represents a revenue-generating activity. Other entities consider these types of leases to be a financing transaction and therefore present the principal payments received as an investing activity. Upon transition, it is unclear whether entities that currently present lease payments received as an investing activity should adjust comparative information in the statement of cash flows after the effective date. We believe that a lessor should apply the cash flow classification guidance in ASC 842-30, which requires a lessor to classify receipt of lease payments within operating activities to all comparative periods presented. Refer to sections 4.9, *Disclosure*, and 5.9, *Disclosure*, for further discussion of classification of lease payments by lessees and lessors, respectively.

Beginning on the effective date (i.e., 1 January 2019 for calendar-year PBEs that do not adopt early), the lessor applies the guidance in ASC 842. Refer to chapter 5, *Lessor accounting*.

If the lease is modified (i.e., the terms and conditions of the contract are changed in a way that results in a change in the scope of or the consideration for the lease) on or after the effective date, and the modified lease is not accounted for as a separate contract, the lessor accounts for the lease under ASC 842. That is, the lessor remeasures the net investment in the lease as of the effective date of the modification using the lessor modification guidance. Refer to section 5.6, *Lease modifications*.

11.4.2 Leases previously classified as sales-type or direct financing leases under ASC 840 that are classified as operating leases under ASC 842

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

y. For each lease classified as an operating lease in accordance with this Topic, the objective is to account for the lease, beginning on the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, as if it had always been accounted for as an operating lease in accordance with this Topic. Consequently, a lessor shall do all of the following:

1. Recognize the underlying asset at what the carrying amount would have been had the lease been classified as an operating lease under Topic 840.
2. Derecognize the carrying amount of the net investment in the lease.
3. Record any difference between the amounts in (y)(1) and (y)(2) as an adjustment to equity.
4. Subsequently account for the operating lease in accordance with this Topic and the underlying asset in accordance with other Topics.

If an entity elects to apply the package of practical expedients described in section 11.2.2, *Transition practical expedients*, sales-type and direct financing leases under ASC 840 remain sales-type and direct financing leases, respectively, under ASC 842 (i.e., lease classification is not reassessed in transition), and the guidance in this section is not applicable. In that case, the guidance in section 11.4.1, *Leases previously classified as sales-type or direct financing leases under ASC 840 that continue to be classified as sales-type or direct financing leases under ASC 842*, is applicable.

A lessor accounts for a sales-type lease or a direct financing lease that exists at the beginning of the earliest comparative period presented or commences after the beginning of the earliest comparative period presented but before the effective date that is classified as an operating lease under ASC 842 as if it had always been accounted for as an operating lease under ASC 842. That is, at the later of (1) the beginning of the earliest comparative period presented or (2) the commencement date of the lease, a lessor:

- Derecognizes the carrying amount of the net investment in the lease
- Recognizes the underlying asset at what the carrying amount would have been had the lease been classified as an operating lease under ASC 840 (which as discussed below could be impacted if the lessor elects to use the hindsight practical expedient as discussed in section 11.2.2, *Transition practical expedients*)

Any difference between those two amounts is recorded as an adjustment to equity.

A lessor subsequently accounts for the operating lease in accordance with ASC 842 (refer to section 5.4, *Operating leases*) and the underlying asset in accordance with ASC 360. Accordingly, we believe lease modifications occurring before the effective date should be evaluated using ASC 842's lease modification guidance. Refer to section 5.6, *Lease modifications*.

If the entity elects to apply the hindsight practical expedient, as discussed in section 11.2.2, *Transition practical expedients*, and concludes the lease term should change, the entity should use the revised lease term to initially subsequently account for the operating lease in accordance with ASC 842. The use of the hindsight practical expedient could also impact lease classification but only if the package of practical expedients is not elected.

11.4.3 Leases previously classified as operating leases under ASC 840 that continue to be classified as operating leases under ASC 842

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

v. For each lease classified as an operating lease in accordance with this Topic, a lessor shall do all of the following:

1. Continue to recognize the carrying amount of the underlying asset and any lease assets or liabilities at the later of the date of initial application and the commencement date as the same amounts recognized by the lessor immediately before that date in accordance with Topic 840.
2. Account for previously recognized securitized receivables as secured borrowings in accordance with other Topics.
3. Write off, as an adjustment to equity, any unamortized initial direct costs at the later of the beginning of the earliest period presented in the financial statements or the commencement date of the lease that do not meet the definition of initial direct costs in this Topic (unless the lessor elects the practical expedients described in (f)).

If an entity elects to apply the package of practical expedients, as described in section 11.2.2, *Transition practical expedients*, operating leases under ASC 840 remain operating leases under ASC 842 (i.e., lease classification is not reassessed in transition). An entity that does not elect to apply the package of practical expedients reassesses whether the arrangement is a lease, lease classification and whether previously deferred costs continue to qualify as initial direct costs. If classification changes from an operating lease to a sales-type or direct financing, lease refer to section 11.4.4, *Leases previously classified as operating leases under ASC 840 that are classified as sales-type or directing financing leases under ASC 842*.

If the entity does not elect to apply the package of practical expedients, the assessment of lease classification may change if the entity elects to apply the hindsight practical expedient (described in 11.2.2, *Transition practical expedients*). The use of the hindsight practical expedient impacts classification of the lease only if use of the package of practical expedients is not elected.

For operating leases existing at the beginning of the earliest comparative period presented, or commencing after the beginning of the earliest comparative period presented but before the effective date, the carrying amounts of the underlying asset and any lease assets or liabilities (e.g., prepaid or accrued rent) are the same as those recognized under ASC 840, which are adjusted for the change in the lease term if the hindsight practical expedient is elected, as discussed in section 11.2.2, *Transition practical expedients*. A lessor writes off, as an adjustment to equity, any unamortized initial direct costs that would not have qualified for capitalization under ASC 842 at the later of (1) the beginning of the earliest comparative period presented or (2) the date the costs were incurred, but no later than the commencement date of the lease (prior to the effective date), unless the entity elects to apply the package of practical expedients described in section 11.2.2, *Transition practical expedients*.

A lessor accounts for previously recognized securitized receivables as secured borrowings in accordance with other US GAAP.

11.4.4 Leases previously classified as operating leases under ASC 840 that are classified as sales-type or directing financing leases under ASC 842

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

w. For each lease classified as a direct financing or a sales-type lease in accordance with this Topic, the objective is to account for the lease, beginning on the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, as if it had always been accounted for as a direct financing lease or a sales-type lease in accordance with this Topic. Consequently, a lessor shall do all of the following:

   1. Derecognize the carrying amount of the underlying asset at the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease.

   2. Recognize a **net investment in the lease** at the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease as if the lease had been accounted for as a direct financing lease or a sales-type lease in accordance with Subtopic 842-30 since lease commencement.

   3. Record any difference between the amounts in (w)(1) and (w)(2) as an adjustment to equity.

   4. Account for the lease in accordance with this Topic after the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease.

If an entity elects to apply the package of practical expedients described in section 11.2.2, *Transition practical expedients*, operating leases under ASC 840 remain operating leases under ASC 842 (i.e., lease classification is not reassessed in transition), and the guidance in this section is not applicable. In that case, the guidance in section 11.4.3, *Leases previously classified as operating leases under ASC 840 that continue to be classified as operating leases under ASC 842*, is applicable.

A lessor accounts for an operating lease that exists at the beginning of the earliest comparative period presented or commences after the beginning of the earliest comparative period presented but before the effective date that is classified as sales-type or direct financing lease under ASC 842 as if it had always been accounted for as a sales-type or direct financing lease under ASC 842. That is, at the later of (1) the beginning of the earliest comparative period presented or (2) the commencement date of the lease, a lessor:

- Derecognizes the carrying amount of the underlying asset and any asset for accrued rent or liability for prepaid rent
- Recognizes a net investment in the lease as if the sales-type or direct financing lease had always been accounted for under ASC 842, which is adjusted for the change in the lease term if the hindsight practical expedient, as discussed in section 11.2.2, *Transition practical expedients*, is elected

Any difference between those two amounts is recorded as an adjustment to equity.

A lessor subsequently accounts for the sales-type or direct financing lease in accordance with ASC 842. Refer to section 5.2, *Sales-type leases*, and section 5.3, *Direct financing leases*.

11.4.5 Leases previously classified as leveraged leases under ASC 840

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

z. For leases that were classified as **leveraged leases** in accordance with Topic 840, and for which the commencement date is before the effective date, a lessor shall apply the requirements in Subtopic 842-50. If a leveraged lease is modified on or after the effective date, it shall be accounted for as a new lease as of the effective date of the modification in accordance with the guidance in Subtopics 842-10 and 842-30.

1. A lessor shall apply the pending content that links to this paragraph to a leveraged lease that meets the criteria in (z) that is acquired in a business combination or an **acquisition by a not-for-profit entity** on or after the effective date.

ASU 2016-02 eliminates leveraged lease accounting for leases that commence on or after its effective date. However, leveraged leases that commenced prior to the effective date are grandfathered. As a result, ASC 842 retains ASC 840's recognition, measurement, presentation and disclosure guidance for grandfathered leveraged leases. We believe lessors will also apply the leveraged lease accounting guidance to an unmodified leveraged lease acquired in a business combination or an acquisition by a not-for-profit entity after the effective date.

If a leveraged lease that commenced prior to the effective date is modified (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease) prior to the effective date but after the beginning of the earliest comparative period presented, the lessor would apply the provisions of ASC 842-50 for the modification. Refer to chapter 10, *Leveraged leases*. While the transition guidance in ASC 842 does not generally address how to account for lease modifications that occur after the beginning of the earliest comparative period presented, but before the effective date, it is clear that modifications of leveraged leases are accounted for under the modification guidance in ASC 842.

If a leveraged lease that commenced prior to the effective date is modified on or after the effective date, it should be accounted for as a new lease as of the effective date of the modification in accordance with ASC 842's recognition and measurement guidance for all other leases. Refer to section 5.7.5, *Leveraged leases*.

Refer to chapter 10, *Leveraged leases,* for an in-depth discussion of the accounting for leveraged leases.

11.5 Other considerations

11.5.1 Sale and leaseback transition

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

aa. If a previous sale and leaseback transaction was accounted for as a sale and a leaseback in accordance with Topic 840, an entity shall not reassess the transaction to determine whether the transfer of the asset would have been a sale in accordance with paragraphs 842-40-25-1 through 25-3.

bb. If a previous sale and leaseback transaction was accounted for as a failed sale and leaseback transaction in accordance with Topic 840 and remains a failed sale at the effective date, the entity shall reassess whether a sale would have occurred at any point on or after the beginning of the earliest period presented in the financial statements in accordance with paragraphs 842-40-25-1 through 25-3. The sale and leaseback transaction shall be accounted for on a modified retrospective basis from the date a sale is determined to have occurred, in accordance with the requirements in (cc) through (dd).

cc. An entity shall account for the leaseback in accordance with the lessee and lessor transition requirements in (k) through (y).

dd. If a previous sale and leaseback transaction was accounted for as a sale and capital leaseback in accordance with Topic 840, the transferor shall continue to recognize any deferred gain or loss that exists at the later of the beginning of the earliest comparative period presented in the financial statements or the date of the sale of the underlying asset as follows:

1. If the underlying asset is land only, straight line over the remaining lease term.
2. If the underlying asset is not land only and the leaseback is a finance lease, in proportion to the amortization of the right-of-use asset.
3. If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the recognition in profit or loss of the total lease cost.

ee. If a previous sale and leaseback transaction was accounted for as a sale and operating leaseback in accordance with Topic 840, the transferor shall do the following:

1. Recognize any deferred gain or loss not resulting from off-market terms (that is, where the consideration for the sale of the asset is not at **fair value** or the lease payments are not at market rates) as a cumulative-effect adjustment at the later of the date of initial application (to equity) or the date of sale (to earnings of the comparative period presented).

2. Recognize any deferred loss resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as an adjustment to the leaseback right-of-use asset at the date of initial application.

3. Recognize any deferred gain resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as a financial liability at the date of initial application.

Entities reassess whether there would have been a sale under ASC 842's sale and leaseback guidance only if the existing sale and leaseback transaction is not being accounted for as a sale and leaseback under ASC 840 at the effective date. If assets and liabilities were recognized only as a result of ASC 840's build-to-suit guidance are derecognized in transition (refer to section 11.3.5, *Lessee involvement in asset construction ('build-to-suit' transactions)*), the entity does not reassess whether there would have been a sale under ASC 842. That is, only failed sale and leaseback transactions (i.e., transactions that were subject to sale leaseback accounting for reasons other than the application of ASC 840's build-to-suit guidance) are reassessed during transition. In those cases, entities reassess whether there would have been a sale by applying the relevant revenue recognition guidance in ASC 606 and the additional concepts in ASC 842. Refer to section 7.2, *Determining whether the transfer of an asset is a sale*. Further when the transaction was a failed sale and leaseback under ASC 840 but would qualify as a sale under ASC 842's sale and leaseback guidance during the comparative periods, the seller-lessee is required to consider ASC 840 to apply the transition provisions in ASC 842-10-65-1(bb) through (ee). That is, to apply the transition provisions, the seller-lessee would determine the lease classification and what the deferred gain, if any, would have under ASC 840, assuming the transaction qualified as a sale and leaseback.

A transaction previously accounted for as a sale and leaseback under ASC 840 is not reassessed as to whether the transfer of asset would have been a sale under ASC 842.

A seller-lessee accounts for any deferred gain or loss on a transaction previously accounted for as a sale and leaseback as follows:

- For leasebacks previously classified as capital leases under ASC 840, the seller-lessee continues to recognize any deferred gain or loss that exists at the later of (1) the beginning of the earliest comparative period presented or (2) the date of the sale of the underlying asset and amortizes it as follows:
  - If the underlying asset is land only, on a straight-line basis over the remaining lease term
  - If the underlying asset includes more than just land and the leaseback is a finance lease under ASC 842, in proportion to the amortization of the right-of-use asset
  - If the underlying asset includes more than just land and the leaseback is an operating lease under ASC 842, in proportion to the recognition in profit or loss of the total lease cost
- For leasebacks previously classified as operating leases under ASC 840, the seller-lessee recognizes any deferred gain or loss not resulting from off-market terms at the later of the beginning of the earliest comparative period presented or the date of sale. This gain or loss is recognized as a cumulative-effect adjustment to equity at the beginning of the earliest comparative period presented or to earnings of the comparative period presented at the date of sale. Any deferred amount that is the result of off-market terms is recognized as an adjustment to the right-of-use asset if the amount is a loss or as a financial liability if it is a gain.

A seller-lessee and a buyer-lessor accounts for the leaseback in accordance with the lessee and lessor transition requirements discussed in sections 11.3, *Lessee transition*, and 11.4, *Lessor transition*, respectively.

For transactions that previously qualified as a sale and leaseback using the guidance in ASC 840, entities are also permitted to apply the package of practical expedients and/or the hindsight practical expedient to classify (as applicable) and account for the leaseback transaction. Electing not to apply the package of practical expedients could impact the accounting in transition. For example, if a seller-lessee had a previous sale and leaseback transaction involving land and other assets (e.g., leasehold improvements) that was accounted for as a sale and capital leaseback in accordance with Topic 840, the amortization of any deferred gain would be impacted by the new lease classification (842-10-65-1(dd)). Conversely, the reassessment of lease classification for a sale and leaseback that was accounted for as a sale and operating leaseback in accordance with ASC 840 does not affect the subsequent amortization of any deferred gain (ASC 842-10-65-1(ee)).

However, we believe the practical expedients are not applicable for a seller-lessee that reassessed a failed sale-leaseback under ASC 840 but after applying the relevant revenue recognition guidance in ASC 606 and the additional concepts in ASC 842 concludes the transaction qualifies as a sale. This is because the seller-lessee will be applying lease accounting for the first time at time the requirements for sale accounting are met. That is, there is not a preexisting lease to reassess using the practical expedients. Refer to 11.2.2, *Transition practical expedients*, for a further discussion on the use of practical expedients in transition.

11.5.2 Amounts previously recognized in a business combination

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

h. If an entity has previously recognized an asset or a liability in accordance with Topic 805 on **business combinations** relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination, the entity shall do all of the following:

1. Derecognize that asset and liability (except for those arising from operating leases for which the entity is a lessor).
2. Adjust the carrying amount of the right-of-use asset by a corresponding amount if the entity is a lessee.
3. Make a corresponding adjustment to equity at the beginning of the earliest comparative period presented if assets or liabilities arise from leases classified as **sales-type leases** or **direct financing leases** in accordance with Topic 840 for which the entity is a lessor.

If an entity has previously recognized an asset or a liability related to favorable or unfavorable (i.e., off-market) terms of an operating lease acquired as part of a business combination, the entity will derecognize that asset and liability (unless they arose from operating leases in which the entity is a lessor) with a corresponding adjustment to the right-of-use asset if the entity is a lessee.

The transition guidance in ASC 842-10-65-1(h) appears to address only the favorable or unfavorable off-market terms recognized for operating leases. We believe that the in-place intangible asset recognized for an operating lease would be bifurcated and not derecognized. Further, we believe that no adjustment is required upon the adoption of ASC 842 for a sales-type or direct financing lease unless a separate asset or liability was previously recognized (other than the separate intangible asset for customer relationship and in-place intangible asset).

11.6 Disclosures

Excerpt from Accounting Standards Codification

Leases — Overall

Transition and Open Effective Date Information

842-10-65-1

i. An entity shall provide the transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraph 250-10-50-1(b)(2).

j. If an entity uses one or both of the practical expedients in (f) and (g), it shall disclose that fact.

Lessees and lessors are required to provide transition disclosures in accordance with ASC 250, *Accounting Changes and Error Correction*s, except for the disclosure of the effect of the change on income from continuing operations, net income, any other affected financial statement line item and any affected per-share amounts for the current period and any prior periods that are adjusted. A lessee or a lessor that makes an election to apply the practical expedients discussed in section 11.2.2, *Transition practical expedients*, is required to disclose that fact.

A Abbreviations used in this publication

Abbreviation	*FASB Accounting Standards Codification*
ASC 230	FASB ASC Topic 230, *Statement of Cash Flows*
ASC 250	FASB ASC Topic 250, *Accounting Changes and Error Corrections*
ASC 310	FASB ASC Topic 310, *Receivables*
ASC 326	FASB ASC Topic 326, *Financial Instruments — Credit Losses*
ASC 330	FASB ASC Topic 330, *Inventory*
ASC 350	FASB ASC Topic 350, *Intangibles — Goodwill and Other*
ASC 360	FASB ASC Topic 360, *Property, Plant, and Equipment*
ASC 405-20	FASB ASC Subtopic 405-20, *Liabilities — Extinguishments of Liabilities*
ASC 410-20	FASB ASC Subtopic 410-20, *Asset Retirement and Environmental Obligations — Asset Retirement Obligations*
ASC 420	FASB ASC Topic 420, *Exit or Disposal Cost Obligations*
ASC 450	FASB ASC Topic 450, *Contingencies*
ASC 460	FASB ASC Topic 460, *Guarantees*
ASC 470	FASB ASC Topic 470, *Debt*
ASC 605	FASB ASC Topic 605, *Revenue Recognition*
ASC 605-25	FASB ASC Subtopic 605-25, *Revenue Recognition — Multiple-Element Arrangements*
ASC 606	FASB ASC Topic 606, *Revenue from Contracts with Customers*
ASC 610-20	FASB ASC Subtopic 610-20, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*
ASC 720-15	FASB ASC Subtopic 720-15, *Other Expenses — Start-Up Costs*
ASC 740	FASB ASC Topic 740, *Income Taxes*
ASC 805	FASB ASC Topic 805, *Business Combinations*
ASC 810	FASB ASC Topic 810, *Consolidation*
ASC 815	FASB ASC Topic 815, *Derivatives and Hedging*
ASC 815-15	FASB ASC Subtopic 815-15, *Derivatives and Hedging — Embedded Derivatives*
ASC 820	FASB ASC Topic 820, *Fair Value Measurement*
ASC 830	FASB ASC Topic 830, *Foreign Currency Matters*
ASC 835-20	FASB ASC Subtopic 835-20, *Interest — Capitalization of Interest*
ASC 840	FASB ASC Topic 840, *Leases*
ASC 842	FASB ASC Topic 842, *Leases*
ASC 845	FASB ASC Topic 845, *Nonmonetary Transactions*
ASC 853	FASB ASC Topic 853, *Service Concession Arrangements*
ASC 860	FASB ASC Topic 860, *Transfers and Servicing*
ASC 970-360	FASB ASC Subtopic 970-360, *Real Estate — General — Property, Plant, and Equipment*
ASC 980	FASB ASC Topic 980, *Regulated Operations*
ASU 2016-02	FASB Accounting Standards Update 2016-02, *Leases (Topic 842)*
ASU 2016-13	FASB Accounting Standards Update 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

Abbreviation	*Other Authoritative Standards*
GASB 13	Governmental Accounting Standards Board Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*
NCGA 5	National Council on Governmental Accounting Statement No. 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*
SAB Topic 11.M	SEC Staff Accounting Bulletin Topic 11.M, *Miscellaneous Disclosure — Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*

Abbreviation	*Non-authoritative Standards*
EITF 01-8	EITF Issue No. 01-8, *Determining Whether an Arrangement Contains a Lease*
FASB Statement 13	FASB Statement No. 13, *Accounting for Leases*
Statement 109	FASB Statement No. 109, *Accounting for Income Taxes*

B Index of ASC references in this publication

ASC paragraph	Section	
270-10-50-6A	5.9	Disclosure
360-10-25-2	1.7	Acquisition of lease residual values
360-10-25-3	1.7	Acquisition of lease residual values
360-10-25-4	1.7	Acquisition of lease residual values
360-10-30-3	1.7	Acquisition of lease residual values
360-10-30-4	1.7	Acquisition of lease residual values
360-10-35-13	1.7	Acquisition of lease residual values
360-10-35-14	1.7	Acquisition of lease residual values
410-20-15-3	2.4.8	Lessee's obligations for asset retirement obligations (AROs)
460-10-25-1	2.10.6	Third-party guarantee of lease payments or residual value
606-10-25-1 through 25-8	7.2	Determining whether the transfer of an asset is a sale
606-10-25-27	7.7.2	Determining whether the lessee controls the underlying asset being constructed
606-10-25-30	5.7.7	Sales of equipment with guaranteed minimum resale amount
606-10-25-30	7.2	Determining whether the transfer of an asset is a sale
606-10-25-30	7.2.3	Seller-lessee guarantee of the residual value
606-10-25-30	7.9	Transfer of tax benefits
606-10-32-2 through 32-27	7.3	Transactions in which the transfer of an asset is a sale
606-10-32-5 through 32-9	7.3.2.1	Variable lease payments
606-10-32-28	1.4.4.3	Allocating variable payments — lessors
606-10-32-28 through 32-41	1.4.4.2	Allocating the consideration in the contract — lessors
606-10-32-42 through 32-45	1.4.4.5	Reassessment — determining and allocating the consideration in the contract
606-10-55-30 through 55-35	1.4.2.2	Guarantees of performance of underlying asset
606-10-55-66 through 55-78	5.7.7	Sales of equipment with guaranteed minimum resale amount
805-20-25-10	8.2	Recognition and measurement of acquired leases
805-20-25-10A	8.2	Recognition and measurement of acquired leases
805-20-25-11	8.2	Recognition and measurement of acquired leases
805-20-25-12	8.2	Recognition and measurement of acquired leases
805-20-25-28A	8.2	Recognition and measurement of acquired leases
805-20-25-28B	8.2	Recognition and measurement of acquired leases

ASC paragraph	Section	
805-20-30-24	8.2.1	Acquiree in a business combination is a lessee in a finance or operating lease
805-20-30-25	8.2.2	Acquiree in a business combination is a lessor in a sales-type or direct financing lease
805-20-35-6	4.7.3.2	Leasehold improvements acquired in business combinations
805-20-35-6	8.2.1	Acquiree in a business combination is a lessee in a finance or operating lease
815-10-15-80	2.10.1	Residual value guarantees as derivatives
815-10-15-81	2.10.1	Residual value guarantees as derivatives
815-15-15-5	2.9.4	Embedded foreign currency derivatives
815-15-15-10	2.9.4	Embedded foreign currency derivatives
840-30-S99-2	10.4	Disclosures
842-10-15-1	1.1	Scope and scope exceptions
842-10-15-2	1.2	Determining whether an arrangement contains a lease
842-10-15-2	2.1	Inception of a contract
842-10-15-3	1.2	Determining whether an arrangement contains a lease
842-10-15-4	1.2	Determining whether an arrangement contains a lease
842-10-15-5	1.2	Determining whether an arrangement contains a lease
842-10-15-6	1.3	Reassessment of the contract
842-10-15-6	4.6.3	Lessee accounting for a modification that is not accounted for as a separate contract
842-10-15-7	1.2	Determining whether an arrangement contains a lease
842-10-15-9	1.2.1	Identified asset
842-10-15-10	1.2.1.1	Substantive substitution rights
842-10-15-11	1.2.1.1	Substantive substitution rights
842-10-15-12	1.2.1.1	Substantive substitution rights
842-10-15-13	1.2.1.1	Substantive substitution rights
842-10-15-14	1.2.1.1	Substantive substitution rights
842-10-15-15	1.2.1.1	Substantive substitution rights
842-10-15-16	1.2.1	Identified asset
842-10-15-17	1.2.2.1	Right to obtain substantially all of the economic benefits from the use of the identified asset
842-10-15-18	1.2.2.1	Right to obtain substantially all of the economic benefits from the use of the identified asset
842-10-15-19	1.2.2.1	Right to obtain substantially all of the economic benefits from the use of the identified asset
842-10-15-20	1.2.2.2	Right to direct the use of the identified asset
842-10-15-21	1.2.2.2	Right to direct the use of the identified asset
842-10-15-22	1.2.2.2	Right to direct the use of the identified asset
842-10-15-23	1.2.2.3	Protective rights
842-10-15-24	1.2.2.2	Right to direct the use of the identified asset
842-10-15-25	1.2.2.2	Right to direct the use of the identified asset
842-10-15-26	1.2.2.2	Right to direct the use of the identified asset
842-10-15-28	1.4.1	Identifying and separating lease components of a contract

ASC paragraph	Section	
842-10-15-29	1.4.1	Identifying and separating lease components of a contract
842-10-15-30	1.4.2	Identifying and separating lease from non-lease components of a contract
842-10-15-31	1.4.2	Identifying and separating lease from non-lease components of a contract
842-10-15-33	1.4.3.2	Allocating the consideration in the contract — lessees
842-10-15-34	1.4.3.2	Allocating the consideration in the contract — lessees
842-10-15-35	1.4.3.1	Determining the consideration in the contract
842-10-15-36	1.4.3.3	Reassessment — determining and allocating the consideration in the contract
842-10-15-37	1.4.2.3	Practical expedient — lessees
842-10-15-38	1.4.4	Determining, allocating and reassessing the consideration in the contract — lessors
842-10-15-39	1.4.4	Determining, allocating and reassessing the consideration in the contract — lessors
842-10-15-40	1.4.4	Determining, allocating and reassessing the consideration in the contract — lessors
842-10-15-41	1.4.4.5	Reassessment — determining and allocating the consideration in the contract
842-10-15-42	1.4.4.5	Reassessment — determining and allocating the consideration in the contract
842-10-15-43	2.10.1	Residual value guarantees as derivatives
842-10-25-1	3.5	Reassessment of lease classification
842-10-25-2	3	Lease classification
842-10-25-3	3	Lease classification
842-10-25-4	2.5	Discount rates
842-10-25-4	3	Lease classification
842-10-25-5	3.4.4	Lease component that contains the right to use more than one underlying asset
842-10-25-6	3.4.10	Classification of subleases
842-10-25-6	6.3	Sublessor accounting
842-10-25-8	4.6.2	Determining whether a lease modification is accounted for as a separate contract
842-10-25-8	5.6.2	Determining whether a lease modification is accounted for as a separate contract
842-10-25-9	4.6.3	Lessee accounting for a modification that is not accounted for as a separate contract
842-10-25-9	5.6.3	Lessor accounting for a modification that is not accounted for as a separate contract
842-10-25-10	2.6.1	Initial direct costs in a lease modification
842-10-25-10	4.6.3	Lessee accounting for a modification that is not accounted for as a separate contract
842-10-25-10	5.6.3	Lessor accounting for a modification that is not accounted for as a separate contract

ASC paragraph	Section	
842-10-25-11	4.6.3	Lessee accounting for a modification that is not accounted for as a separate contract
842-10-25-12	4.6.3	Lessee accounting for a modification that is not accounted for as a separate contract
842-10-25-13	4.6.3	Lessee accounting for a modification that is not accounted for as a separate contract
842-10-25-14	4.6.3	Lessee accounting for a modification that is not accounted for as a separate contract
842-10-25-15	5.6.3.1	Modification to an operating lease that is not accounted for as a separate contract
842-10-25-16	5.6.3.2	Modification to a direct financing lease that is not accounted for as a separate contract
842-10-25-17	5.6.3.3	Modification to a sales-type lease that is not accounted for as a separate contract
842-10-25-19	1.5	Contract combinations
842-10-30-1	2.3.1	Lease term
842-10-30-2	2.3.1	Lease term
842-10-30-3	2.3.2	Purchase options
842-10-30-5	2.4	Lease payments
842-10-30-6	2.4	Lease payments
842-10-30-6	2.4.10	Amounts not included in lease payments
842-10-30-7	2.4.8	Lessee's obligations for asset retirement obligations (AROs)
842-10-30-9	2.6	Initial direct costs
842-10-30-10	2.6	Initial direct costs
842-10-35-1	2.3.6.1	Lessees
842-10-35-3	2.3.6.2	Lessors
842-10-35-3	3.5	Reassessment of lease classification
842-10-35-3	5.2.4	Remeasurement of the net investment in the lease
842-10-35-3	5.3.4	Remeasurement of the net investment in the lease
842-10-35-4	2.4.11.1	Lessees
842-10-35-4	4.5	Remeasurement of lease liabilities and right-of-use assets — operating and finance leases
842-10-35-5	2.4.11.1	Lessees
842-10-35-5	4.5	Remeasurement of lease liabilities and right-of-use assets — operating and finance leases
842-10-35-6	2.4.11.2	Lessors
842-10-55-2	3.4.3	Evaluating 'major part,' 'substantially all' and 'at or near the end'
842-10-55-3	3.4.6	Fair value of the underlying asset
842-10-55-4 through 55-6	3.4.1	Transfer of ownership
842-10-55-7	3.4.7	Alternative use criterion
842-10-55-8	3.4.6.1	Effect of investment tax credits
842-10-55-9 through 55-10	2.10.4	Residual value guarantee of a group of assets — lessors

ASC paragraph	Section	
842-10-55-11	8.1	Classification of acquired leases
842-10-55-12	9.1	Related party leasing transactions
842-10-55-13 through 55-14	3.4.9	Leases of government-owned facilities
842-10-55-15	3.4.8	Lessee indemnifications for environmental contamination
842-10-55-16	4.6.4	Lease modifications in connection with the refunding of tax-exempt debt
842-10-55-17	2.2.1	Lease commencement date for master lease agreements
842-10-55-17 through 55-18	4.4	Master lease agreements
842-10-55-17 through 55-18	5.1.5	Master lease agreements
842-10-55-19 through 55-20	2.2	Commencement date of the lease
842-10-55-19 through 55-21	4.8.6	Rent capitalization
842-10-55-22	2.2.1	Lease commencement date for master lease agreements
842-10-55-23 through 55-24	2.3.3	Cancellable leases
842-10-55-25 through 55-26	2.3.1	Lease term
842-10-55-27	2.3.5.4	Fiscal funding clause
842-10-55-28 through 55-29	2.3.6.1	Lessees
842-10-55-30	2.4.1.2	Lease incentives
842-10-55-30	4.7	Lease incentives
842-10-55-31	2.4.1.1	In-substance fixed lease payments
842-10-55-33	1.4.2.2	Guarantees of performance of underlying asset
842-10-55-34	2.10.2	Residual value guarantee of deficiency that is attributable to damage, extraordinary wear and tear or excessive usage
842-10-55-35	2.4.6.2	Requirement for lessee to purchase the underlying asset
842-10-55-36	2.4.6.1	Third-party insurance that guarantees the asset's residual value
842-10-55-37	2.4.8	Lessee's obligations for asset retirement obligations (AROs)
842-10-55-38 through 55-40	2.4.9	Tax indemnifications in lease agreements
842-10-55-42 through 55-51	C1	Example 1 — Rail cars
842-10-55-52 through 55-54	C2	Example 2 — Concession space
842-10-55-55 through 55-62	C3	Example 3 — Fiber-optic cable
842-10-55-63 through 55-71	C4	Example 4 — Retail unit
842-10-55-72 through 55-78	C5	Example 5 — Truck rental

ASC paragraph	Section	
842-10-55-79 through 55-91	C6	Example 6 — Ship
842-10-55-92 through 55-99	C7	Example 7 — Aircraft
842-10-55-100 through 55-107	C8	Example 8 — Contract for shirts
842-10-55-108 through 55-123	1.2.2.2	Right to direct the use of the identified asset
842-10-55-124 through 55-130	C9	Example 9 — Contract for network services
842-10-55-132 through 55-137	1.4.5	Examples — identifying and separating components of a contract and determining and allocating the consideration in the contract
842-10-55-138 through 55-140	1.4.5	Examples — identifying and separating components of a contract and determining and allocating the consideration in the contract
842-10-55-141 through 55-145	1.4.2.1	Executory costs
842-10-55-146 through 55-149	1.4.1	Identifying and separating lease components of a contract
842-10-55-150 through 55-152	1.4.5	Examples — identifying and separating components of a contract and determining and allocating the consideration in the contract
842-10-55-153 through 55-156	1.4.5	Examples — identifying and separating components of a contract and determining and allocating the consideration in the contract
842-10-55-157 through 55-158	1.4.5	Examples — identifying and separating components of a contract and determining and allocating the consideration in the contract
842-10-55-160 through 55-161	4.6.5.1	Modification is accounted for as a separate contract
842-10-55-162 through 55-165	4.6.5.2	Modification increases the lease term
842-10-55-166 through 55-167	4.6.5.2	Modification increases the lease term
842-10-55-168 through 55-176	4.6.5.3	Modification grants an additional right of use — not a separate contract
842-10-55-177 through 55-185	4.6.5.4	Modification partially terminates a lease
842-10-55-186 through 55-189	4.6.5.5	Modification only changes lease payments
842-10-55-190 through 55-193	5.6.3.1	Modification to an operating lease that is not accounted for as a separate contract
842-10-55-194 through 55-197	5.6.3.1	Modification to an operating lease that is not accounted for as a separate contract
842-10-55-198 through 55-200	5.6.3.1	Modification to an operating lease that is not accounted for as a separate contract
842-10-55-201 through 55-205	5.6.3.2	Modification to a direct financing lease that is not accounted for as a separate contract
842-10-55-206 through 55-207	5.6.3.2	Modification to a direct financing lease that is not accounted for as a separate contract

ASC paragraph	Section	
842-10-55-208 through 55-209	5.6.3.2	Modification to a direct financing lease that is not accounted for as a separate contract
842-10-55-240 through 55-242	2.6	Initial direct costs
842-10-55-244 through 55-247	11.3.4.1	Leases previously classified as capital leases under ASC 840
842-10-55-249 through 55-254	11.3.4.2	Leases previously classified as operating leases under ASC 840
842-10-65-1(a) through 65-1(b)	11.1	Effective date
842-10-65-1(c) through 65-1(e)	11.2	Transition
842-10-65-1(f) through 65-1(g)	11.2.2	Transition practical expedients
842-10-65-1(h)	11.5.2	Amounts previously recognized in a business combination
842-10-65-1(i) through 65-1(j)	11.6	Disclosures
842-10-65-1(k) through 65-1(q)	11.3.3	Leases previously classified as operating leases under ASC 840 that are classified as operating or finance leases under ASC 842
842-10-65-1(r)	11.3.1	Leases previously classified as capital leases under ASC 840 that are classified as finance leases under ASC 842
842-10-65-1(s) through 65-1(t)	11.3.2	Leases previously classified as capital leases under ASC 840 that are classified as operating leases under ASC 842
842-10-65-1(t)	11.3.1	Leases previously classified as capital leases under ASC 840 that are classified as finance leases under ASC 842
842-10-65-1(u)	11.3.5	Lessee involvement in asset construction ('build-to-suit' transactions)
842-10-65-1(v)	11.4.3	Leases previously classified as operating leases under ASC 840 that continue to be classified as operating leases under ASC 842
842-10-65-1(w)	11.4.4	Leases previously classified as operating leases under ASC 840 that are classified as sales-type or directing financing leases under ASC 842
842-10-65-1(x)	11.4.1	Leases previously classified as sales-type or direct financing leases under ASC 840 that continue to be classified as sales-type or direct financing leases under ASC 842
842-10-65-1(y)	11.4.2	Leases previously classified as sales-type or direct financing leases under ASC 840 that are classified as operating leases under ASC 842
842-10-65-1(z)	5.7.5	Leveraged leases
842-10-65-1(z)	10.1	Introduction and grandfathering
842-10-65-1(z)	11.4.5	Leases previously classified as leveraged leases under ASC 840
842-10-65-1(aa) through 65-1(ee)	11.5.1	Sale and leaseback transition
842-20-25-1	4.1	Initial recognition
842-20-25-2	4.1	Initial recognition
842-20-25-3	4.1	Initial recognition
842-20-25-5	4.3.2	Subsequent measurement
842-20-25-6	4.2.2	Subsequent measurement

ASC paragraph	Section	
842-20-25-7	4.2.5	Impairment of right-of-use assets after the effective date
842-20-25-8	4.2.2	Subsequent measurement
842-20-30-1	4.2.1	Initial measurement
842-20-30-2	2.5	Discount rates
842-20-30-3	2.5	Discount rates
842-20-30-3	2.5.2	Lessees
842-20-30-5	4.2.1	Initial measurement
842-20-35-1	4.3.2	Subsequent measurement
842-20-35-2	4.3.2	Subsequent measurement
842-20-35-3	4.2.2	Subsequent measurement
842-20-35-4	4.2.2	Subsequent measurement
842-20-35-4	4.5	Remeasurement of lease liabilities and right-of-use assets — operating and finance leases
842-20-35-5	4.5	Remeasurement of lease liabilities and right-of-use assets — operating and finance leases
842-20-35-7	4.3.2	Subsequent measurement
842-20-35-8	4.3.2	Subsequent measurement
842-20-35-9	4.2.5	Impairment of right-of-use assets after the effective date
842-20-35-10	4.2.5	Impairment of right-of-use assets after the effective date
842-20-35-12	4.7.3	Amortization of leasehold improvements
842-20-35-13	4.7.3.2	Leasehold improvements acquired in business combinations
842-20-35-14	6.3	Sublessor accounting
842-20-35-15	6.3	Sublessor accounting
842-20-40-1	4.8.1	Lease termination
842-20-40-2	4.8.2	Purchase of a leased asset during the lease term
842-20-40-3	6.1.1	The original lessee is relieved of the primary obligation — not a sublease
842-20-45-1	4.9	Presentation
842-20-45-2	4.9	Presentation
842-20-45-3	4.9	Presentation
842-20-45-4	4.9	Presentation
842-20-45-5	4.9	Presentation
842-20-50-1	4.10	Disclosure
842-20-50-2	4.10	Disclosure
842-20-50-3	4.10	Disclosure
842-20-50-4	4.10	Disclosure
842-20-50-6	4.10	Disclosure
842-20-50-7	4.10	Disclosure
842-20-50-7	9.1	Related party leasing transactions
842-20-50-8	4.10	Disclosure
842-20-50-9	4.10	Disclosure
842-20-55-1 through 55-2	2.9.1	Lessee accounting for variable lease payments
842-20-55-1 through 55-2	4.2.3	Expense recognition

ASC paragraph	Section	
842-20-55-1 through 55-2	4.3.2	Subsequent measurement
842-20-55-3	4.2.3	Expense recognition
842-20-55-4 through 55-9	4.8.7	Lessee accounting for maintenance deposits
842-20-55-10	4.8.3	Leases denominated in a foreign currency
842-20-55-18 through 55-20	4.8.4	Portfolio approach
842-20-55-22 through 55-39	4.11	Lessee illustrations
842-20-55-48 through 55-51	4.2.5	Impairment of right-of-use assets after the effective date
842-20-55-53	4.10	Disclosure
842-30-25-1	5.2.1	Initial recognition and measurement
842-30-25-2	2.9.2	Lessor accounting for variable lease payments
842-30-25-2	5.2.2	Subsequent measurement
842-30-25-3	5.2.1	Initial recognition and measurement
842-30-25-4	5.2.1	Initial recognition and measurement
842-30-25-5	5.2.1	Initial recognition and measurement
842-30-25-6	5.2.1	Initial recognition and measurement
842-30-25-6	5.3.1	Initial recognition and measurement
842-30-25-7	5.3.1	Initial recognition and measurement
842-30-25-8	5.3.1	Initial recognition and measurement
842-30-25-9	2.9.2	Lessor accounting for variable lease payments
842-30-25-9	5.3.2	Subsequent measurement
842-30-25-10	5.4	Operating leases
842-30-25-11	2.9.2	Lessor accounting for variable lease payments
842-30-25-11	5.4	Operating leases
842-30-25-12	5.4	Operating leases
842-30-25-13	5.4	Operating leases
842-30-30-1	5.2.1	Initial recognition and measurement
842-30-30-1	5.3.1	Initial recognition and measurement
842-30-30-2	5.3.1	Initial recognition and measurement
842-30-30-4	5.4	Operating leases
842-30-35-1	5.2.2	Subsequent measurement
842-30-35-1	5.3.2	Subsequent measurement
842-30-35-2	5.2.4	Remeasurement of the net investment in the lease
842-30-35-2	5.3.4	Remeasurement of the net investment in the lease
842-30-35-3	5.2.3	Impairment of the net investment in the lease
842-30-35-4	5.7.1	Sale of lease receivables
842-30-35-5	5.7.2	Accounting for the underlying asset at the end of a lease
842-30-35-6	5.4	Operating leases
842-30-35-7	6.2	Original lessor accounting
842-30-40-1	5.2.1	Initial recognition and measurement

ASC paragraph	Section	
842-30-40-1	5.3.1	Initial recognition and measurement
842-30-40-2	5.7.3	Lease termination
842-30-40-3	6.2	Original lessor accounting
842-30-40-4	1.7	Acquisition of lease residual values
842-30-45-1	5.8	Presentation
842-30-45-2	5.8	Presentation
842-30-45-3	5.8	Presentation
842-30-45-4	5.8	Presentation
842-30-45-5	5.8	Presentation
842-30-45-6	5.8	Presentation
842-30-45-7	5.8	Presentation
842-30-50-3	5.9	Disclosure
842-30-50-4	5.9	Disclosure
842-30-50-4	9.1	Related party leasing transactions
842-30-50-5	5.9	Disclosure
842-30-50-6	5.9	Disclosure
842-30-50-7	5.9	Disclosure
842-30-50-8	5.9	Disclosure
842-30-50-9	5.9	Disclosure
842-30-50-10	5.9	Disclosure
842-30-50-11	5.9	Disclosure
842-30-50-12	5.9	Disclosure
842-30-50-13	5.9	Disclosure
842-30-55-1 through 55-15	5.7.7	Sales of equipment with guaranteed minimum resale amount
842-30-55-16	2.4.9	Tax indemnifications in lease agreements
842-30-55-17	5.4	Operating leases
842-30-55-19 through 55-24	5.5	Examples — lessor accounting
842-30-55-25 through 55-30	5.5	Examples — lessor accounting
842-30-55-31 through 55-39	5.5	Examples — lessor accounting
842-30-55-40 through 55-43	5.5	Examples — lessor accounting
842-40-15-2	7.1	Overview
842-40-25-1	7.2	Determining whether the transfer of an asset is a sale
842-40-25-2	7.2	Determining whether the transfer of an asset is a sale
842-40-25-3	7.2	Determining whether the transfer of an asset is a sale
842-40-25-4	7.3	Transactions in which the transfer of an asset is a sale
842-40-25-5	7.4	Transactions in which the transfer of an asset is not a sale
842-40-30-1	7.3	Transactions in which the transfer of an asset is a sale
842-40-30-2	7.3	Transactions in which the transfer of an asset is a sale
842-40-30-3	7.3	Transactions in which the transfer of an asset is a sale

ASC paragraph	Section	
842-40-30-4	7.3	Transactions in which the transfer of an asset is a sale
842-40-30-6	7.4	Transactions in which the transfer of an asset is not a sale
842-40-50-1	7.8	Disclosure
842-40-50-2	7.8	Disclosure
842-40-55-1 through 55-2	7.1	Overview
842-40-55-3 through 55-5	7.7	Lessee involvement in asset construction ('build-to-suit' transactions)
842-40-55-7	7.7.1	Lessee indemnification of environmental contamination
842-40-55-8 through 55-10	7.1.5	Sale subject to a preexisting lease
842-40-55-11 through 55-17	7.9	Transfer of tax benefits
842-40-55-18 through 55-19	7.1.6	Sale-leaseback-sublease transactions
842-40-55-20 through 55-21	7.2.3	Seller-lessee guarantee of the residual value
842-40-55-23 through 55-30	7.3.3	Example
842-40-55-31 through 55-38	7.4.2	Example
842-40-55-40 through 55-44	7.7.2	Determining whether the lessee controls the underlying asset being constructed
842-50-15-1	5.7.5	Leveraged leases
842-50-15-1	10.1	Introduction and grandfathering
842-50-25-1	10.2	Definition of a leveraged lease
842-50-25-2	8.5	Leveraged lease acquired in a business combination or by a not-for-profit entity
842-50-30-1	10.3	Accounting for leveraged leases
842-50-30-2	8.5	Leveraged lease acquired in a business combination or by a not-for-profit entity
842-50-35-1	8.5	Leveraged lease acquired in a business combination or by a not-for-profit entity
842-50-35-2	10.3	Accounting for leveraged leases
842-50-35-3	10.3	Accounting for leveraged leases
842-50-35-4	10.3	Accounting for leveraged leases
842-50-35-5	10.3	Accounting for leveraged leases
842-50-35-6	10.3.4	Change in leveraged lease assumptions
842-50-35-7	10.3.4	Change in leveraged lease assumptions
842-50-35-8	10.3.4	Change in leveraged lease assumptions
842-50-35-9	10.3.4	Change in leveraged lease assumptions
842-50-35-10	10.3.4	Change in leveraged lease assumptions
842-50-35-11	10.3.4	Change in leveraged lease assumptions
842-50-35-12	10.3.4	Change in leveraged lease assumptions
842-50-35-13	10.3.4	Change in leveraged lease assumptions

ASC paragraph	Section	
842-50-35-14	10.3.4	Change in leveraged lease assumptions
842-50-35-15	10.3.4	Change in leveraged lease assumptions
842-50-35-16	10.3.4.2	Impact of AMT on leveraged lease accounting
842-50-35-17	10.3.4.2	Impact of AMT on leveraged lease accounting
842-50-35-18	10.3.4.2	Impact of AMT on leveraged lease accounting
842-50-35-19	10.3.4.2	Impact of AMT on leveraged lease accounting
842-50-35-20	10.3.4.2	Impact of AMT on leveraged lease accounting
842-50-45-1	10.3.3	Accounting for income taxes related to leveraged leases
842-50-45-2	10.3.3	Accounting for income taxes related to leveraged leases
842-50-45-3	10.3.3	Accounting for income taxes related to leveraged leases
842-50-50-1	10.4	Disclosures
842-50-50-2	10.4	Disclosures
842-50-50-3	10.4	Disclosures
842-50-55-1	10.2.1	Leveraged lease involving an existing asset of a regulated entity
842-50-55-2 through 55-3	10.3.5	Impact of delayed equity investment on leveraged lease accounting
842-50-55-4 through 55-5	10.3.3	Accounting for income taxes related to leveraged leases
842-50-55-6 through 55-15	10.3.6	Leveraged lease — comprehensive illustration
842-50-55-24 through 55-26	10.3.4.3	Impact of change or projected change in the timing of cash flows relating to income taxes generated by a leveraged lease transaction
842-50-55-27 through 55-33	8.5	Leveraged lease acquired in a business combination or by a not-for-profit entity
853-10-05-1	1.8	Service concession arrangements
853-10-05-2	1.8	Service concession arrangements
853-10-15-2	1.8	Service concession arrangements
853-10-15-4	1.8.1	Service concession arrangements in regulated operations
860-10-55-6	5.7.1.1	Sales or securitizations of lease receivables associated with sales-type and direct financing leases
860-10-55-6	5.7.1.2	Accounting for a guaranteed residual value
860-20-55-26	5.7.1.1	Sales or securitizations of lease receivables associated with sales-type and direct financing leases
860-20-55-58 through 55-59	5.7.1.1	Sales or securitizations of lease receivables associated with sales-type and direct financing leases
980-842-05-1	7.6	Sale and leasebacks by entities with regulated operations
980-842-25-1	7.6	Sale and leasebacks by entities with regulated operations
980-842-25-2	7.6	Sale and leasebacks by entities with regulated operations
980-842-35-1	7.6	Sale and leasebacks by entities with regulated operations
980-842-45-3	7.6	Sale and leasebacks by entities with regulated operations

C Illustrations from ASC 842 on the application of the definition of a lease

ASC 842 includes the following examples on the application of the definition of a lease. Refer to section 1.2, *Determining whether a contract contains a lease*.

C1 Example 1 — Rail cars

Excerpt from Accounting Standards Codification

Example 1 — Rail Cars

Case A — Contract Contains a Lease

842-10-55-42

A contract between Customer and a freight carrier (Supplier) provides Customer with the use of 10 rail cars of a particular type for 5 years. The contract specifies the rail cars; the cars are owned by Supplier. Customer determines when, where, and which goods are to be transported using the cars. When the cars are not in use, they are kept at Customer's premises. Customer can use the cars for another purpose (for example, storage) if it so chooses. However, the contract specifies that Customer cannot transport particular types of cargo (for example, explosives). If a particular car needs to be serviced or repaired, Supplier is required to substitute a car of the same type. Otherwise, and other than on default by Customer, Supplier cannot retrieve the cars during the five-year period.

842-10-55-43

The contract also requires Supplier to provide an engine and a driver when requested by Customer. Supplier keeps the engines at its premises and provides instructions to the driver detailing Customer's requests to transport goods. Supplier can choose to use any one of a number of engines to fulfill each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers (for example, if other customers require the transport of goods to destinations close to the destination requested by Customer and within a similar timeframe, Supplier can choose to attach up to 100 rail cars to the engine).

842-10-55-44

The contract contains leases of rail cars. Customer has the right to use 10 rail cars for 5 years.

842-10-55-45

There are 10 identified cars. The cars are explicitly specified in the contract. Once delivered to Customer, the cars can be substituted only when they need to be serviced or repaired. The engine used to transport the rail cars is not an identified asset because it is neither explicitly specified nor implicitly specified in the contract.

842-10-55-46

Customer has the right to control the use of the 10 rail cars throughout the 5-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the cars over the five-year period of use. Customer has exclusive use of the cars throughout the period of use, including when they are not being used to transport Customer's goods.

b. Customer has the right to direct the use of the cars. The contractual restrictions on the cargo that can be transported by the cars are protective rights of Supplier and define the scope of Customer's right to use the cars. Within the scope of its right of use defined in the contract, Customer makes the relevant decisions about how and for what purpose the cars are used by being able to decide when and where the rail cars will be used and which goods are transported using the cars. Customer also determines whether and how the cars will be used when not being used to transport its goods (for example, whether and when they will be used for storage). Customer has the right to change these decisions during the five-year period of use.

842-10-55-47

Although having an engine and driver (controlled by Supplier) to transport the rail cars is essential to the efficient use of the cars, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the rail cars are used. Consequently, Supplier does not control the use of the cars during the period of use.

Case B — Contract Does Not Contain a Lease

842-10-55-48

The contract between Customer and Supplier requires Supplier to transport a specified quantity of goods by using a specified type of rail car in accordance with a stated timetable for a period of five years. The timetable and quantity of goods specified are equivalent to Customer having the use of 10 rail cars for 5 years. Supplier provides the rail cars, driver, and engine as part of the contract. The contract states the nature and quantity of the goods to be transported (and the type of rail car to be used to transport the goods). Supplier has a large pool of similar cars that can be used to fulfill the requirements of the contract. Similarly, Supplier can choose to use any one of a number of engines to fulfill each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers. The cars and engines are stored at Supplier's premises when not being used to transport goods.

842-10-55-49

The contract does not contain a lease of rail cars or of an engine.

842-10-55-50

The rail cars and the engines used to transport Customer's goods are not identified assets. Supplier has the substantive right to substitute the rail cars and engine because:

a. Supplier has the practical ability to substitute each car and the engine throughout the period of use. Alternative cars and engines are readily available to Supplier, and Supplier can substitute each car and the engine without Customer's approval.

b. Supplier would benefit economically from substituting each car and the engine. There would be minimal, if any, cost associated with substituting each car or the engine because the cars and engines are stored at Supplier's premises and Supplier has a large pool of similar cars and engines. Supplier benefits from substituting each car or the engine in contracts of this nature because substitution allows Supplier to, for example, (1) use cars or an engine to fulfill a task for which the cars or engine are already positioned to perform (for example, a task at a rail yard close to the point of origin) or (2) use cars or an engine that would otherwise be sitting idle because they are not being used by a customer.

842-10-55-51

Accordingly, Customer does not direct the use and does not have the right to obtain substantially all of the economic benefits from use of an identified car or an engine. Supplier directs the use of the rail cars and engine by selecting which cars and engine are used for each particular delivery and obtains substantially all of the economic benefits from use of the rail cars and engine. Supplier is only providing freight capacity.

C2 Example 2 — Concession space

Excerpt from Accounting Standards Codification

Example 2 — Concession Space

842-10-55-52

A coffee company (Customer) enters into a contract with an airport operator (Supplier) to use a space in the airport to sell its goods for a three-year period. The contract states the amount of space and that the space may be located at any one of several boarding areas within the airport. Supplier has the right to change the location of the space allocated to Customer at any time during the period of use. There are minimal costs to Supplier associated with changing the space for the Customer: Customer uses a kiosk (that it owns) that can be moved easily to sell its goods. There are many areas in the airport that are available and that would meet the specifications for the space in the contract.

842-10-55-53

The contract does not contain a lease.

842-10-55-54

Although the amount of space Customer uses is specified in the contract, there is no identified asset. Customer controls its owned kiosk. However, the contract is for space in the airport, and this space can change at the discretion of Supplier. Supplier has the substantive right to substitute the space Customer uses because:

a. Supplier has the practical ability to change the space used by Customer throughout the period of use. There are many areas in the airport that meet the specifications for the space in the contract, and Supplier has the right to change the location of the space to other space that meets the specifications at any time without Customer's approval.

b. Supplier would benefit economically from substituting the space. There would be minimal cost associated with changing the space used by Customer because the kiosk can be moved easily. Supplier benefits from substituting the space in the airport because substitution allows Supplier to make the most effective use of the space at boarding areas in the airport to meet changing circumstances.

C3 Example 3 — Fiber-optic cable

Excerpt from Accounting Standards Codification

Example 3 — Fiber-Optic Cable

Case A — Contract Contains a Lease

842-10-55-55

Customer enters into a 15-year contract with a utilities company (Supplier) for the right to use 3 specified, physically distinct dark fibers within a larger cable connecting Hong Kong to Tokyo. Customer makes the decisions about the use of the fibers by connecting each end of the fibers to its electronic equipment (for example, Customer "lights" the fibers and decides what data and how much data those fibers will transport). If the fibers are damaged, Supplier is responsible for the repairs and maintenance. Supplier owns extra fibers but can substitute those for Customer's fibers only for reasons of repairs, maintenance, or malfunction (and is obliged to substitute the fibers in these cases).

842-10-55-56

The contract contains a lease of dark fibers. Customer has the right to use the 3 dark fibers for 15 years.

842-10-55-57

There are three identified fibers. The fibers are explicitly specified in the contract and are physically distinct from other fibers within the cable. Supplier cannot substitute the fibers other than for reasons of repairs, maintenance, or malfunction.

842-10-55-58

Customer has the right to control the use of the fibers throughout the 15-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the fibers over the 15-year period of use. Customer has exclusive use of the fibers throughout the period of use.

b. Customer has the right to direct the use of the fibers. Customer makes the relevant decisions about how and for what purpose the fibers are used by deciding when and whether to light the fibers and when and how much output the fibers will produce (that is, what data and how much data those fibers will transport). Customer has the right to change these decisions during the 15-year period of use.

842-10-55-59

Although Supplier's decisions about repairing and maintaining the fibers are essential to their efficient use, those decisions do not give Supplier the right to direct how and for what purpose the fibers are used. Consequently, Supplier does not control the use of the fibers during the period of use.

Case B — Contract Does Not Contain a Lease

842-10-55-60

Customer enters into a 15-year contract with Supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong to Tokyo. The specified amount is equivalent to Customer having the use of the full capacity of 3 strands within the cable (the cable contains 15 fibers with similar capacities). Supplier makes decisions about the transmission of data (that is, Supplier lights the fibers and makes decisions about which fibers are used to transmit Customer's traffic and about the electronic equipment that Supplier owns and connects to the fibers).

842-10-55-61

The contract does not contain a lease.

842-10-55-62

Supplier makes all decisions about the transmission of its customers' data, which requires the use of only a portion of the capacity of the cable for each customer. The capacity portion that will be provided to Customer is not physically distinct from the remaining capacity of the cable and does not represent substantially all of the capacity of the cable. Consequently, Customer does not have the right to use an identified asset.

C4 Example 4 — Retail unit

Excerpt from Accounting Standards Codification

Example 4 — Retail Unit

842-10-55-63

Customer enters into a contract with property owner (Supplier) to use Retail Unit A for a five-year period. Retail Unit A is part of a larger retail space with many retail units.

842-10-55-64

Customer is granted the right to use Retail Unit A. Supplier can require Customer to relocate to another retail unit. In that case, Supplier is required to provide Customer with a retail unit of similar quality and specifications to Retail Unit A and to pay for Customer's relocation costs. Supplier would benefit economically from relocating Customer only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favorable to cover the costs of relocating Customer and other tenants in the retail space that the new tenant will occupy. However, although it is possible that those circumstances will arise, at inception of the contract, it is not likely that those circumstances will arise. For example, whether a major new tenant will decide to lease a large amount of retail space at a rate that would be sufficiently favorable to cover the costs of relocating Customer is highly susceptible to factors outside Supplier's influence.

842-10-55-65

The contract requires Customer to use Retail Unit A to operate its well-known store brand to sell its goods during the hours that the larger retail space is open. Customer makes all of the decisions about the use of the retail unit during the period of use. For example, Customer decides on the mix of goods sold from the unit, the pricing of the goods sold, and the quantities of inventory held. Customer also controls physical access to the unit throughout the five-year period of use.

842-10-55-66

The contract requires Customer to make fixed payments to Supplier as well as variable payments that are a percentage of sales from Retail Unit A.

842-10-55-67

Supplier provides cleaning and security services as well as advertising services as part of the contract.

842-10-55-68

The contract contains a lease of retail space. Customer has the right to use Retail Unit A for five years.

842-10-55-69

Retail Unit A is an identified asset. It is explicitly specified in the contract. Supplier has the practical ability to substitute the retail unit, but could benefit economically from substitution only in specific circumstances. Supplier's substitution right is not substantive because, at inception of the contract, those circumstances are not considered likely to arise.

842-10-55-70

Customer has the right to control the use of Retail Unit A throughout the five-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of Retail Unit A over the five-year period of use. Customer has exclusive use of Retail Unit A throughout the period of use. Although a portion of the cash flows derived from sales from Retail Unit A will flow from Customer to Supplier, this represents consideration that Customer pays Supplier for the right to use the retail unit. It does not prevent Customer from having the right to obtain substantially all of the economic benefits from use of Retail Unit A.

b. Customer has the right to direct the use of Retail Unit A. The contractual restrictions on the goods that can be sold from Retail Unit A and when Retail Unit A is open define the scope of Customer's right to use Retail Unit A. Within the scope of its right of use defined in the contract, Customer makes the relevant decisions about how and for what purpose Retail Unit A is used by being able to decide, for example, the mix of products that will be sold in the retail unit and the sale price for those products. Customer has the right to change these decisions during the five-year period of use.

842-10-55-71

Although cleaning, security, and advertising services are essential to the efficient use of Retail Unit A, Supplier's decisions in this regard do not give it the right to direct how and for what purpose Retail Unit A is used. Consequently, Supplier does not control the use of Retail Unit A during the period of use, and Supplier's decisions do not affect Customer's control of the use of Retail Unit A.

C5 Example 5 — Truck rental

Excerpt from Accounting Standards Codification

Example 5 — Truck Rental

842-10-55-72

Customer enters into a contract with Supplier for the use of a truck for one week to transport cargo from New York to San Francisco. Supplier does not have substitution rights. Only cargo specified in the contract is permitted to be transported on this truck for the period of the contract. The contract specifies a maximum distance that the truck can be driven. Customer is able to choose the details of the journey (speed, route, rest stops, and so forth) within the parameters of the contract. Customer does not have the right to continue using the truck after the specified trip is complete.

842-10-55-73

The cargo to be transported and the timing and location of pickup in New York and delivery in San Francisco are specified in the contract.

842-10-55-74

Customer is responsible for driving the truck from New York to San Francisco.

842-10-55-75

The contract contains a lease of a truck. Customer has the right to use the truck for the duration of the specified trip.

842-10-55-76

There is an identified asset. The truck is explicitly specified in the contract, and Supplier does not have the right to substitute the truck.

842-10-55-77

Customer has the right to control the use of the truck throughout the period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from the use of the truck over the period of use. Customer has exclusive use of the truck throughout the period of use.

b. Customer has the right to direct the use of the truck. How and for what purpose the truck will be used (that is, the transport of specified cargo from New York to San Francisco within a specified time frame) are predetermined in the contract. Customer directs the use of the truck because it has the right to operate the truck (for example, speed, route, and rest stops) throughout the period of use. Customer makes all of the decisions about the use of the truck that can be made during the period of use through its control of the operations of the truck.

842-10-55-78

Because the duration of the contract is one week, this lease meets the definition of a short-term lease.

C6 Example 6 — Ship

Excerpt from Accounting Standards Codification

Example 6 — Ship

Case A — Contract Does Not Contain a Lease

842-10-55-79

Customer enters into a contract with a ship owner (Supplier) for the transport of cargo from Rotterdam to Sydney on a specified ship. The ship is explicitly specified in the contract, and Supplier does not have substitution rights. The cargo will occupy substantially all of the capacity of the ship. The contract specifies the cargo to be transported on the ship and the dates of pickup and delivery.

842-10-55-80

Supplier operates and maintains the ship and is responsible for the safe passage of the cargo onboard the ship. Customer is prohibited from hiring another operator for the ship or operating the ship itself during the term of the contract.

842-10-55-81

The contract does not contain a lease.

842-10-55-82

There is an identified asset. The ship is explicitly specified in the contract, and Supplier does not have the right to substitute that specified ship.

842-10-55-83

Customer has the right to obtain substantially all of the economic benefits from use of the ship over the period of use. Its cargo will occupy substantially all of the capacity of the ship, thereby preventing other parties from obtaining economic benefits from use of the ship.

842-10-55-84

However, Customer does not have the right to control the use of the ship because it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the ship is used. How and for what purpose the ship will be used (that is, the transport of specified cargo from Rotterdam to Sydney within a specified time frame) are predetermined in the contract. Customer has no right to change how and for what purpose the ship is used during the period of use. Customer has no other decision-making rights about the use of the ship during the period of use (for example, it does not have the right to operate the ship) and did not design the ship. Customer has the same rights regarding the use of the ship as if it were one of multiple customers transporting cargo on the ship.

Case B — Contract Contains a Lease

842-10-55-85

Customer enters into a contract with Supplier for the use of a specified ship for a five-year period. The ship is explicitly specified in the contract, and Supplier does not have substitution rights.

842-10-55-86

Customer decides what cargo will be transported and whether, when, and to which ports the ship will sail, throughout the five-year period of use, subject to restrictions specified in the contract. Those restrictions prevent Customer from sailing the ship into waters at a high risk of piracy or carrying hazardous materials as cargo.

842-10-55-87

Supplier operates and maintains the ship and is responsible for the safe passage of the cargo onboard the ship. Customer is prohibited from hiring another operator for the ship or operating the ship itself during the term of the contract.

842-10-55-88

The contract contains a lease. Customer has the right to use the ship for five years.

842-10-55-89

There is an identified asset. The ship is explicitly specified in the contract, and Supplier does not have the right to substitute that specified ship.

842-10-55-90

Customer has the right to control the use of the ship throughout the five-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the ship over the five-year period of use. Customer has exclusive use of the ship throughout the period of use.

b. Customer has the right to direct the use of the ship. The contractual restrictions about where the ship can sail and the cargo to be transported by the ship define the scope of Customer's right to use the ship. They are protective rights that protect Supplier's investment in the ship and Supplier's personnel. Within the scope of its right of use, Customer makes the relevant decisions about how and for what purpose the ship is used throughout the five-year period of use because it decides whether, where, and when the ship sails, as well as the cargo it will transport. Customer has the right to change these decisions throughout the five-year period of use.

842-10-55-91

Although the operation and maintenance of the ship are essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the ship is used. Instead, Supplier's decisions are dependent on Customer's decisions about how and for what purpose the ship is used.

C7 Example 7 — Aircraft

Excerpt from Accounting Standards Codification

Example 7 — Aircraft

842-10-55-92

Customer enters into a contract with an aircraft owner (Supplier) for the use of an explicitly specified aircraft for a two-year period. The contract details the interior and exterior specifications for the aircraft.

842-10-55-93

There are contractual and legal restrictions in the contract on where the aircraft can fly. Subject to those restrictions, Customer determines where and when the aircraft will fly and which passengers and cargo will be transported on the aircraft.

842-10-55-94

Supplier is responsible for operating the aircraft, using its own crew. Customer is prohibited from hiring another operator for the aircraft or operating the aircraft itself during the term of the contract.

842-10-55-95

Supplier is permitted to substitute the aircraft at any time during the two-year period and must substitute the aircraft if it is not working. Any substitute aircraft must meet the interior and exterior specifications in the contract. There are significant costs involved in outfitting an aircraft in Supplier's fleet to meet Customer's specifications.

842-10-55-96

The contract contains a lease. Customer has the right to use the aircraft for two years.

842-10-55-97

There is an identified asset. The aircraft is explicitly specified in the contract, and although Supplier can substitute the aircraft, its substitution right is not substantive. Supplier's substitution right is not substantive because of the significant costs involved in outfitting another aircraft to meet the specifications required by the contract such that Supplier is not expected to benefit economically from substituting the aircraft.

842-10-55-98

Customer has the right to control the use of the aircraft throughout the two-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the aircraft over the two-year period of use. Customer has exclusive use of the aircraft throughout the period of use.

b. Customer has the right to direct the use of the aircraft. The restrictions on where the aircraft can fly define the scope of Customer's right to use the aircraft. Within the scope of its right of use, Customer makes the relevant decisions about how and for what purpose the aircraft is used throughout the two-year period of use because it decides whether, where, and when the aircraft travels as well as the passengers and cargo it will transport. Customer has the right to change these decisions throughout the two-year period of use.

842-10-55-99

Although the operation of the aircraft is essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the aircraft is used. Consequently, Supplier does not control the use of the aircraft during the period of use, and Supplier's decisions do not affect Customer's control of the use of the aircraft.

C8 Example 8 — Contract for shirts

Excerpt from Accounting Standards Codification

Example 8 — Contract for Shirts

842-10-55-100

Customer enters into a contract with a manufacturer (Supplier) to purchase a particular type, quality, and quantity of shirts for a three-year period. The type, quality, and quantity of shirts are specified in the contract.

842-10-55-101

Supplier has only one factory that can meet the needs of Customer. Supplier is unable to supply the shirts from another factory or source the shirts from a third-party supplier. The capacity of the factory exceeds the output for which Customer has contracted (that is, Customer has not contracted for substantially all of the capacity of the factory).

842-10-55-102

Supplier makes all decisions about the operations of the factory, including the production level at which to run the factory and which customer contracts to fulfill with the output of the factory that is not used to fulfill Customer's contract.

842-10-55-103

The contract does not contain a lease.

842-10-55-104

The factory is an identified asset. The factory is implicitly specified because Supplier can fulfill the contract only through the use of this asset.

842-10-55-105

However, Customer does not control the use of the factory because it does not have the right to obtain substantially all of the economic benefits from use of the factory. This is because Supplier could decide to use the factory to fulfill other customer contracts during the period of use.

842-10-55-106

Customer also does not control the use of the factory because it does not have the right to direct the use of the factory. Customer does not have the right to direct how and for what purpose the factory is used during the three-year period of use. Customer's rights are limited to specifying output from the factory in the contract with Supplier. Customer has the same rights regarding the use of the factory as other customers purchasing shirts from the factory. Supplier has the right to direct the use of the factory because Supplier can decide how and for what purpose the factory is used (that is, Supplier has the right to decide the production level at which to run the factory and which customer contracts to fulfill with the output produced).

842-10-55-107

Either the fact that Customer does not have the right to obtain substantially all of the economic benefits from use of the factory or the fact that Customer does not have the right to direct the use of the factory would be sufficient in isolation to conclude that Customer does not control the use of the factory.

C9 Example 9 — Contract for network services

Excerpt from Accounting Standards Codification

Example 10 — Contract for Network Services

Case A — Contract Does Not Contain a Lease

842-10-55-124

Customer enters into a contract with a telecommunications company (Supplier) for network services for two years. The contract requires Supplier to supply network services that meet a specified quality level. To provide the services, Supplier installs and configures servers at Customer's premises; Supplier determines the speed and quality of data transportation in the network using the servers. Supplier can reconfigure or replace the servers when needed to continuously provide the quality of network services defined in the contract. Customer does not operate the servers or make any significant decisions about their use.

842-10-55-125

The contract does not contain a lease. Instead, the contract is a service contract in which Supplier uses the equipment to meet the level of network services determined by Customer.

842-10-55-126

Customer does not control the use of the servers because Customer's only decision-making rights relate to deciding on the level of network services (the output of the servers) before the period of use — the level of network services cannot be changed during the period of use without modifying the contract. For example, even though Customer produces the data to be transported, that activity does not directly affect the configuration of the network services and, thus, it does not affect how and for what purpose the servers are used. Supplier is the only party that can make decisions about the use of the servers during the period of use. Supplier has the right to decide how data are transported using the servers, whether to reconfigure the servers, and whether to use the servers for another purpose. Accordingly, Supplier controls the use of the servers in providing network services to Customer. There is no need to assess whether the servers are identified assets because Customer does not have the right to control the use of the servers.

Case B — Contract Contains a Lease

842-10-55-127

Customer enters into a contract with an information technology company (Supplier) for the use of an identified server for three years. Supplier delivers and installs the server at Customer's premises in accordance with Customer's instructions and provides repair and maintenance services for the server, as needed, throughout the period of use. Supplier substitutes the server only in the case of malfunction. Customer decides which data to store on the server and how to integrate the server within its operations. Customer can change its decisions in this regard throughout the period of use.

842-10-55-128

The contract contains a lease. Customer has the right to use the server for three years.

842-10-55-129

There is an identified asset. The server is explicitly specified in the contract. Supplier can substitute the server only if it is malfunctioning.

842-10-55-130

Customer has the right to control the use of the server throughout the three-year period of use because:

a. Customer has the right to obtain substantially all of the economic benefits from use of the server over the three-year period of use. Customer has exclusive use of the server throughout the period of use.

b. Customer has the right to direct the use of the server. Customer makes the relevant decisions about how and for what purpose the server is used because it has the right to decide which aspect of its operations the server is used to support and which data it stores on the server. Customer is the only party that can make decisions about the use of the server during the period of use.

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Technical Line

FASB — final guidance

How the FASB's new leases standard will affect real estate entities

In this issue:

What you need to know

- The FASB has issued final guidance that requires lessees to recognize most leases on their balance sheets.
- Lessees and lessors will classify most leases using a principle that is generally consistent with current US GAAP but without the bright lines. Lease classification determines how lease-related expense and revenue is recognized as well as what lessors record on the balance sheet.
- The guidance eliminates today's real estate-specific provisions and changes what qualifies as initial direct costs.
- For calendar-year public business entities, the guidance is effective in 2019, and interim periods within that year. For other calendar-year entities, it is effective in 2020, and interim periods in 2021. Early adoption is permitted for all entities.

Overview

Real estate entities will need to change certain lease accounting practices when implementing the new leases standard, Accounting Standards Codification (ASC) 842, *Leases,* issued by the Financial Accounting Standards Board (FASB or Board). ASC 842 significantly changes the accounting for lessees that are real estate tenants, requiring them to recognize most leases on their balance sheets as lease liabilities with corresponding right-of-use assets.

Building a better working world

For lessors, ASC 842 does not make fundamental changes to today's lessor accounting model. However, it modifies what qualifies as a sales-type and direct financing lease as well as the related accounting. ASC 842 also eliminates today's real estate-specific provisions that apply to all entities and changes which costs qualify as initial direct costs.

Like ASC 840, ASC 842 requires lessees to classify most leases as either finance leases (generally capital leases under ASC 840) or operating leases. Lessors are required to classify all leases as either sales-type, direct financing or operating leases.

Leases are classified using a principle that is generally consistent with ASC 840 but without today's bright lines (i.e., the "75% of economic life" and "90% of fair value" tests). Lease classification determines how and when a lessee and a lessor recognize lease expense and income, respectively, and what assets a lessor records.

For lessees, the income statement recognition pattern for finance leases and operating leases is similar to that of today's capital leases and operating leases, respectively. That is, finance leases generally have a front-loaded expense recognition pattern, and operating lease expense is generally recognized on a straight-line basis.

Entities will need to adjust their accounting policies, processes and internal controls to implement the new standard.

ASC 842 is effective for public business entities (PBE) for annual periods beginning after 15 December 2018, and interim periods within those years. For all other entities, it is effective for annual periods beginning after 15 December 2019, and interim periods the following year. Early adoption is permitted for all entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period presented in the financial statements. For example, for a calendar-year PBE that presents three years of financial statements, the effective date will be 1 January 2019 and the transition provisions must be applied beginning 1 January 2017. Full retrospective application is prohibited.

This publication summarizes the new standard and describes some industry-specific issues you may want to start working on. Like all other entities, you'll also need to apply the new standard to leases of office space, office equipment and all other leased assets.

This publication is intended to complement our Financial reporting developments (FRD) publication, *Lease accounting — Accounting Standards Codification 842, Leases* (SCORE No. 00195-171US), which provides an in-depth discussion of ASC 842. We refer to that publication as our Leases FRD. Engineering & construction entities should refer to our Technical Line, *How the FASB's new leases standard will affect the engineering and construction entities* (SCORE No. 00525-161US).

The views we express in this publication are preliminary as of April 14, 2016. We may identify additional issues as we analyze ASC 842 and entities begin to interpret it, and our views may evolve during that process.

Key considerations

Scope and scope exceptions

Consistent with ASC 840, the scope of ASC 842 is limited to leases of property, plant and equipment (i.e., land and depreciable assets), including subleases of those assets. ASC 842 does not apply to any of the following:

- Leases of intangible assets

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources, including the intangible rights to explore for those natural resources and rights to use the land in which those natural resources are contained
- Leases of biological assets, including timber
- Leases of inventory
- Leases of assets under construction

Definition of a lease

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to control the use of identified property, plant or equipment (i.e., an identified asset) for a period of time in exchange for consideration.

The concept of an identified asset is generally consistent with the "specified asset" concept in ASC 840. Under ASC 842, an identified asset could be either implicitly or explicitly specified in a contract and can be a physically distinct portion of a larger asset (e.g., a floor of a building). Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use. A substitution right is substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from the exercise of its right to substitute the asset.

While the lessor accounting model isn't changing as much as the lessee model, real estate entities still need to modify aspects of their accounting.

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

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

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any byproducts (e.g., renewable energy credits that are generated through use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realized from a commercial transaction with a third party. However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset.

A customer has the right to direct the use of an identified asset throughout the period of use when either:

- The customer has the right to direct how and for what purpose the asset is used throughout the period of use.
- The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either (1) has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use without the supplier having the right to change the operating instructions or (2) designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract. The standard also says that if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

For most real estate contracts, the landlord does not have a substantive substitution right. Further, the tenant generally has exclusive use of the leased property and therefore has the right to substantially all of the economic benefits from its use. The tenant also generally has the right to direct the use of the underlying property because the tenant decides how and for what purpose the property will be used. For example, in a lease of a retail unit, the tenant generally decides the mix of products that will be sold and the sales price for those products, and has the sole discretion to change such decisions.

Property leases often contain clauses requiring the tenant to maintain the property and/or allowing the landlord to inspect the condition of the property. Such clauses are designed to protect the landlord's interest in the property and are examples of protective rights, which do not, by themselves, prevent the tenant from having the right to direct the use of the property.

If a lease involves land and other assets, the right to use land is accounted for as a separate component unless the effect of doing so is insignificant.

How we see it

We believe that the assessment of whether a real estate contract is or contains a lease will be straightforward in most arrangements and real estate entities will generally reach conclusions that are similar to those they reach today.

Identifying and separating components of a contract and allocating contract consideration

Identifying and separating lease components

For contracts that contain the rights to use multiple assets but not land (e.g., a building and equipment, multiple buildings), the right to use each asset is considered a separate lease component if both of these conditions are met: (1) the lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee and (2) the right of use is neither dependent on, nor highly interrelated with, the other right(s) to use the underlying assets in the contract. However, for contracts that involve the right to use land and other assets (e.g., land and a building), ASC 842 requires an entity to classify and account for the right to use land as a separate lease component, even if the criteria above for separating lease components are not met, unless the accounting effect of not separately accounting for land is insignificant.

Identifying and separating non-lease components of a contract

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). For these contracts, the non-lease components are identified and accounted for separately from the lease component, in accordance with other US GAAP. For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to ASC 606, *Revenue from Contracts with Customers*, by lessors (suppliers). ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component.

Lessees that do not make an accounting policy election to use this practical expedient are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis. Lessees are required to use observable standalone prices (i.e., prices at which a customer would purchase a component of a contract separately) when readily available. If observable standalone prices are not readily available, lessees estimate standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate when the standalone price for a component is highly variable or uncertain.

Lessors are generally required to apply ASC 606 to allocate the consideration in a contract between the lease and non-lease components on a relative standalone selling price basis. The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. When standalone selling prices are not directly observable, the lessor must estimate the standalone selling price. The guidance in ASC 606 also provides suitable methods for estimating the standalone selling price.

A lessor allocates any variable payment amounts specifically related to the lessor's efforts to transfer goods or services that are not a lease component entirely to the non-lease component(s) to which the variable payment specifically relates if doing so would be consistent with the transaction price allocation objective in ASC 606-10-32-28.[1] If any part of the variable payment amounts relate to the lease component, even partially, a lessor treats the entire variable payment as a variable lease payment. A lessor recognizes the variable lease payments as income in the period when the changes in facts and circumstances on which the variable payment is based occur.

Considerations for real estate lessors — tenant reimbursements

Under ASC 840, lease-related executory costs (e.g., insurance, maintenance, taxes) are considered part of the lease component (or lease element) when lease and non-lease elements are separated. Under ASC 842, payments for maintenance activities, including common area maintenance (CAM) (e.g., cleaning the lobby of a building, removing snow from a parking lot for employees and customers) and other goods or services transferred to the lessee (e.g., providing utilities or trash removal) are considered non-lease components. As a result, real estate lessors will be required to apply ASC 606 to allocate and recognize consideration related to reimbursements for CAM, maintenance activities and other goods or services provided to the lessee if doing so is consistent with the transaction price allocation objective in ASC 606, unless the consideration received is variable and relates, at least partially, to the lease component.

Lessors will evaluate the criteria in ASC 606 to determine whether the distinct services provided to the lessee are a single (or multiple) performance obligation(s). If the services meet the criteria to be considered a series of services that are "substantially the same and have the same pattern of transfer" to the lessee, they are accounted for as a single performance obligation. Any variable consideration received for performing these services may be eligible for the variable consideration "allocation exception" in ASC 606. That is, variable consideration (e.g., pro-rata reimbursement) is allocated to a specific part of the contract (e.g., a distinct month of services) and recognized, if both:

- The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct service.
- Allocating the variable amount of consideration entirely to the performance obligation or the distinct service is consistent with the overall allocation objective of ASC 606.

This allocation exception is only used to recognize variable consideration.

Fixed reimbursements for services provided are accounted for using the standard model in ASC 606. That is, lessors will allocate the consideration in the contract between the lease and non-lease components using the principles in ASC 606 and recognize the consideration allocated to the non-lease component(s) (i.e., the transaction price under ASC 606) as it transfers control[2] of the services (i.e., as it provides the services) to the lessee over the term of the contract.

How we see it

ASC 842 requires that lessors account for consideration related solely to services provided using the guidance in ASC 606. If the variable consideration allocation exception criteria in ASC 606 are met, the resulting pattern of revenue recognition for many arrangements may be consistent with how entities recognize such operating lease and lease related revenue today.

Lessors may allocate variable consideration they receive for services to the period in which they perform those services, if certain criteria are met.

In some leases, a lessee also may reimburse (or make certain payments on behalf of) the lessor that relate to the leased asset (e.g., insurance premiums and real estate taxes associated with the lessor's asset). Under ASC 842, insurance that protects the lessor's interest in the underlying asset and taxes related to the asset are not separate components of the contract because they do not represent payments for goods or services (i.e., the payments are for the use of the leased asset and are attributable to the lease component). Entities should evaluate whether lease payments made for insurance that protects the lessor's interest in the underlying asset and taxes relating to such asset are fixed (or in-substance fixed) lease payments or variable lease payments. See "Variable lease payments" section below for further discussion of the accounting for variable lease payments.

Considerations for real estate lessors — lease structures

As described above, real estate lease arrangements most often require that the tenant (1) provide consideration (e.g., monthly payment) to the lessor for use of the leased space and (2) separately reimburse the lessor for its share of operating costs (e.g., CAM, real estate taxes, insurance associated with the lessor's asset). However, other types of real estate structures also exist.

Certain real estate lease arrangements require the lessee to remit a single monthly payment that compensates the lessor for use of the property, including the related ownership costs of the building (e.g., taxes, insurance) and other services. Today, many lessors recognize the single payments received from these "gross lease" arrangements as lease revenue on a straight-line basis. In contrast, ASC 842 requires that entities determine whether such an arrangement contains non-lease components (e.g., maintenance or other CAM services) and allocate consideration to those components based on their standalone selling prices.

How we see it

Identifying non-lease components of contracts (e.g., CAM) may change practice for some lessors in the real estate industry. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for variable payments from an operating lease and an executory contract) is often the same.

Lease classification

At lease commencement, a lessee classifies a lease as a finance lease and a lessor classifies a lease as a sales-type lease if the lease meets any of the following criteria:

- 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 a major part of the remaining economic life of the underlying asset. This criterion is not applicable for leases that commence at or near the end of the underlying asset's economic life.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments 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.

A lessee classifies a lease as an operating lease when it does not meet any of the criteria above.

A lessor classifies a lease as a direct financing lease when none of the criteria above are met but the lease meets **both** of the following criteria:

- The present value of the sum of lease payments and any residual value guaranteed by the lessee and **any other third party unrelated to the lessor** equals or exceeds substantially all of the fair value of the underlying asset.
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

A key difference between the sales-type lease and direct financing lease classification tests is the treatment of residual value guarantees provided by unrelated third parties other than the lessee. Those third-party guarantees are excluded from the evaluation of the "substantially all" criterion in the sales-type lease test. However, they are included in the evaluation in the direct financing lease test. In addition, the evaluation of the collectibility of lease payments and residual value guarantees affects direct financing lease classification, whereas it does not affect sales-type lease classification. However, the evaluation of collectiblity does affect sales-type lease recognition and measurement.

For lessors, all leases not classified as sales-type leases or direct financing leases are classified as operating leases.

Lessees and lessors are required to reassess lease classification upon a modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that does not result in a separate contract. Lessees also are required to reassess lease classification when there is a change in their assessment of either the lease term or whether they are reasonably certain to exercise an option to purchase the underlying asset.

ASC 842 also makes the following changes to today's classification guidance that will affect real estate entities:

- ASC 842 eliminates the real estate-specific classification criteria in ASC 840. For example, under ASC 840, only the "transfer of ownership" and "bargain purchase" criteria are considered when evaluating the classification of land leases. As a result, the classification of some land lease arrangements could change under ASC 842.
- Under today's guidance, if a lease involves land and a building, an entity must separately evaluate the classification of the land and building if the fair value of the land is 25% or more of the total fair value of the property. ASC 842 eliminates this requirement. However, as discussed above, an entity is still required to assess classification of separate lease components if a lease involves land and other assets unless the accounting effect of doing so would be insignificant.
- ASC 842 eliminates today's requirement that, in order for a lease of real estate to be classified as a sales-type lease, the lessor must transfer title to the lessee prior to the end of the lease term.
- ASC 842 eliminates today's requirement for lessors to classify leases of part of a building as operating leases when the cost and fair value of the leased portion is not objectively determinable. Under ASC 842, entities do not have to apply the "lease payments" criterion if the fair value of the underlying asset cannot be practicably determined (i.e., without undue cost or effort) but do have to apply the other classification criteria. As a result, a lease of part of a building could be a sales-type or direct financing lease if any other criteria are met.

How we see it

An entity that leases an entire building (i.e., 100% of the building) is inherently leasing the land underneath the building and would potentially account for the land and the building as separate lease components. However, this would not necessarily be the case when an entity only leases part of the building (e.g., one floor of a multi-story building).

Lessor accounting

Operating leases

ASC 842 requires lessors to account for operating leases in a manner similar to how they account for operating leases under ASC 840. That is, lessors continue to recognize the underlying asset, and lease payments for which collectibility is probable at lease commencement are recognized over the lease term on a straight-line basis unless another systematic and rational basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. However, when collectibility of lease payments is not probable at the commencement date for an operating lease (including a lease that would otherwise have qualified as a direct financing lease if it had met the related collectibility requirements), lease income is limited to the lesser of (1) the straight-line amount and (2) the lease payments, including any variable lease payments, that have been collected from the lessee.

The FASB said in the Basis for Conclusions for operating leases (BC 326–327) that "recognizing rental income on a straight-line basis often will reflect the pattern in which income is earned from the underlying asset." However, the FASB said "that will not always be the case" and decided that a lessor can recognize rental income on another systematic and rational basis if it is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset. The FASB further said that "a lessor is expected to recognize uneven fixed lease payments on a straight-line basis when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (for example, when there is significant front loading or back loading of payments or when rent-free periods exist in a lease)."

How we see it

Determining that lease payments in an operating lease should be recognized on a basis other than straight line will likely require judgment. There might not be a clear distinction between increases in scheduled lease payments that reflect the pattern in which lease income is earned (e.g., "stepped" increases to compensate the lessor for changes in the market rentals) and other scheduled increases that do not.

Sales-type leases

Under ASC 842, lessors account for sales-type leases using an approach that is similar to ASC 840's sales-type lease accounting. That is, lessors derecognize the carrying amount of the underlying asset, recognize the net investment in the lease and recognize any selling profit or selling loss[3] in net income. However, if collection of lease payments and any residual value guarantee provided by the lessee is not probable at lease commencement, a lessor does not derecognize the underlying asset and does not recognize its net investment in the lease. Instead, a lessor continues to account for the underlying asset using other GAAP and recognizes lease payments received, including variable lease payments that do not depend on an index or rate, as a deposit liability until the earlier of either of the following:

ASC 842 eliminates today's real estate-specific classification criteria.

- Collection of lease payments, plus any amounts necessary to satisfy a residual value guarantee provided by the lessee, becomes probable.
- Either (1) the contract is terminated, and the lease payments received from the lessor are nonrefundable, or (2) the lessor repossesses the underlying asset and has no further obligation to the lessee under the contract and the lease payments received from the lessee are nonrefundable.

Direct financing leases

Lessors account for direct financing leases using an approach that is similar to the accounting for sales-type leases for which collectibility is probable. However, for a direct financing lease, any selling profit is deferred at lease commencement and included in the initial measurement of the net investment in the lease. The lessor recognizes interest income over the lease term in an amount that produces a constant periodic discount on the remaining balance of the net investment in the lease.

Lessee accounting

At the commencement date of a lease, a lessee recognizes a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

The initial recognition of the right-of-use asset and the lease liability is the same for finance leases and operating leases, as is the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for finance leases and operating leases differs under ASC 842. For finance leases, lessees are required to separately recognize the interest expense on the lease liability and the amortization expense on the right-of-use asset. This generally results in a front-loaded expense recognition pattern, which is consistent with the subsequent measurement of capital leases under ASC 840. The periodic lease expense for operating leases is generally recognized on a straight-line basis, similar to the accounting for operating leases under ASC 840.

Real estate entities that are lessees (e.g., a lessee in a ground lease arrangement) need to consider the effect of ASC 842 on their financial statements. In some circumstances, the lease liabilities and right-of-use assets recognized under ASC 842 could be significant.

How we see it

The requirement in ASC 842 that lessees recognize assets and liabilities for most leases could affect the leasing strategies of tenants of real estate entities. For example, certain tenants that today enter into net leases of single-tenant properties may make different decisions about whether to lease or buy. In addition, some tenants may seek to negotiate shorter lease terms than they currently have in order to reduce the amounts of the assets and liabilities they will need to record. Many factors will influence a tenant's decisions, including the nature of its business, its access to capital and its real estate strategy.

Refer to the appendix for examples of lessee accounting for a finance lease and an operating lease.

Initial direct costs only include costs that would not have been incurred if a lease had not been obtained (e.g., commissions).

Short-term leases recognition and measurement exemption

Lessees can make an accounting policy election (by class of underlying asset to which the right of use relates) to apply accounting similar to ASC 840's operating lease accounting to leases that, at the commencement date, have a lease term of 12 months or less and do not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise (short-term leases). If an entity applies this exception, short-term leases are not recognized on the balance sheet and the related lease expense is recognized on a straight-line basis over the lease term.

Other considerations

Initial direct costs

Under ASC 842, initial direct costs are incremental costs that would not have been incurred if the lease had not been obtained (e.g., commissions, payments made to an existing tenant to incentivize that tenant to terminate its lease). Lessees and lessors apply the same definition of initial direct costs. ASC 842's guidance on initial direct costs is consistent with the concept of incremental costs of obtaining a contract in the new revenue recognition standard.

ASC 842 requires lessors to recognize initial direct costs for operating leases as expenses over the lease term on the same basis as lease income. Lessors include initial direct costs in the initial measurement of their net investments in direct financing leases and sales-type leases with no selling profit or loss. However, initial direct costs related to sales-type leases with selling profit or loss are expensed at lease commencement.

How we see it

The new standard's requirement that only costs that wouldn't be incurred if a lease hadn't been obtained qualify as initial direct costs will change practice for many real estate lessors. Lessors will no longer be able to include allocated costs (e.g., salaries) and costs that are incurred regardless of whether the lease is obtained (e.g., certain legal advice) in initial direct costs.

ASC 842 requires lease modifications that meet certain criteria to be accounted for as a separate contract.

Sale and leaseback transactions

Because lessees are required to recognize most leases on the balance sheet (i.e., all leases except for short-term leases if the lessee makes an accounting policy election to use this exemption), sale and leaseback transactions no longer provide lessees with a source of off-balance sheet financing.

ASC 842 requires seller-lessees and buyer-lessors to consider the new revenue recognition standard and other criteria in ASC 842 (e.g., a sale with a finance leaseback would not qualify as a sale) to determine whether a sale has occurred. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale (or purchase) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties.

ASC 842 also eliminates today's real estate-specific guidance for sale and leaseback transactions involving real estate, including ASC 840's requirement that the seller-lessee evaluate whether the sale of real estate satisfies the criteria of ASC 360-20, *Real Estate Sales*. Under ASC 840, even when these criteria are met, up-front gain recognition is generally prohibited (i.e., deferral and amortization of the gain are required) if substantially all of the property sold is leased back.

How we see it

The elimination of today's real estate-specific guidance, including the restrictions for sale and leaseback transactions, is a significant change. We generally expect more sale and leaseback transactions involving real estate to be accounted for as sales and subsequent leasebacks under the new standard than under today's guidance. Requiring the buyer-lessor to consider the revenue recognition guidance to determine whether it has obtained control the underlying property also would be a change in practice.

Lease modifications

ASC 842 defines a lease modification as a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease.

In a change from today's guidance, lessees and lessors account for a lease modification as a separate contract (i.e., separate from the original contract) when both of the following conditions are met:

- The modification grants the lessee an additional right of use not included in the original lease (e.g., a right to use an additional underlying asset).
- The lease payments increase commensurate with the standalone price for the additional right-of-use, adjusted for the circumstances of the particular contract.

If both of these conditions are met, the lease modification results in two separate contracts, the unmodified original contract and a separate contract.

Refer to our Leases FRD for more details on accounting for lease modifications, including the accounting for a lease when the modification does not result in a separate new contract.

Variable lease payments

Variable lease payments that depend on an index or a rate are included in the lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). Variable lease payments that do not depend on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset, are not included as lease payments.

Variable payments that are not based on an index or rate and are not in substance fixed are recognized in a manner similar to today's accounting. Lessees recognize expense in the period in which the obligation for those payments is incurred.[4] Lessors recognize income in the period when the changes in facts and circumstances on which the variable lease payments are based occur.

Under ASC 842, lessees are required to reassess variable lease payments that depend on an index or rate only when the lease liability is remeasured for other reasons (e.g., due to a change in the lease term). Otherwise, lessees will recognize changes to index- and rate-based variable lease payments in profit or loss in the period of the change (i.e., similar to other variable lease payments). Lessors are required to account for changes in variable lease payments that depend on an index or rate when they occur.

Next steps

- Entities should perform a preliminary assessment as soon as possible to determine how their lease accounting will be affected. Two critical first steps include (1) identifying the sources and locations of an entity's lease data and (2) accumulating that data in a way that will facilitate the application of ASC 842. For entities with decentralized operations (e.g., an entity that is geographically dispersed), this could be a complex process, given the possibility of differences in operational, economic and legal environments. Entities will also need to make sure they have processes (including internal controls) and systems in place to collect the necessary information to implement ASC 842.
- Entities also may want to monitor the discussions of the Board and others including the Securities and Exchange Commission (SEC) staff as they consider interpretations and the application of ASC 842 to common transactions.
- Real estate entities should begin to educate personnel in their leasing and tenant coordination departments about ASC 842. An entity may want these departments to evaluate its current portfolio of leases and/or prospective targets to identify tenants that may seek to alter their leasing strategies as a result of the new guidance.

Endnotes:

1 The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

2 ASC 606 includes three criteria for evaluating whether control of a good or service is transferred over time. Contracts to provide services (e.g., CAM) will generally meet the criteria that "the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs," but an entity will need to evaluate each arrangement to reach this conclusion. Consideration from arrangements that do not meet the criteria for over time recognition is recognized at a point in time.

3 At the commencement date, selling profit and loss is calculated as the difference between the fair value of the underlying asset or the lease receivable, if lower, and the carrying amount of the underlying asset net of any unguaranteed residual asset.

4 A lessee should recognize cost from variable lease payments before the achievement of the specified target provided the achievement of the target is probable.

Appendix: Lessee accounting examples

The following examples illustrate a lessee's recognition and presentation of operating and finance leases under ASC 842. We are not providing examples of lessor accounting under ASC 842 because the guidance won't significantly change a lessor's recognition or presentation for most operating leases. However, lessors should understand how they will be affected by changes ASC 842 makes to other aspects of the lessor model (e.g., classification, initial direct costs, sale and leaseback transactions, accounting for sales-type and direct financing leases). See our Leases FRD for lessor accounting examples.

Illustration 1 — Lessee accounting for an operating lease

Apartment Company V (Lessee) enters into a three-year lease of office space for a satellite field office and concludes that the agreement is an operating lease. Apartment Company V agrees to pay the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 using a discount rate of approximately 4.235%. Apartment Company V uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Apartment Company V calculates that the annual straight-line lease expense is $12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3].

Analysis: At lease commencement Apartment Company V would recognize the right-of-use asset and lease liability that it wouldn't recognize today:

Right-of-use asset	$ 33,000	
Lease liability		$ 33,000

To initially recognize the lease-related asset and liability

- The following journal entries would be recorded in the first year:

Lease expense	$ 12,000	
Right-of-use asset		$ 2,000
Cash		$ 10,000
Lease liability	$ 8,602	
Right-of-use asset		$ 8,602

- To record lease expense and adjust the right-of-use asset for the difference between cash paid and straight-line lease expense (i.e., accrued rent). To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $8,602 is calculated as the initially recognized lease liability ($33,000) less the present value of remaining lease payments ($24,398) at the end of year one.

- A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments:		$ 10,000	$ 12,000	$ 14,000
Income statement:				
Periodic lease expense (straight-line)		12,000	12,000	12,000
Prepaid (accrued) rent for period		$ (2,000)	$ –	$ 2,000
Balance sheet:				
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –
Right-of-use asset				
Lease liability	$ 33,000	$ 24,398	$ 13,431	$ –
Adjust: prepaid/(accrued) rent (cumulative)	–	(2,000)	(2,000)	–
Right-of-use asset	$ 33,000	$ 22,398	$ 11,431	$ –

- Immaterial differences may arise in the re-computation of amounts in the example above due to rounding.

Illustration 2 — Lessee accounting for a finance lease

Office Owner D (Lessee) enters into a three-year ground lease for a parking lot adjacent to an office building it owns and concludes that the agreement is a finance lease because it contains a purchase option that the lessee is reasonably certain to exercise. Office Owner D agrees to make the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 (present value of lease payments using a discount rate of 4.235%). Office Owner D uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Office Owner D amortizes the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Office Owner D would recognize the right-of-use asset and lease liability in a manner similar to what it would do today:

Right-of-use asset	$ 33,000	
Lease liability		$ 33,000

To initially recognize the lease-related asset and liability

- The following journal entries would be recorded in the first year:

Interest expense	$ 1,398	
Lease liability		$ 1,398

To record interest expense and accrete the lease liability using the interest method ($33,000 x 4.235%)

Amortization expense	$ 11,000	
Right-of-use asset		$ 11,000

To record amortization expense on the right-of-use asset ($33,000 ÷ 3 years)

Lease liability	$ 10,000	
Cash		$ 10,000

To record lease payment

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments		$ 10,000	$ 12,000	$ 14,000
Lease expense recognized				
Interest expense		$ 1,398	$ 1,033	$ 569
Amortization expense		11,000	11,000	11,000
Total periodic expense		$ 12,398	$ 12,033	$ 11,569
Balance sheet				
Right-of-use asset	$ 33,000	$ 22,000	$ 11,000	$ –
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –

Immaterial differences may arise in the re-computation of amounts in the example above due to rounding.

Illustration 3 — Comparing the two types of leases for lessees

This table illustrates the similarities and differences in accounting for the finance lease (see illustration 2) and the operating lease (see illustration 1):

Finance lease:

Time	Lease liability	Right-of-use (ROU) asset	Interest expense	Amortization expense	Total expense
Initial	$ 33,000	$ 33,000			
Year 1	$ 24,398	$ 22,000	$ 1,398	$ 11,000	$ 12,398
Year 2	$ 13,431	$ 11,000	1,033	11,000	12,033
Year 3	$ –	$ –	569	11,000	11,569
			$ 3,000	$ 33,000	$ 36,000

Operating lease:

Time	Lease liability	Cumulative prepaid (accrued) rent[1]	ROU asset	Lease expense
Initial	$ 33,000	$ –	$ 33,000	
Year 1	$ 24,398	$ (2,000)	$ 22,398	$ 12,000
Year 2	$ 13,431	$ (2,000)	$ 11,431	12,000
Year 3	$ –	$ –	$ –	12,000
				$ 36,000

[1] Prepaid and accrued rent amounts would not be presented separately on the balance sheet. Instead, the ROU asset would be presented on the balance sheet net of cumulative prepaid or accrued amounts (if any).

The initial measurement of the right-of-use asset and the lease liability is the same for finance and operating leases. Also, the same total lease expense is recognized over the life of the arrangement but with different income statement classification and timing of recognition. However, a lessee generally recognizes higher periodic lease expense in the earlier periods of a finance lease than it does for an operating lease.

KPMG

Build-to-suit leases

Issues In-Depth

US GAAP

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Contents

Navigating substantially different accounting

The FASB's new lease accounting standard (Topic 842) will usher in widespread changes to the accounting for leases, particularly for lessees. One of the areas that will change significantly is how lessees account for 'build-to-suit' lease arrangements. Topic 842 changes how lessees:

— assess whether they are the accounting owner of the underlying asset in build-to-suit lease arrangements under Topic 842, which differs substantially from that assessment under current US GAAP; and

— evaluate whether a sale and leaseback occurs at the end of the asset construction period.

Topic 842 will generally permit, and frequently *require*, lessees with build-to-suit assets and liabilities recognized under current US GAAP to derecognize those assets and liabilities in transition, which may significantly affect certain historical balance sheet metrics and ratios and lessees' future accounting.

Given the transition provisions, it is not surprising that some companies are considering early adoption. In this edition of *Issues In-Depth*, which supplements our April 2016 Issues In-Depth on Topic 842, we provide additional information to help lessees assess whether they are the accounting owner of an asset under construction. We also provide detailed information about the transition provisions for build-to-suit lease arrangements.

Our discussion of the build-to-suit transition provisions includes detailed flowcharts and analysis of a variety of potential scenarios in which lessees with these arrangements may find themselves as they prepare to implement Topic 842.

We trust this edition of Issues In-Depth will enhance your understanding and assist you in your ongoing efforts to implement this substantially changed lease accounting guidance.

Scott A. Muir and Brian W. Byrd

Department of Professional Practice, KPMG LLP

Current US GAAP requirements

A build-to-suit lease is a contractual arrangement that requires the developer to construct an asset based on the lessee's specifications that the lessee will lease when construction is complete. The developer finances the construction, retains ownership, and then leases the asset to the lessee at completion.

While most build-to-suit projects involve real estate, build-to-suit guidance applies to all asset construction projects with lessee involvement.

Is the lessee the accounting owner?

Under current US GAAP, a lessee involved in the construction or design of an asset before lease commencement is the accounting owner during the construction period if it either: [840-40-55-2 – 55-16]

— takes on substantially all of the construction-period risks, determined through a 'maximum guarantee test'; or

— engages in one or more specifically prohibited activities, such as directly funding construction costs, making in-substance equity investments in the project, providing prohibited indemnifications, or taking title to the asset or land on which the asset is built.

A lessee who is the accounting owner of a construction project recognizes a construction-in-progress asset on its balance sheet with a corresponding liability for construction costs funded by the lessor. When construction is complete and the lease term begins, the lessee evaluates the transaction as a sale-leaseback transaction.

If the transaction **qualifies as a sale** based on the sale-leaseback guidance, the lessee derecognizes the construction asset and recognizes profit or loss in the same manner as it would for other sale-leaseback transactions.

If the transaction **does not qualify as a sale** based on the sale-leaseback guidance, the lessee continues to report the constructed asset and any asset funding from the lessor on its balance sheet. Once the asset is in service, the lessee begins depreciating the asset in the same manner as its owned property, plant and equipment. It accounts for the lease payments as debt service payments towards the asset funding liability. For many lessees, build-to-suit assets and liabilities remain on their balance sheets long after construction is complete because the transaction fails to qualify for sale-leaseback accounting.

New build-to-suit guidance

Is the lessee the accounting owner of an asset under construction?

In contrast to current US GAAP, the new lease accounting standard (Topic 842) focuses on whether the lessee controls the underlying asset before the lease commencement date when the asset is under construction. Topic 842 does not consider exposure to construction period risks, nor does it explicitly prohibit certain activities. However, it does state that any one of the following characteristics would demonstrate that the lessee controls the underlying asset before the lease commencement date. [842-40-55-5]

- The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (e.g. by making a payment to the lessor).
- The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessor.
- The lessee legally owns both the land and the property improvements that are under construction, or the non-real estate asset that is being constructed (e.g. a ship or aircraft).
- The lessee controls the land on which the property improvements will be constructed (which includes where the lessee transfers the land to the owner-lessor, but that transfer does not qualify as a sale – e.g. because of a lessee repurchase option) and does not enter into a lease of the land prior to the beginning of the construction that, together with the renewal options[1], permits the lessor or another related party to lease the land for substantially all of the economic life of the property improvements.
- The lessee is leasing the land on which the property improvements will be constructed, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements and does not enter into a sublease of the land prior to the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements.

Note 1:

'Options' refers to all renewal options, regardless of whether it is reasonably certain that those options will be exercised. In other words, this criterion considers the maximum possible lease term, rather than the 'lease term' as defined in Topic 842.

This list is not exhaustive. There may be other factors or circumstances that demonstrate that a lessee controls an underlying asset that is under construction before the commencement date.

Section 9.4.1 of our April 2016 Issues In-Depth provides some examples that show how to apply the new guidance to determine whether a lessee controls an underlying asset that is under construction before the commencement date.

KPMG observation: **Lessee ownership of assets under construction**

Because Topic 842 changes the underlying principle to determine when a lessee is the accounting owner of an asset under construction, we expect there will be some different accounting outcomes compared with current US GAAP.

Control evaluation

The FASB observed that conceptually the evaluation of whether a lessee controls an underlying asset under construction is similar to the evaluation made under the new revenue recognition standard to determine whether a performance obligation is satisfied over time.

The revenue guidance says that a customer obtains control of a good as it is being produced (or modified), and the entity satisfies its performance obligation to transfer that good over time when either or both: [606-10-25-27]

— the entity's performance creates or enhances an asset (e.g. work-in-process) that the customer controls as the asset is created or enhanced; or

— the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

We believe it was the Board's view that the evaluation of whether a lessee controls an asset under construction should be similar to evaluating whether a customer controls an asset during construction that it will own after construction ends. [ASU 2016-02.BC400(b)]

Contingent call options

A call option on the underlying asset under construction does not have to be unconditional to confer control of the asset to the lessee. A call option that is contingent on an event *within the lessee's control* – e.g. the contingent event is a default on the construction timeline and lessee is the construction manager – would also confer control of the underlying asset to the lessee.

Call options that do not exist throughout the construction period

A lessee call option that would confer control of the underlying asset to the lessee may not be exercisable at the beginning of the construction period, but may become exercisable during construction. If so, the lessee becomes the accounting owner of the asset at the point in time the option becomes exercisable.

Conversely, a lessee call option that confers control of the underlying asset to the lessee could expire before the end of the construction period. The lessee would still account for the arrangement as a sale-leaseback transaction at the end of the construction period when the leaseback commences.

Lessor put options

While the guidance only refers to lessee call options conferring the control of the underlying asset to the lessee, we believe control would also be conferred to the lessee if the lessor has a 'significant economic incentive' to exercise a put option – i.e. an option to force the lessee to purchase the underlying asset under construction. Our view is based on the repurchase agreements guidance in the new revenue recognition standard, which states that the seller of a good retains control of that good if the customer has a significant economic incentive to exercise an option to return the good to the seller. [606-10-55-72]

Other factors or circumstances

The new guidance states that there may be 'other factors or circumstances', beyond those listed, that demonstrate that a lessee controls an underlying asset that is under construction. At present, it is unclear what those other factors or circumstances would be, because none have been identified in practice. It is our understanding that the Board and the staff did not have any specific other factors or circumstances in mind when drafting the guidance. However, lessees should keep the control principle from the new revenue recognition standard in mind – i.e. the ability to direct the use of, and obtain substantially all the remaining benefits from, an asset – when considering whether they control an underlying asset under construction.

Lessee accounting owner recognizes asset and liability

The accounting by a lessee that is the accounting owner of an asset under construction is substantially the same as current US GAAP. However, because Topic 842 significantly changes the sale-leaseback guidance, fewer sale-leaseback transactions involving build-to-suit real estate will result in failed sales. Consequently, there are fewer factors that would keep lessees from derecognizing build-to-suit assets and liabilities at the end of the asset construction period. Section 9.1 of our April 2016 Issues In-Depth provides additional information about the changes to sale-leaseback accounting.

Transition for existing build-to-suit arrangements

Evaluating previous build-to-suit conclusions

A lessee is not required to reevaluate whether it would have been the accounting owner of an asset under construction in accordance with Topic 842 unless construction of the asset is in progress at the effective date. This is the case regardless of whether the lessee was or was not the accounting owner of the asset under current US GAAP. [842-40-55-5]

If a lessee is determined to be the accounting owner of an asset under construction as of the effective date for which it **was not the accounting owner** under current US GAAP, it will recognize the assets and liabilities arising from being the accounting owner of an asset under construction at the later of (1) the beginning of the earliest period presented, or (2) the date it becomes the accounting owner of the asset under construction based on the guidance in Topic 842. The lessee would account for the assets after the effective date using the Topic 842 sale-leaseback guidance.

Derecognition of build-to-suit assets and liabilities

The transition guidance in Topic 842 requires lessees to derecognize any assets (e.g. property, plant and equipment or construction-in-progress) and liabilities recorded solely as a result of being the accounting owner of a construction project under current US GAAP unless both: [842-10-65-1(u)]

— construction of the asset is in progress at the effective date of Topic 842; and

— the lessee is the accounting owner of the underlying asset under construction based on Topic 842.

A lessee derecognizes existing build-to-suit assets and liabilities at the later of the: [842-10-65-1(u)]

— beginning of the earliest period presented; or

— date the lessee was determined to be the accounting owner of the asset under current US GAAP.

Any difference between the assets and liabilities derecognized is recorded to equity on that date.

Derecognition of the existing build-to-suit assets and liabilities would occur in accordance with the preceding paragraphs regardless of whether the transaction qualified as a sale-leaseback transaction under current US GAAP.

Build-to-suit arrangements accounted for as successful sale-leaseback transactions

If the construction period ended before the beginning of the earliest period presented, and the transaction qualified for sale-leaseback accounting under current US GAAP before that date, the lessee only accounts for a lease, because the build-to-suit assets and liabilities would already have been derecognized. The lessee applies the transition requirements in the same manner as it does for other sale-leaseback transactions in transition. Section 13.7 of our April 2016 Issues In-Depth discusses the sale-leaseback transition provisions of Topic 842.

KPMG observation: **Transition**

Control guidance applies only on or after the effective date

The changes to the sale-leaseback guidance in Topic 842 will make it easier for a lessee that is the accounting owner of an asset under construction to derecognize the underlying asset at the end of the construction period.

We believe that the FASB did not intend for a lessee to look back to periods before the effective date of Topic 842 to determine whether it would have been the accounting owner of an asset under construction. This intention would be inconsistent with much of the Board's rationale for its transition approach. It also would appear to be at odds with the guidance on sale-leaseback transactions that says the lessee does not reconsider whether a successful sale that occurred before the effective date also would have also been successful under Topic 842.

Instead, Topic 842 requires that the lessee consider whether it is the owner of an asset under construction only if construction is ongoing at the effective date.

Topic 842 does not appear to *prohibit* reevaluation of ownership if the lessee was not the accounting owner under current US GAAP

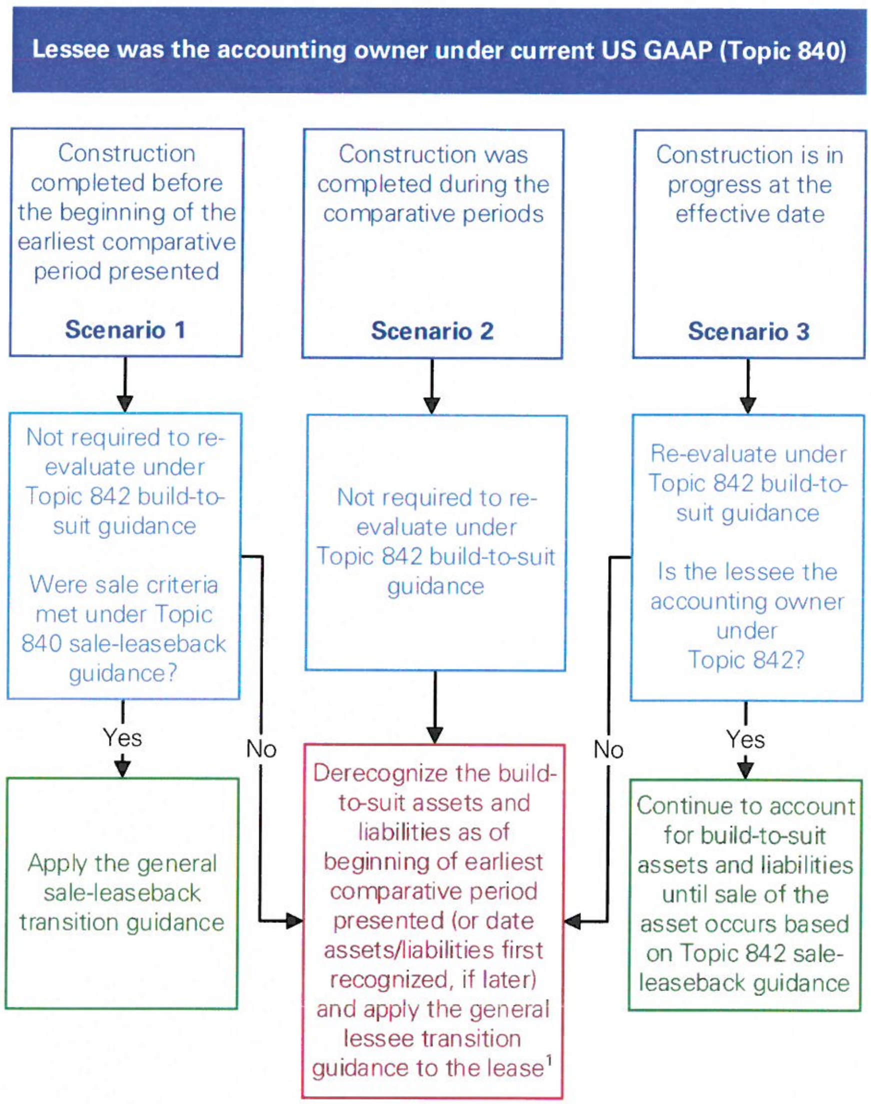
The transition guidance for existing build-to-suit assets and liabilities appears to preclude continued recognition of build-to-suit assets and liabilities on the balance sheet when construction is complete by the effective date, even if the lessee would have been the accounting owner of the underlying asset under Topic 842.

However, because the transition guidance is silent, we believe that it does not prohibit a lessee from evaluating under Topic 842 whether it was the accounting owner of an asset for which construction was complete by the effective date and for which it was **not** the accounting owner under current US GAAP.

We expect it to be rare that a lessee would choose to voluntarily make this evaluation. However, if it does, we believe that it would recognize the assets and liabilities arising from being the accounting owner of an asset under construction at the later of (1) the beginning of the earliest period presented, or (2) the date it becomes the accounting owner of the asset under construction. The lessee would account for the transaction from the recognition date using the Topic 842 sale-leaseback guidance.

Illustrative decision tree

The following information summarizes our understanding of the transition requirements for a number of potential build-to-suit transition scenarios.



Note 1:

Section 13.3 of our April 2016 Issues In-Depth discusses the lessee transition provisions of Topic 842.

Scenario 1:
Construction completed before the beginning of the earliest comparative period presented

Do not reevaluate whether lessee would have been accounting owner under Topic 842

The lessee should not evaluate whether it would have been the accounting owner of the asset under Topic 842, because construction was completed before the effective date. The lessee's transition accounting will depend on whether the current US GAAP sale criteria for a sale-leaseback transaction were met.

Were the current US GAAP sale criteria for a sale-leaseback transaction met?

When the current US GAAP sale criteria for a sale-leaseback transaction were met before the beginning of the earliest comparative period presented, the lessee does not reevaluate that conclusion, and applies the Topic 842 transition guidance to the sale-leaseback.

Failed sale-leaseback transaction under current US GAAP

When the construction period ended before the beginning of the earliest comparative period presented, but the current US GAAP sale criteria for a sale-leaseback transaction were not met, the lessee derecognizes the build-to-suit assets and liabilities that were recognized under current US GAAP as of the beginning of the earliest comparative period presented. Any difference is recorded as an adjustment to equity at that date. The lessee then applies the transition guidance to the lease.

Scenario 2:
Construction was completed during the comparative periods

Do not evaluate whether lessee would have been accounting owner under Topic 842

The lessee should not evaluate whether it would have been the accounting owner of the asset under construction based on the new leases guidance because the construction was completed before the effective date.

Therefore, the lessee derecognizes the build-to-suit assets and liabilities that it recognized under current US GAAP as of the later of (a) the beginning of the earliest comparative period presented, and (b) the date the lessee was determined to be the accounting owner of the underlying asset. Any difference is recorded as an adjustment to equity at that date. The lessee then applies the general lessee transition guidance to the lease.

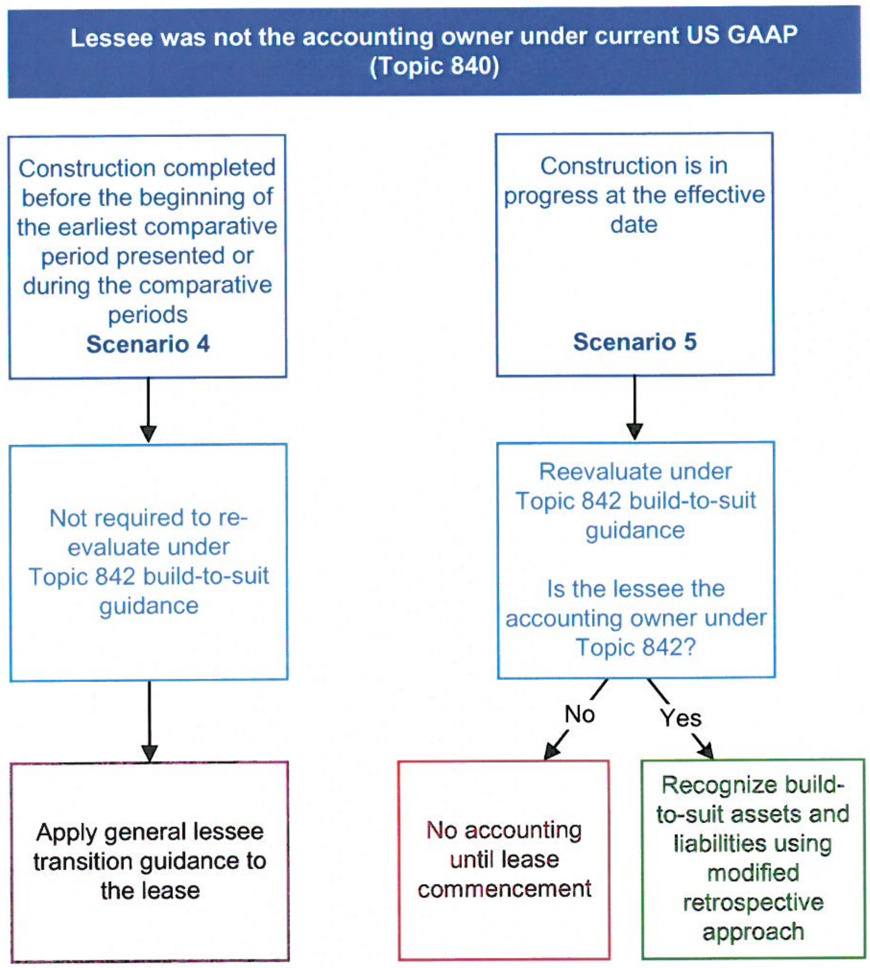
Scenario 3: **Construction is in progress at the effective date**

When lessee is the accounting owner under Topic 842

The lessee continues to recognize the construction-in-progress assets and liabilities that arose because the lessee is the accounting owner until they qualify for derecognition under the sale-leaseback requirements of Topic 842. Then the lessee accounts for the transaction in the same manner as other sale-leaseback transactions.

When lessee is not the accounting owner under Topic 842

The lessee derecognizes the build-to-suit assets and liabilities that it recognized under current US GAAP as of the later of (a) the beginning of the earliest comparative period presented, or (b) the date the lessee was determined to be the accounting owner of the asset under current US GAAP. The lessee records the difference as an adjustment to equity at that date. The lessee then applies the general lessee transition guidance to the lease.



Scenario 4: **Construction completed before the beginning of the earliest comparative period presented** or **during the comparative periods**

No requirement to evaluate whether lessee would have been the accounting owner under Topic 842

The lessee is not required to evaluate whether it would have been the accounting owner of the asset while it was under construction in accordance with Topic 842. However, we do not believe the transition guidance prohibits a lessee from making this evaluation.

If the lessee does not undertake this evaluation, it applies the general lessee transition requirements to the lease.

In the unlikely event that the lessee chooses to evaluate whether it would have been the accounting owner under Topic 842, we believe that it would recognize the assets and liabilities arising from being the accounting owner of the asset under construction at the later of (1) the beginning of the earliest period presented, or (2) the date it was determined to be the accounting owner of the asset under construction under Topic 842. The lessee would account for the transaction in accordance with the sale-leaseback guidance in Topic 842 from the date of recognition.

Scenario 5: **Construction is in progress at the effective date**

Lessee is required to evaluate whether it is the accounting owner under Topic 842

The lessee must evaluate whether it controls, at the effective date of Topic 842, an underlying asset a developer is presently constructing or designing that it will subsequently lease. If it controls the underlying asset, it would be the accounting owner under Topic 842.

When lessee is the accounting owner under Topic 842

The lessee should recognize the assets and liabilities resulting from the conclusion that it is the accounting owner of the asset under construction at the later of (1) the beginning of the earliest period presented, or (2) the date the lessee was determined to be the accounting owner of the asset under construction under Topic 842. The lessee will account for the transaction in accordance with the sale-leaseback guidance in Topic 842 from the effective date.

When lessee is not the accounting owner under Topic 842

That means the lessee was neither the accounting owner of the asset under current US GAAP nor under Topic 842. Therefore, the lessee applies the requirements of the new leases standard at lease commencement.

Effective dates and transition

Effective dates		
	First date of adoption for calendar year-end entities	**Effective date**
Public business entities	January 1, 2019	Annual and interim periods in fiscal years beginning after December 15, 2018
Other entities – annual periods	January 1, 2020	Annual periods beginning after December 15, 2019
Other entities – interim periods	January 1, 2021	Interim periods in fiscal years beginning after December 15, 2020
Early adoption	All entities can adopt Topic 842 immediately.	
Transition method	Modified retrospective, which requires application of the new guidance for all periods presented.	

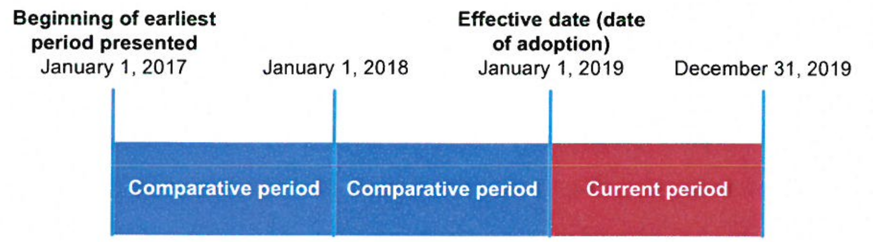
KPMG observation:
Lessees with build-to-suit leases may early adopt

In many cases, the transition provisions in Topic 842 permit (or require) lessees to derecognize build-to-suit assets and liabilities that were previously recognized under current US GAAP, including such assets and liabilities that have remained recognized because of the existing sale-leaseback requirements.

In addition, the changes to the sale-leaseback guidance in Topic 842 make it easier for many lessees to derecognize build-to-suit assets and liabilities at the end of the construction period. Fewer build-to-suit arrangements for which a lessee is determined to be the accounting owner will result in 'failed sales'.

Therefore, some lessees for which these factors are relevant have indicated they intend to early adopt Topic 842. A calendar year-end public business entity that early adopts will need to quickly begin collecting the information necessary to apply the standard because it is already in the comparative period.

Transition dates for calendar year-end public business entities



KPMG observation: **SAB Topic 11.M disclosure of impact on future periods**

SEC Staff Accounting Bulletin Topic 11.M (SAB Topic 11.M or SAB 74) requires SEC registrants to evaluate new accounting standards that they have not yet adopted and to disclose their potential material effects. These disclosures generally should include a discussion about the effect that adoption is expected to have on the financial statements, unless this is not known or reasonably estimable.

As discussed in this publication, in transition, a lessee may derecognize significant fixed assets and debt obligations that originally arose from build-to-suit lease arrangements. In their place, the lessee may recognize ROU assets and lease liabilities for the lease of the constructed assets. If this is the case for a lessee, amongst other disclosures it should likely provide in accordance with SAB Topic 11.M, it should disclose these facts and provide a quantification of the related amounts. If precise quantification of the amounts is not yet practicable, a range may be provided. We believe the SEC generally expects that a lessee will refine its estimates (i.e. narrow ranges previously provided) as the effective date approaches and that it will not be acceptable for an entity to provide 'boilerplate' disclosures while only stating that it is continuing to evaluate the impact of Topic 842.

Read KPMG's Executive View on SAB 74 and the leases transition disclosures.

KPMG's Financial Reporting View

Insights for financial reporting professionals.

As you evaluate the implications of new financial reporting standards on your company, FRV is ready to inform your decision-making.

Visit FRV for accounting and financial reporting information with insights and analysis of significant decisions, proposals, and final standards and regulations.

FRV focuses on the new major standards (revenue recognition, leases and financial instruments) – and also covers IFRS, SEC matters, broad transactions and more.

Acknowledgments

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We would like to acknowledge the efforts of the main contributors to this Issues In-Depth:

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Leases – Issues In-Depth

US GAAP

April 2016

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Contents

A step closer to understanding

The FASB's new lease accounting standard ushers in a new era. Lessees will recognize most leases on-balance sheet, increasing their reported assets and liabilities – sometimes very significantly. And while lessor accounting remains substantially similar, there are some important changes. For both lessees and lessors, the details of the standard won't always match your expectations based on summary-level descriptions that you've heard, and in some cases will be surprisingly different.

The new standard impacts organizations across all industries that use leases for real estate, equipment, fleet, and automobiles, among others. Although implementation in 2019 seems a long way off, assessing the standard's impact now will allow you to develop an efficient and timely adoption plan – especially important given concurrent revenue recognition accounting change implementation efforts.

For many of you, implementation of the new standard will have broad organizational impacts beyond general accounting and financial reporting, including in areas such as legal, real estate, treasury, internal audit, IT, tax, budgeting, training, regulatory, contract management, and forecasting functions.

We trust that this edition of Issues In-Depth will give you an advantage in understanding the new standard. We take you through the standard step by step, explaining what the requirements really mean, providing examples, and giving our own observations about the requirements.

Kimber Bascom and Scott Muir

Department of Professional Practice, KPMG LLP

About this publication

The purpose of this edition of Issues In-Depth is to assist you in understanding the requirements of FASB ASC Topic 842, *Leases*, which was created by the issuance of FASB Accounting Standards Update No. 2016-02, *Leases*, in February 2016.

Organization of the text

Step by step, we take you through Topic 842, using our knowledge of the FASB's leases project to provide in-depth analysis and our perspective on the requirements. We have also included a chapter on your next steps toward eventual implementation of the new requirements.

The discussion includes references to the FASB ASC (or Codification). For example, *842-10-25-1* is paragraph 25-1 of ASC Subtopic 842-10, and *ASU 2016-02.BC160* is paragraph 160 of the basis for conclusions to ASU 2016-02.

Interaction with the new revenue recognition standard, Topic 606

As you read this Issues In-Depth, you may be surprised by the level of interaction between the requirements for lessors and the requirements for suppliers under FASB ASC Topic 606, *Revenue from Contracts with Customers*. This link between the two standards acknowledges the FASB's view that leasing is, in effect, a revenue-generating activity for lessors.

For a deeper understanding of the requirements of Topic 606, see the latest news on KPMG's Financial Reporting Network.

Comparison with current US GAAP

Throughout this Issues In-Depth, we highlight differences between Topic 842 and the current lease accounting requirements in FASB ASC Topic 840, *Leases*, and we include references to Topic 840. The significance of many of these differences will vary by entity, but this comparison provides a starting point for your analysis.

Comparison with the new International leasing standard, IFRS 16

Throughout this Issues In-Depth, we highlight what we regard as significant differences between Topic 842 and IFRS 16, *Leases*, and we include references to IFRS 16. We do not attempt to identify every difference, and we generally do not include differences that exist between the current literature, Topic 840 and IAS 17, *Leases*. To understand the differences between Topic 840 and IAS 17, see our publication, *IFRS compared to US GAAP* on KPMG's Financial Reporting Network.

Abbreviations

We use the following abbreviations in the charts and diagrams throughout this Issues In-Depth:

FV	Fair value
PV	Present value
ROU	Right-of-use (asset)
RVG	Residual value guarantee

1 Executive summary

Transparency and comparability

Topic 842 was developed to provide financial statement users with more information about an entity's leasing activities.

- Lessees will recognize all leases, including operating leases, with a term greater than 12 months on-balance sheet
- Lessees and lessors will disclose key information about their leasing transactions.

Effective in 2019

Public business entities apply Topic 842 for interim and annual periods in fiscal years beginning after December 15, 2018.

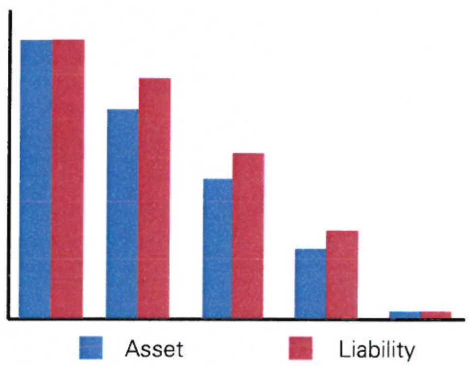
All other entities apply Topic 842 for fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning one year later.

This could affect your business

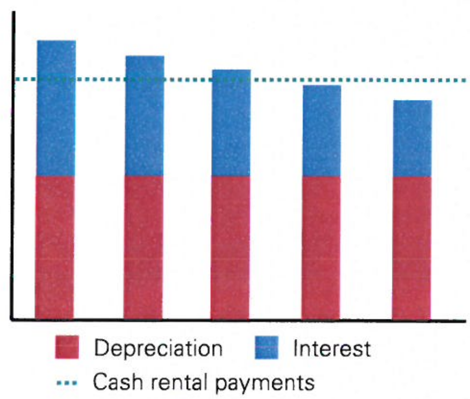
Key balance sheet measures and ratios

The effect on **lessees** will be direct, affecting investor and analyst expectations and potentially compliance with contractual covenants. For **lessors**, this may lead your customers to request shorter lease periods or different terms and conditions.

Entities with operating leases will increase their reported assets and liabilities, sometimes significantly.



Total lease expense will be front-loaded, even when rent payments are constant.



Systems, processes, and internal controls

Lessee accounting will require new significant judgments and reassessments during the lease term, which will require changes in processes and internal controls. In addition, IT systems may need to be upgraded or modified to ensure all leases are captured and the lease data necessary to apply Topic 842 are accumulated.

While **lessor** accounting will be substantially unchanged, some systems, processes, and control changes will likely be necessary as a result of the accounting changes that will result from Topic 842 and the increased disclosure requirements.

A lessee's perspective – Leases on balance sheet

The debits and credits

A lessee will recognize a lease liability and a right-of-use asset for all leases, including operating leases, with a term greater than 12 months, which may significantly increase reported assets and liabilities for some lessees.

The critical accounting determination will be whether a contract is or contains a lease. The lease classification distinction (which is broadly consistent with current US GAAP) will affect how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet as it does under current US GAAP.

For all leases, the lease liability is measured as follows, both initially and subsequently. Lease payments exclude contingent payments other than those that are in-substance fixed. The discount rate is the lessor's implicit rate if that rate is readily determinable; otherwise the lessee's incremental borrowing rate.

Lease liability = **PV of *unpaid* lease payments**

For all leases, on initial recognition the right-of-use asset is derived from the calculation of the lease liability. Topic 842 has a narrow definition of initial direct costs. Some costs incurred in negotiating and arranging a lease that are capitalized under current US GAAP will now be expensed when incurred.

Initial measurement of the lease liability + **Initial direct costs** + **Prepaid lease payments** – **Lease incentives received**

The measurement of the right-of-use asset subsequent to initial recognition depends on whether the lease is a finance or an operating lease.

For **finance leases:**

ROU asset = **Beginning balance** – **Accumulated amortization[1]** – **Accumulated impairment losses**

Note 1:

Amortization will generally be on a straight-line basis over the lease term.

For **operating leases**, there are two possible approaches to subsequent measurement (which will yield the same result).

Method 1 derives the carrying amount of the right-of-use asset from the measurement of the lease liability at each reporting date.

Lease liability carrying amount + **Unamortized initial direct costs** +/(–) **Prepaid/(accrued) lease payments** – **Unamortized balance of lease incentives received**

Method 2 amortizes the right-of-use asset, and the periodic amortization is a balancing figure.

ROU asset = **Beginning balance** – **Accumulated amortization**[1]

Note 1:

The amortization of the right-of-use asset each period is calculated as the difference between the straight-line lease cost for the period (including amortization of initial direct costs) and the periodic accretion of the lease liability using the effective interest method.

The right-of-use asset is subject to impairment testing under Topic 360 (property, plant, and equipment). Once an operating lease right-of-use asset is impaired, the two methods above no longer apply. Instead, subsequent amortization of the right-of-use asset is calculated in the same way as for finance lease right-of-use assets – generally on a straight-line basis over the remaining lease term.

More frequent revisions to lease accounting will require new processes and controls

A lease liability is remeasured when:

- The lease is modified and that modification is not accounted for as a separate contract.
- There is a change in the assessment of:
  - the lease term; or
  - a purchase option being exercised.
- There is a change in the amount probable of being owed under a RVG.
- A contingency is resolved that results in some or all variable lease payments becoming fixed payments.

The lease term and purchase options are reassessed when:

- There is a significant event or significant change in circumstances that is within the lessee's control and directly affects the assessment of whether the lessee is reasonably certain to exercise an option (extension, termination, or purchase).
- The lessee elects to exercise an option even though the entity has previously determined that the lessee was not reasonably certain to do so – or vice versa.

Build-to-suit guidance eliminated

Topic 842 eliminates the current build-to-suit lease accounting guidance, and instead stipulates that a lessee is the accounting owner of an asset under construction when it *controls* that asset before the lease commencement date.

The new guidance on determining when a lessee controls an underlying asset before lease commencement probably will result in fewer transactions where the lessee is considered the accounting owner of an asset during the construction period. This means that fewer build-to-suit lease arrangements will become subject to the sale-leaseback guidance.

The changes to the sale-leaseback guidance make it easier for lessees to remove real estate assets recognized during the construction period from their books.

The transition provisions of Topic 842 will permit many entities to derecognize build-to-suit assets and liabilities that have remained on the balance sheet after the end of the construction period under current US GAAP.

A lessor's perspective – The devil is in the detail

Overall model substantially unchanged

A lessor will classify leases using criteria similar to current US GAAP, as (1) sales-type, (2) direct financing, or (3) operating leases. Leveraged lease classification is eliminated prospectively. Once classified, the accounting model applied to each type of lease is also substantially similar to the lessor accounting model under current US GAAP.

	Balance sheet	Income statement	Cash flow statement
Sales-type and direct financing leases	– Recognize net investment in lease – Derecognize underlying asset	– Selling profit (loss) at lease commencement[1] – Interest income over lease term	– Cash received from leases as operating cash flows
Operating leases	– Continue to recognize underlying asset	– Lease income generally on straight-line basis over lease term	– Cash received from leases as operating cash flows

Note 1:

Selling profit is recognized over the lease term for direct financing leases.

Key concepts and definitions mostly consistent with current US GAAP

Along with the basic lessor accounting model remaining substantially unchanged, most of the key definitions and concepts relevant to lessor accounting are also consistent with current US GAAP. The following are examples.

Term	Equals
Net investment in the lease:	Lease receivable + unguaranteed residual asset
Lease receivable:	PV of lease payments + PV of guaranteed portion of estimated residual value
Unguaranteed residual asset:	PV of unguaranteed portion of estimated residual value
Lease payments:	Undiscounted fixed (including in-substance fixed) payments + optional payments (e.g. for purchase options, optional renewal periods, periods subsequent to a termination option) that are 'reasonably certain' to be owed
Discount rate for the lease:	Rate implicit in the lease, which is... The rate that causes the PV of lease payments + PV of estimated residual value = FV of the underlying asset (net of related investment tax credits) + capitalizable initial direct costs

But a change in the treatment of collectibility uncertainties

Unlike current US GAAP, a lease with collectibility uncertainties can be classified as a sales-type lease. If collectibility of the lease payments, plus any amount necessary to satisfy a lessee residual value guarantee, is not probable for a sales-type lease, lease payments received are recognized as a deposit liability (i.e. not recognized as lease income) and the underlying asset is not derecognized generally until collectibility of the remaining amounts becomes probable.

Collectibility uncertainties for a lease that otherwise would be a direct financing lease result in operating lease classification. Lease income recognized for operating leases when collectibility is not probable is limited to cash received from the lessee until collectibility of the remaining lease payments becomes probable.

Issues arising from significant lease payments

Unlike current US GAAP, leases with predominantly variable payments may be classified as sales-type or direct financing leases. Because variable lease payments are excluded from the net investment in the lease, this may result in either:

- a negative discount rate for the lease based on the definition of 'rate implicit in the lease' in Topic 842; or
- loss recognition at lease commencement.

And a narrower definition of initial direct costs

The new definition of initial direct costs includes only those incremental costs of a lease that would not have been incurred if the lease had not been obtained, which is narrower than current US GAAP. Some costs (e.g. legal fees and allocated internal costs) that an entity is permitted to capitalize as initial direct costs under current US GAAP will be expensed when incurred under Topic 842. For some lessors, this may result in recognizing more expenses prior to the start of a lease and higher margins on lease income earned over the lease term.

Typical initial direct costs	
Include	**Exclude**
– Commissions – Payments made to an existing tenant to incentivize that tenant to terminate the lease	– Legal fees – Costs of evaluating the prospective lessee's financial condition – Costs of negotiating lease terms and conditions – General overheads

Applicable to both lessees and lessors

Allocating consideration to lease and non-lease components

Topic 842 only governs the accounting for leases. If there are lease and non-lease components (e.g. services), an entity applies Topic 842 to the lease components and other US GAAP to the non-lease components, unless a lessee elects (by class of underlying asset) to account for non-lease components as part of the lease component to which they relate.

Contract		
Lease components	Non-lease components	Not a component
Allocate consideration in the contract		Activities (or lessor costs) that do not transfer a good or service to the lessee

The consideration in the contract is allocated in a way that maximizes the use of observable information. The **lessee** performs the allocation on a relative stand-alone price basis. The **lessor** follows the transaction price allocation guidance in the new revenue recognition standard (Topic 606).

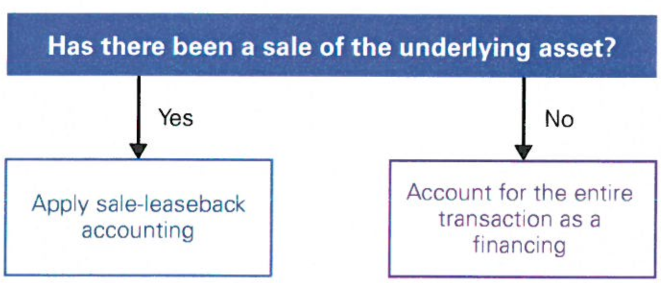
As the diagram shows, executory costs that do not represent payments for a good or service (e.g. payments to cover the lessor's costs of ownership, such as property taxes or insurance) are *not* non-lease components, and therefore payments for those costs are allocated to the lease and non-lease components in the same manner as all other payments in the contract. The result of this is that those payments will not be excluded from lease accounting as they are under current US GAAP.

Sale-leaseback accounting substantially changed

Topic 842 eliminates sale-leaseback transactions as an off-balance sheet financing proposition for **lessees**. This is because seller-lessees will recognize a right-of-use asset and lease liability in place of the underlying asset (and any asset financing repaid with the sale proceeds). Unlike current US GAAP, the sale-leaseback guidance is the same for real estate assets as it is for all other assets (e.g. equipment).

Topic 606 is used by *both* the seller-lessee and the buyer-lessor to assess whether a sale of the asset from the seller-lessee to the buyer-lessor has occurred. Purchase options will generally preclude sale accounting, unless (1) the strike price of the repurchase option is the fair value of the asset at the option exercise date, and (2) assets that are substantially the same as the underlying asset are readily available in the marketplace. This is expected to eliminate real estate sale-leaseback transactions with purchase options from qualifying for sale accounting.

In addition, sale and capital (finance) leasebacks will no longer exist; a conclusion that a leaseback is a finance (sales-type) lease will result in a conclusion that the sale-leaseback transaction does not qualify as a sale.



If the sale-leaseback transaction does not qualify as a sale, *both* the seller-lessee and the buyer-lessor account for the transaction as a financing arrangement. The seller-lessee recognizes a financial liability and continues to recognize (and depreciate) the asset, while the buyer-lessor recognizes a financial asset (i.e. a receivable).

If the sale-leaseback transaction does qualify as a sale of the underlying asset, the seller-lessee recognizes the entire gain from the sale (subject to adjustment for off-market terms) at the time of sale rather than over the leaseback term, as is typically the result under current US GAAP. The buyer-lessor accounts for the purchase of the underlying asset in the same manner as any other purchase of a nonfinancial asset (subject to a requirement to adjust the purchase price of the underlying asset for off-market terms).

Expanded qualitative and quantitative disclosures

Topic 842 requires lessees and lessors to disclose more qualitative and quantitative information about their leases than current US GAAP. Entities will need to consider whether they have appropriate systems, processes, and internal controls to capture completely and accurately the lease data necessary to provide those expanded disclosures.

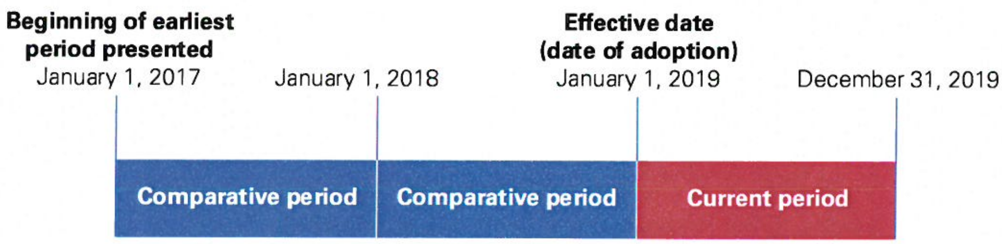
The following are examples.

Lessees	Lessors
Qualitative disclosures	
– Significant judgments and assumptions made, such as whether a contract contains a lease, stand-alone prices for lease and non-lease components, and the discount rate for the entity's leases. – Information about the nature of leases, such as the terms and conditions of variable lease payments, extension and termination options, purchase options, and residual value guarantees.	– Significant accounting judgments and estimates. – Information about the nature of leases, such as the nature of variable payment arrangements, and termination, renewal, and purchase options. – Information about how the lessor manages residual asset risk, including information about residual value guarantees and other means of limiting that risk.
Quantitative disclosures	
– Operating lease cost. – Amortization of finance lease right-of-use assets and interest on finance lease liabilities. – Variable lease cost. – Weighted-average remaining lease term, and weighted-average discount rate. – Maturity analysis of lease liabilities.	– Maturity analysis of lease receivables for sales-type/direct financing leases and of lease payments for operating leases. – Selling profit (or loss) recognized at lease commencement and interest income for sales-type/direct financing leases. – Operating lease income. – Variable lease income.

A modified retrospective transition approach, with relief

Topic 842 requires a modified retrospective transition approach, with application in all comparative periods presented. Entities will apply the new guidance at the beginning of the earliest period presented in the financial statements in which they first apply Topic 842.

If a calendar year-end public business entity adopts Topic 842 in accordance with the mandatory effective date, then the following are the relevant dates.



The standard includes certain practical expedients to ease the burden of adoption on preparers.

Package of practical expedients (all or nothing)	**Use of hindsight (elect on its own or with the package of practical expedients)**
An entity may elect not to reassess: – whether expired or existing contracts contain leases under the new definition of a lease; – lease classification for expired or existing leases; and – whether previously capitalized initial direct costs would qualify for capitalization under Topic 842.	An entity may use hindsight: – in determining the lease term, and in assessing the likelihood that a lessee purchase option will be exercised; and – for lessees, in assessing the impairment of right-of-use assets.

2 Scope

How the standard works

- Topic 842 applies to arrangements that meet the definition of a lease except for leases of/to:
  - » intangible assets;
  - » explore for or use non-regenerative resources (e.g. minerals, oil, or natural gas);
  - » biological assets (e.g. crops);
  - » inventory; and
  - » assets under construction.
- In addition, the right to use the grantor's infrastructure under a service concession arrangement is outside the scope of Topic 842.
- Leases of the following are in the scope of Topic 842:
  - » non-core assets;
  - » long-term leases of land; and
  - » certain sales with repurchase rights (from the supplier's perspective).

2.1 Explicit scope exclusions

2.1.10 Topic 842 is an inclusive standard, and applies to all leases (including subleases) unless there is a specific scope exclusion. The following are the specific scope exclusions from Topic 842. [842-10-15-1]

Excludes leases of/to...	Commentary
Intangible assets	Intangible assets and rights to use intangible assets continue to be accounted for under Topic 350 (intangibles – goodwill and other).
Explore for or use non-regenerative resources (e.g. minerals, oil, or natural gas)	– The scope exclusion includes the *intangible right* to explore for those natural resources, and rights to use the land in which those natural resources are contained. However, the scope exclusion does not apply if those rights of use include more than the right to explore for natural resources. – Rights to use *equipment* used to explore for natural resources are in the scope of Topic 842.
Biological assets (e.g. crops)	The scope exclusion includes leases of timber to be consistent with current US GAAP.
Inventory	Inventory is a defined term in US GAAP; only leases of assets that meet that definition are excluded from the scope of Topic 842. Therefore, the description of an asset as 'inventory' alone does not necessarily mean that a lease of that asset is outside the scope of Topic 842. – For example, sometimes entities refer to a collection of assets, such as spare parts, as inventory. If those spare parts are depreciable assets under other accounting guidance, a right to use those assets is in the scope of Topic 842.
Assets under construction	– If a lessee controls the asset under construction before the commencement date of the lease, the transaction is in the scope of the sale-leaseback guidance. – Topic 842 includes guidance (and examples) about when a lessee controls an asset that is under construction before lease commencement, and guidance on accounting for costs associated with the construction or design of the underlying asset in a lease. Section 9.4 discusses the accounting.

KPMG observation – Assets under construction are outside scope of Topic 842

2.1.20 The Board observed that there was no clear conceptual basis for stipulating that an entity cannot lease an asset that is under construction. However, the Board concluded that the additional complexity that this concept would introduce into lease accounting was not justified by the relatively few situations (in relation to the overall volume of leases in the scope of Topic 842) in which those leases would exist. In reaching its conclusion, the Board further noted that in many cases it might be difficult to distinguish when a lessee controls the asset that is under construction itself, or controls *the right to use* that asset before construction is complete. [ASU 2016-02.BC110E]

2.2 Interaction with other standards

Derivative instruments

2.2.10 Leases that are within the scope of Topic 842 are not derivative instruments. Residual value guarantees that are subject to the guidance in Topic 842 are not subject to the guidance in Topic 815; residual value guarantees are discussed in section 5.4.6. [842-10-15-43]

2.2.20 However, a derivative instrument embedded in a lease may be subject to the requirements of Topic 815 (derivatives and hedging). For example, a third-party residual value guarantor is required to consider the guidance in Subtopic 815-10 for all residual value guarantees that it provides to determine whether they (1) are derivative instruments, and (2) qualify for any of the scope exceptions under Subtopic 815-10. [815-10-15-81]

Service concession arrangements

2.2.30 A service concession arrangement is an arrangement between a public-sector entity grantor and an operating entity under which the operating entity operates the grantor's infrastructure (e.g. airports, roads, and bridges) and may also provide construction, upgrading, or maintenance services. [853-10-15-2]

2.2.40 Although there is no explicit scope exclusion for service concession arrangements in Topic 842 itself, the consequential amendments to Topic 853 are explicit that the right to use the infrastructure in a service concession arrangement is not in the scope of Topic 842. [853-10-25-2]

2.3 In the scope of Topic 842

Non-core assets

2.3.10 Non-core assets, such as a corporate jet or an administrative office, are not used in an entity's primary operations. Leases of non-core assets are not excluded from the scope of Topic 842. The Board's reasons included the following.

- US GAAP does not distinguish core and non-core assets that are purchases (or otherwise acquired) for purposes of recognition and measurement; therefore, it would be inconsistent to create such a distinction for leased assets.
- Conceptually, the lease of a non-core asset creates no less of a right-of-use asset or lease liability than the lease of a core asset; the same thinking applies to non-core assets that an organization purchases on a financed basis. Excluding leases of non-core assets from the scope of Topic 842 would have left material right-of-use assets and lease liabilities unrecognized. [ASU 2016-02.BC111–BC112]

Long-term leases of land

2.3.20 The scope of Topic 842 does not exclude long-term leases of land (e.g. 99- or 999-year leases). Although there is an argument that such long-term leases are economically similar to the purchase or sale of land, the Board decided against a scope exclusion. This was principally because there is no conceptual basis for differentiating long-term leases of land from leases of other assets, and inevitably any definition of a long-term lease of land would be arbitrary. [ASU 2016-02.BC113]

Certain sales with repurchase rights – supplier's perspective

2.3.30 In addition to those transactions within the scope of Topic 842, some arrangements within the scope of Topic 606 or Topic 610 (other income) in which an entity sells a nonfinancial asset to another party, but with the right or obligation to repurchase that asset from the customer, will be accounted for as leases by the supplier. [606-10-55-66 – 55-78, ASU 2014-09.BC427]

- If an entity sells an asset and also has an obligation or a right to repurchase the asset (i.e. a forward or a call option), the entity accounts for the arrangement as a lease if it can or must repurchase the asset for an amount that is less than the original selling price of the asset. If a call option is non-substantive, it should be ignored (for consistency with the general requirement for any non-substantive term in a contract). [606-10-55-68, ASU 2014-09.BC427]
- If an entity sells an asset and also has an obligation to repurchase the asset at the customer's request (i.e. a put option), the entity accounts for the arrangement as a lease if the customer has a 'significant economic incentive' to require the entity to repurchase the asset. [606-10-55-72]

2.3.40 The Board's rationale for requiring these arrangements to be accounted for as leases by the supplier is that the combined effect of the sale and repurchase agreement in each case is that the entity does not transfer control of the asset to the customer. Instead, the arrangement merely permits the customer to control the use of the asset for a period of time (which may not be defined) in exchange for consideration. [ASU 2014-09.BC424–BC431]

KPMG observation – Unclear whether sales with repurchase rights are leases by analogy

2.3.50 The repurchase agreements guidance in Topic 606 refers to the sale of any nonfinancial asset, which includes assets that, if leased, are outside the scope of Topic 842 (e.g. intangible assets). Therefore, it is unclear whether the Board intends for entities in this scenario to analogize to the leases guidance for sales of such assets or whether those requirements do not apply to arrangements for the sale of such assets.

KPMG observation – Suppliers and customers may account for sales with repurchase rights differently

2.3.60 Topic 606 and Topic 610 (other income) do not apply to the *customers* in sale transactions. Consequently, the customer in a sale transaction that will be accounted for as a lease by the supplier will not necessarily account for that transaction as a lease unless the arrangement meets the definition of a lease in Topic 842 (see chapter 3).

2.3.70 Customers will generally apply other guidance – (e.g. Topic 360 (property, plant, and equipment) or Topic 330 (inventory) – in determining whether, and how, to account for, the purchase. Because there is limited guidance in US GAAP about whether a purchase of an asset has occurred, we believe that customers in these arrangements with repurchase provisions may still conclude that they have purchased the asset even if Topic 606 or Topic 610 requires the supplier to account for the transaction as a lease.

2.4 Differences/changes in scope

2.4.10 The Board decided to fundamentally retain the scope of its current leasing guidance in its new leasing guidance, which means that there are only minor differences in scope between Topic 842 and current US GAAP (Topic 840). [ASU 2016-02.BC110]

The scope of IFRS 16

GAAP differences largely carried forward

2.4.20 Like the FASB, the IASB decided to broadly retain the scope of the current standard (IAS 17) for IFRS 16. Therefore, it is largely differences between the scope of current US GAAP and current IFRS that have resulted in scope divergence between Topic 842 and IFRS 16. [IFRS 16.BC67]

Leases of intangible assets, inventory, and assets under construction

2.4.30 Unlike Topic 842, IFRS 16 does not exclude from its scope leases of intangible assets (other than licenses of intellectual property granted by a lessor within the scope of IFRS 15, and rights held by a lessee under licensing arrangements within the scope of IAS 38 (intangible assets) for such items as motion picture films, video recordings, etc.), inventory, or assets under construction. The current IFRS leases guidance (IAS 17) similarly differs from the scope of the current US GAAP leases guidance (Topic 840) with respect to those leases. [IFRS 16.3, BC68]

Comparison with current US GAAP

2.4.40 In general, the scope of Topic 842 is consistent with the scope of the current US GAAP leases guidance in Topic 840, with only a couple of relatively minor differences.

Sale of an asset with a seller-provided residual value guarantee

2.4.50 Before the adoption of Topic 606, which is not yet effective, arrangements in which the seller of an asset provides a guarantee of the asset's future residual value to the buyer are accounted for as leases by the seller under US GAAP, regardless of whether the buyer has to return the asset to the seller to receive a guarantee payment. [840-10-55-14 (before ASU 2014-09)]

2.4.60 On the adoption of Topic 606, a seller residual value guarantee will not necessarily preclude sale accounting by the seller and, therefore, require the seller to account for the transaction as a lease. As a result, some arrangements involving seller residual value guarantees that are accounted for as leases under current US GAAP will not be accounted for as leases once the guidance in Topic 606 becomes effective. An arrangement in which the seller has the right or the obligation (i.e. call option or forward) to reacquire the asset *may* be accounted for as a lease by the seller depending on the terms of the repurchase agreement. [606-10-55-66 – 55-78]

2.4.70 The arrangement would be accounted for as a lease if the seller can or must repurchase the asset for an amount that is less than the price at which the asset was sold (unless the contract is part of a sale and leaseback transaction). A vendor (or supplier) with an arrangement of this nature will need to consider the guidance in Topic 842 and the repurchase agreements guidance in Topic 606.

No mention of heat supply contracts for nuclear fuel

2.4.80 Current US GAAP explicitly *includes* heat supply contracts for nuclear fuel that meet the definition of a lease within the scope of the lease accounting requirements, while the guidance in Topic 842 does not. Entities will need to apply the general requirements of Topic 842 to determine whether those types of contracts are within its scope. In addition, because nuclear fuel leases are not explicitly excluded from the scope of Topic 842, entities will have to consider whether such arrangements meet the definition of a lease (see chapter 3). [840-10-15-9, 55-7]

The scope of IFRS 16 – Summary comparison table

2.4.90 The following table:

- identifies arrangements that do and do not fall within the scope of IFRS 16 and Topic 842; and
- compares the scope of IFRS 16 and Topic 842 with the scope of current IFRS and current US GAAP.

	In Scope?			
Arrangement	**IAS 17[1]** (legacy)	**IFRS 16** (new)	**ASC 840** (legacy)	**ASC 842** (new)
Leases of tangible assets	✓	✓	✓	✓
Long-term leases of land	✓	✓	✓	✓
Sale-leaseback transactions	✓	✓	✓	✓
Subleases	✓	✓	✓	✓
Leases of inventory	✓	✓	✗	✗
Leases of intangible assets	W/E	W/E	✗	✗
Leases of biological assets[2]	NBM	✗	✗	✗
Investment property[3]	NBM	NBM	N/A	N/A
Right-of-use assets of property, plant and equipment that are measured at a revalued amount in accordance with IAS 16	N/A	NBM	N/A	N/A
Leases to explore for or use minerals, oil, natural gas, etc.	✗	✗	✗	✗
Service concession arrangements	✗	✗	✗	✗
Leases of assets under construction	✓	✓	✗	✗

✓ In-scope
✗ Not in-scope
W/E – In scope, but with exceptions (see 2.4.30)

NBM – In scope, but standard not applied as the basis for measurement
N/A – Not applicable (i.e. no existing guidance for this specific type of arrangement)

Notes:

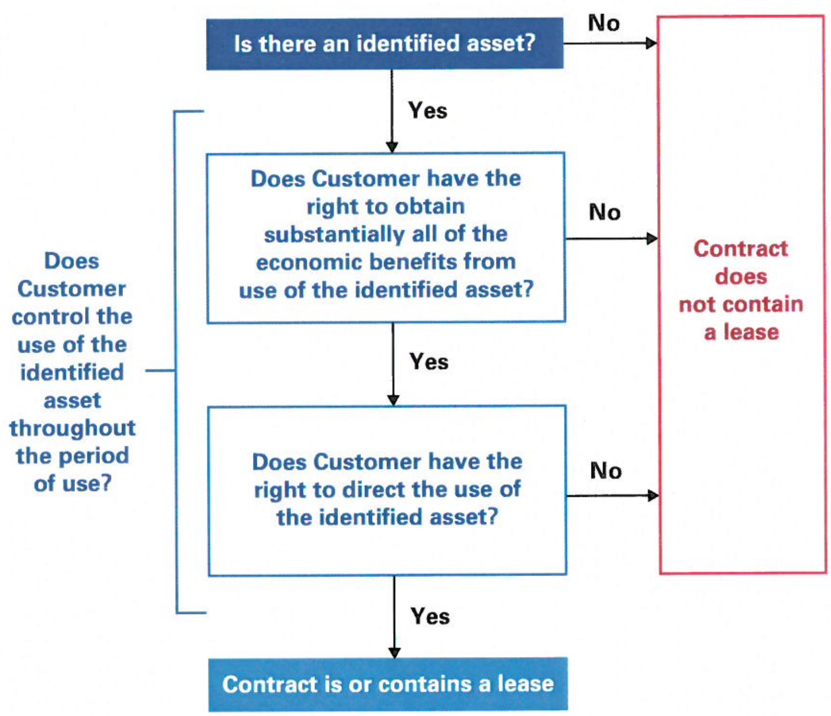
1. Including IFRIC 4 (arrangements containing leases).
2. IAS 41 (agriculture) applies to biological assets held by lessees under finance leases and biological assets provided by lessors under operating leases. The requirements of IAS 17 apply to all other aspects of lease accounting for these assets.
3. IAS 40 (investment property) applies to the measurement of investment property provided by lessors under operating leases and for property held by lessees that is accounted for as investment property. The requirements of IAS 17 apply to all other aspects of lease accounting for these assets.

3 Definition of a lease

How the standard works

An entity assesses at contract inception whether that contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset (land or a depreciable asset) for a period of time in exchange for consideration.

The key elements of the definition are:

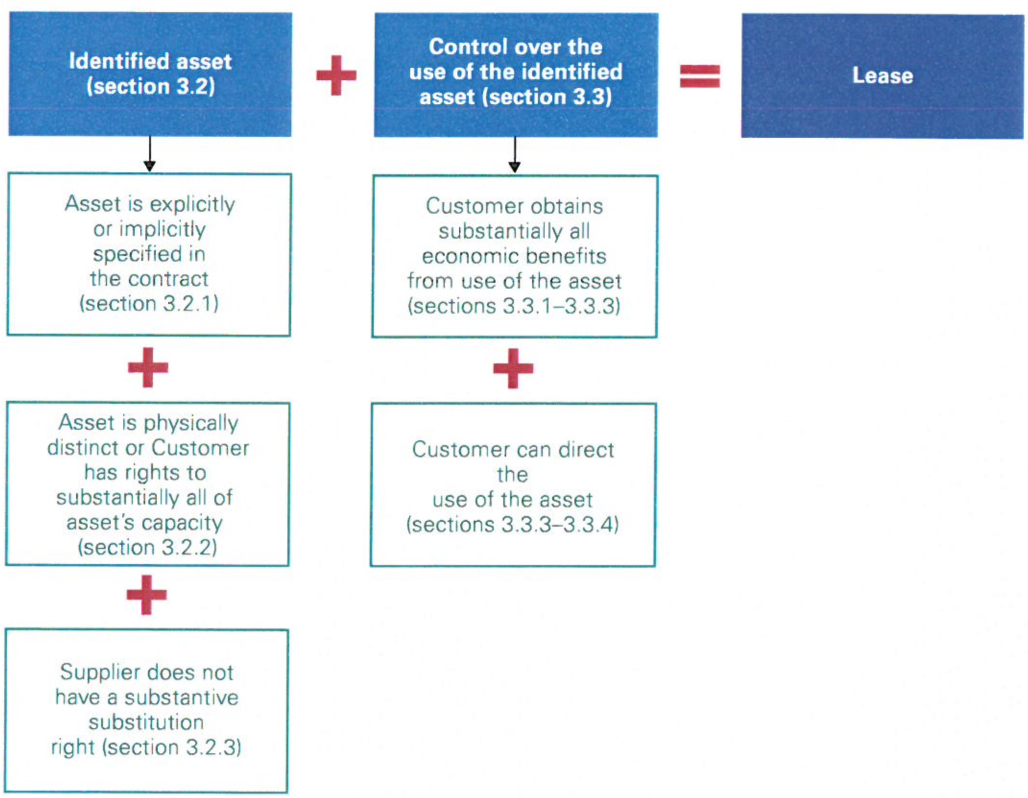


3.1 An overview

3.1.10 A lease is 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. A period of time may be described in terms of a specified amount of use of an identified asset – e.g. the number of production units an item of equipment will be used to produce. [842-10-15-3]

3.1.20 Both parties to a contract (the customer and the supplier) evaluate at inception of the contract whether it is or contains a lease. An entity does not reassess whether a contract is or contains a lease unless the terms and conditions of the contract are changed. [842-10-15-2, 15-6 – 15-7]

3.1.30 The following diagram highlights the two conditions required to meet the definition of a lease, plus the specific tests that must be passed to meet those conditions, which are discussed in this chapter.



3.1.40 The definition of a lease is converged between Topic 842 and IFRS 16, and the two conditions necessary to meet that definition are familiar under current US GAAP:

- there is an identified asset in the contract that is land or a depreciable asset (i.e. property, plant, or equipment); and
- the customer has the right to control the use of the identified asset.

3.1.50 While those two conditions appear similar to the requirements for identifying a lease under current US GAAP, important details have changed. Most notably, the second condition (i.e. the customer must have the right to control the use of the identified asset) is now more closely aligned with how control is defined and applied in the consolidation guidance (Topic 810) and the new revenue recognition standard (Topic 606). This is because, while an entity has to consider the customer's right to obtain the output or other utility from use of the identified asset under current US GAAP (which is similar to evaluating the customer's right to obtain the economic benefits from use of the underlying asset under Topic 842), the concept of evaluating whether the customer has the right to direct the use of the identified asset (a 'power' element of control) is new to the leases guidance.

3.1.60 In most cases, a customer will have the right to direct the use of an identified asset if it can direct (and change) 'how and for what purpose' the asset will be used throughout the 'period of use' (see section 3.3.5). However, if how and for what purpose the asset will be used is determined before the beginning of the period of use (e.g. predetermined in the contract or by the design of the asset), a customer still directs the use of the asset if it has either (1) operational control over the asset, or (2) had control over the design of those aspects of the asset that predetermine how and for what purpose it will be used.

3.1.70 Determining whether a contract contains a lease is an important step under Topic 842. When a contract contains a lease, the core principle of Topic 842 is that the customer (lessee) should recognize both a lease liability for its obligation to make lease payments to the supplier (lessor) and a right-of-use asset reflecting its right to use the underlying asset during the lease term. Whether a contract is or contains a lease also triggers specific disclosure requirements for lessees *and* lessors. Consequently, properly identifying leases is important to all entities, regardless of their role as customer or supplier in the arrangement.

3.1.80 Throughout this chapter, the 'period of use' is referred to in looking at the economic benefits to which the customer has rights, and the power that the customer has to control the use of the asset. The period of use is the total period of time that an asset is used to fulfill a contract with a customer, including the sum of any non-consecutive periods of time. [842 Glossary]

KPMG observation – Lease definition is the new on/off-balance sheet test

3.1.90 Under current US GAAP, the critical determination in lessee accounting is lease classification, because lease assets and lease liabilities are recognized only for capital leases. In contrast, under Topic 842 a lessee will recognize lease assets and lease liabilities for all leases other than 'short-term leases' (see section 6.3.1), whether classified as operating or finance leases. It is therefore effectively the new test to determine whether an arrangement is on- or off-balance sheet for the customer. While the lease classification distinction continues to exist in Topic 842, it now affects how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet.

3.1.100 This change will require lessees to implement new or more robust processes and controls over the identification of leases because of the critical shift in risk points (see chapter 14).

KPMG observation – Lease identification occurs at contract inception

3.1.110 An entity determines whether a contract is or contains a lease at inception of the contract under Topic 842. When a lease exists, an entity applies the recognition and measurement provisions at the 'commencement date of the lease'.

3.1.120 Determining whether a contract is or contains a lease occurs at inception for practical reasons. Because Topic 842 establishes the lease commencement date for recognition and measurement items, while other Topics use different dates (e.g. Topic 606 measures and allocates the transaction price to performance obligations at contract inception), it is necessary to identify whether a contract includes one or more leases at contract inception to know whether the leases recognition and measurement guidance applies and, if so, which guidance (i.e. Topic 842 and/or another Topic) governs.

KPMG observation – A straightforward analysis in most cases

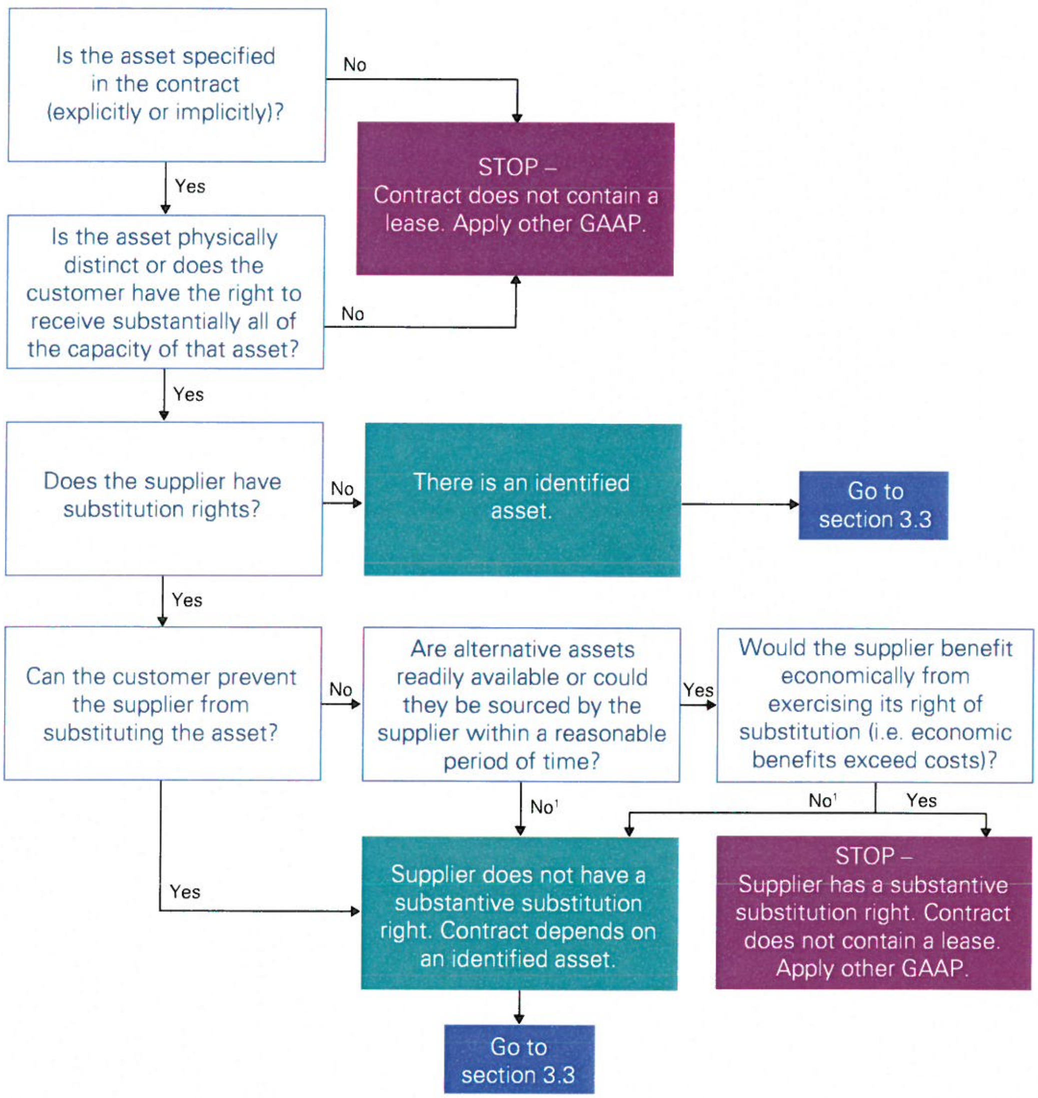
3.1.130 In the Board's view, assessing whether a lease exists will be straightforward in most cases. A contract will either fail to meet, or will clearly meet, the definition of a lease without the need for significant judgment. The new definition will likely continue to easily capture most common lease arrangements (e.g. leases of vehicles, office equipment, and real estate). However, for more complicated scenarios, the Board added guidance to assist entities in their evaluations. Examples of more complicated lease identification scenarios may include some outsourcing arrangements, as well as other arrangements in which both the customer and the supplier have decision-making rights about the use of an asset; this includes some equipment arrangements where the customer makes most or all of the decisions about how and for what purpose the asset will be used (see section 3.3.4), but the supplier retains the decision-making rights over operations and/or maintenance of the equipment. [ASU 2016-02.BC127]

KPMG observation – Meaning of *period of time*

3.1.140 A lease conveys the right to control the use of an identified asset for a *period of time* in exchange for consideration. The use of the phrase 'period of time' is not intended to suggest that a lease does not exist solely because there is not an explicit period of time assigned to the customer's right to control the use of the identified asset. A period of time, for purposes of identifying a lease, may be described in terms of the amount of use of the identified asset. For example, a customer may control the use of an identified asset for the period of time it takes to produce a specified number of units, or to complete a specific task, using the identified asset. [ASU 2016-02.BC123]

3.2 Is there an identified asset?

3.2.10 The following flowchart takes the diagram in section 3.1, and highlights in greater detail the key considerations in determining whether there is an identified asset – i.e. whether the first requirement for there being a lease is met. [842-10-15-9 – 15-16]



Note 1:

Or it is impractical for the customer to make this determination.

3.2.1 Is the asset specified in the contract?

3.2.20 An identified asset may be explicitly or implicitly specified in a contract. In most cases, the asset that is the subject of the lease will be *explicitly* specified in a contract (e.g. by serial number, or a specified floor of a building). However, consistent with current US GAAP, an identified asset can be one that is *implicitly* specified. An asset is implicitly specified if the supplier does not have a substantive right to substitute alternative assets to fulfill the contract (e.g. the supplier has only one asset to fulfill the contract). [842-10-15-9, ASU 2016-02.BC128]

3.2.30 An asset can be implicitly specified even if the customer does not know whether the supplier has multiple assets or only one asset to fulfill the contract – i.e. whether the supplier has the practical ability to substitute an alternative asset. All an entity must conclude for there to be an identified asset is that fulfillment of the contract depends on an item of property, plant, or equipment (e.g. a piece of equipment) and that substitution of that asset would not be economically beneficial to the supplier. [ASU 2016-02.BC128]

3.2.40 If the customer cannot readily determine whether substitution would be economically beneficial to the supplier, the customer should assume it is *not* economically beneficial. This is discussed in section 3.2.3. [842-10-15-15]

3.2.2 Is the asset physically distinct?

3.2.50 In most cases, the asset will be a complete asset and therefore easy to identify (e.g. a building or a piece of equipment). However, a capacity portion of an asset can also be an identified asset if: [842-10-15-16]

- it is physically distinct (e.g. the floor of a building, a specified strand of a fiber-optic cable, or a distinct segment of a pipeline); or
- it is not physically distinct, but the customer has the right to receive substantially all (see 3.3.300–310) of the capacity of the asset (e.g. substantially all of the data capacity of a fiber-optic cable).

Example 3.1
Assessing whether the asset is physically distinct

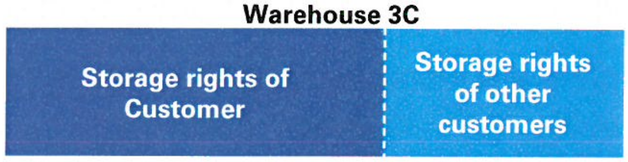
Scenario 1: Rights to a capacity portion – Not physically distinct

3.2.60 Customer enters into an arrangement with Supplier for the right to store its products in a specified climate-controlled storage warehouse (storage warehouse 3C).

3.2.70 Supplier has no substitution rights. However, the arrangement allows Supplier to store products from other customers in storage warehouse 3C. The exact space to be used by Customer within storage warehouse 3C is not specified. Instead, Supplier decides where each customer's products are stored within storage warehouse 3C and can relocate them at its sole discretion.

3.2.80 At inception of the contract, Customer has storage rights that permit Customer to use up to 60% of the capacity of storage warehouse 3C throughout the term of the contract. Supplier can use the other 40% of the warehouse as it sees fit.

Warehouse 3C

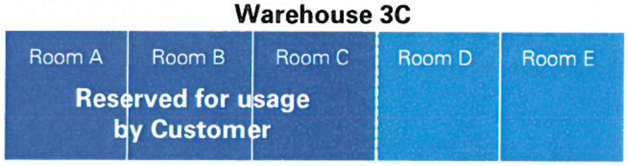


3.2.90 In this scenario, there is not an identified asset because Customer only has rights to a capacity portion of storage warehouse 3C that is not physically distinct from the remainder of the warehouse. In addition, the capacity of the storage warehouse that Customer has the right to use does not represent substantially all of the capacity of storage warehouse 3C. Because there is not an identified asset, the contract does not contain a lease.

Scenario 2: Rights to a capacity portion – Physically distinct

3.2.100 Changing the facts of Scenario 1, the contract provides Customer the right to use rooms A, B, and C within storage warehouse 3C, and Supplier has no substantive right to substitute alternative space in place of rooms A, B, and C. Rooms A, B, and C represent only 60% of storage warehouse 3C's total capacity.

Warehouse 3C



3.2.110 In this scenario, there is an identified asset even though rooms A, B, and C represent only 60% of storage warehouse 3C's total capacity. This is because the rooms are specified in the contract, are physically distinct from other storage locations within the warehouse, and Supplier has no substantive substitution right.

3.2.120 Accordingly, the next step is for Customer to determine whether it has the right to control the use of rooms A, B, and C (see section 3.3) to determine if there is a lease.

KPMG observation – Board decided against including all capacity portions

3.2.130 In deciding on the requirements in 3.2.50, the Board reasoned that a customer is unlikely to have the right to control the use of a capacity portion of an asset that is not physically distinct or that is less than substantially all of the capacity of the asset, because the relevant decisions about an asset's use are generally made at the whole asset level. That is, having rights to only a capacity portion of an asset (that is not substantially all of the asset's capacity), a customer will generally not have decision-making rights as to how the asset is used. [ASU 2016-02.BC133]

3.2.140 Therefore, the Board decided not to broaden the concept of an identified asset to the use of *any* capacity portion of a larger asset, because it may have forced entities to analyze all contracts for goods or services in which a customer obtains some amount of capacity from an asset as possible leases, only to then conclude that they were not leases because the customer does not have the relevant decision-making rights about the asset's use. [ASU 2016-02.BC133]

3.2.3 Does the supplier have a substantive substitution right?

3.2.150 Even if an asset is specified, there is not an identified asset (and therefore the contract does not contain a lease) if the supplier has a *substantive* right to substitute the asset throughout the period of use. A substitution right is substantive when the supplier: [842-10-15-10]

- has the practical ability to substitute alternative assets throughout the period of use; and
- would benefit economically from the exercise of its substitution right – i.e. the economic benefits that will be derived from substituting the asset exceed the costs of the substitution; for example, costs to transport/relocate the original and the alternative asset, and associated labor costs.

3.2.160 In considering whether the supplier has the practical ability to substitute alternative assets, an entity considers whether the customer can prevent substitution, and whether the supplier has ready access to an alternative asset or could source an alternative asset within a reasonable period. [842-10-15-10(a)]

3.2.170 An entity evaluates whether a supplier substitution right is substantive based on the facts and circumstances at inception of the contract. This evaluation excludes consideration of future events that, at inception, are not likely to occur.[1, 2] For example: [842-10-15-11, 55-64]

- an agreement by a future customer to pay an above-market rate for use of the asset;
- the introduction of new technology not substantially developed at contract inception;

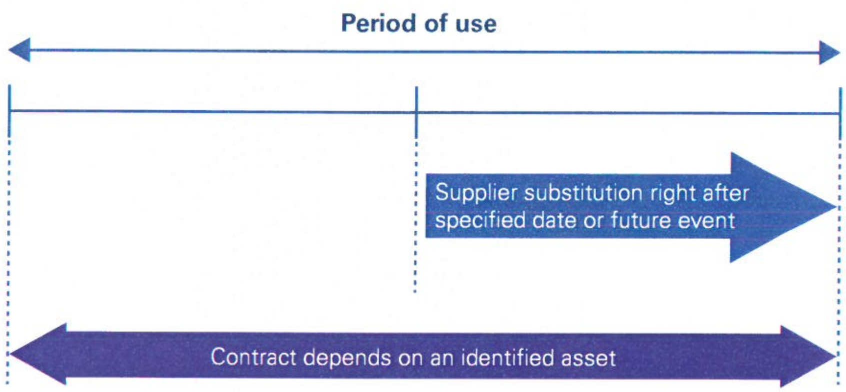
Notes:

1. Under US GAAP, 'probable' is defined as "the future event or events are likely to occur." Therefore, we believe that 'likely to occur' is effectively the same threshold as 'probable' in Topic 405 (liabilities).
2. Example 4 in Subtopic 842-10 suggests that the Board views facts and circumstances that are "highly susceptible to factors outside of the supplier's influence" as not likely to occur. [842-10-55-63 – 55-71]

- a substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract; and/or
- a substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract.

3.2.180 Topic 842 provides additional guidance to assist entities in determining whether a supplier substitution right is substantive, including the following.

- When the asset is located at the customer's premises (or someplace other than the supplier's premises), the costs of substituting the asset are generally higher than when located at the supplier's premises. Accordingly, those costs are more likely to exceed the economic benefits of substitution. [842-10-15-12]
- When a supplier has a right or an obligation to substitute the asset only on or after either (1) a particular date or (2) the occurrence of a specified event, the supplier does not have the practical ability to substitute alternative assets throughout the period of use. The substitution right is not substantive because the contract restricts when the supplier can substitute the asset. As a result, there is an identified asset for the entire period of use (as illustrated in the diagram), unless or until the identified asset is actually substituted by the supplier. [842-10-15-13, ASU 2016-02.BC131]



- A supplier right or obligation to substitute the asset for repairs and maintenance, because the asset is not operating properly, or because a technical upgrade becomes available, does not preclude the customer from having the right to use an identified asset. [842-10-15-14]

3.2.190 To the extent a customer cannot readily determine whether a supplier substitution right is substantive, it should presume that the substitution right is *not* substantive. [842-10-15-15]

Example 3.2
Substitution rights

Scenario 1: Supplier has substantive substitution right

3.2.200 Customer enters into an arrangement with Supplier for a climate-controlled storage warehouse to store its coffee beans.

3.2.210 Supplier has the right to substitute the storage warehouse without Customer's consent throughout the term of the contract. The following additional facts are relevant.

- Supplier has many identical storage warehouses that are maintained in a single, accessible location and Supplier could easily substitute another storage warehouse for the one specified in the contract at a nominal cost.
- Supplier would benefit economically from substituting the storage warehouse because substitution allows it to make the most effective use of its storage warehouse portfolio to meet regularly changing circumstances, which are likely to continue throughout the period of use.

3.2.220 In this scenario, there is *not* an identified asset, because Supplier's substitution right is substantive. Accordingly, the contract does not contain a lease.

Scenario 2: Supplier has substitution right but the underlying asset is significantly customized

3.2.230 Changing the facts of Scenario 1, although Supplier has the right to substitute the storage warehouse without Customer's consent throughout the period of use, there are no other similarly customized warehouses in Supplier's portfolio or readily available from other suppliers.

3.2.240 In this scenario, the substitution right is not substantive because a similarly customized storage warehouse is not readily available – i.e. Supplier does not have the practical ability to substitute the storage warehouse.[1] Therefore, there is an identified asset. The next step is for the entity to determine whether Customer has the right to control the use of the warehouse (see section 3.3) to determine if there is a lease.

Note 1:

Even if Supplier could customize an alternative warehouse in its portfolio within a reasonable period of time, the cost of customizing and providing a similar alternative storage warehouse would likely exceed the economic benefits that would be realized from substitution – i.e. while Supplier would not obtain additional payments from Customer for the substitution, Supplier would incur potentially significant costs to customize an alternative warehouse to Customer's needs and to relocate Customer's inventory to the alternative warehouse. In that case, Supplier's substitution right would still not be substantive because it would not benefit economically from the exercise of its substitution right.

Scenario 3: Customer unable to determine whether substitution rights are substantive – Customer assumes substitution right is not substantive

3.2.250 Changing the facts of Scenario 2, Customer is unable to determine whether the substitution right is substantive. In particular, Customer is unable to determine whether a similarly customized storage warehouse is readily available, or whether the economic benefits that would result from substitution exceed the expected costs of making the substitution. In this scenario, Customer does not know whether Supplier has alternative warehouses or could source one in a reasonable period of time, and also does not know if Supplier would economically benefit from substituting the warehouse.

3.2.260 In this scenario, Customer presumes that the substitution right is *not* substantive, and therefore that there is an identified asset. The next step is for Customer to determine whether it has the right to control the use of the warehouse (see section 3.3) to determine if there is a lease.

Example 3.3

Supplier substitution right – Evaluation of economic benefits

3.2.270 Customer enters into a three-year lease of a multi-function copier/printer. The contract provides Customer with the right to determine how to use the machine during the three-year term (subject to the limitations of its design and capabilities).

3.2.280 Supplier is required to provide an equivalent machine to the extent the one originally delivered ceases to operate properly. Supplier may also substitute an equivalent machine at any time during the period of use at its expense and without Customer's approval.

3.2.290 Regarding Supplier's right of substitution, Supplier has other equivalent machines readily available. However, it is not likely that events or circumstances will arise from which Supplier would be able to generate more rental income by substituting an equivalent machine for the original machine than it would by leaving the original machine in place. Supplier would incur costs both to transport and install an equivalent machine at Customer's location, and to remove and transport the original machine to storage or to another customer's location.

3.2.300 In this example, Supplier's substitution right is not substantive, because the economic benefits from substituting the original machine for an alternate machine would not exceed the costs of the substitution. Therefore, there is an identified asset. The next step is for the entity to determine whether Customer has the right to control the use of the machine (see section 3.3) to determine if there is a lease.

KPMG observation – Substantive substitution rights change the substance of the arrangement

3.2.310 Evaluating whether a supplier substitution right is substantive is effectively a test to determine whether the supplier (rather than the customer) controls the use of the asset because it can substitute that asset *throughout the period of use*. When a substitution right is substantive, meaning that the supplier can substitute and redeploy that asset as it sees fit, the supplier has the right to decide how and for what purpose the asset is used, and therefore directs its use. A substantive substitution right changes the substance of the arrangement (i.e. there is not an identified asset). [ASU 2016-02.BC128–BC129]

3.2.320 The Board believes that it will be clear in many situations whether a substitution right is substantive. However it may sometimes be difficult for a customer to make that determination. For example, a customer may not have sufficient information to perform the evaluation – e.g. assessing the supplier's costs and potential economic benefits from substituting the asset may be particularly difficult in many cases. This is why the Board included the presumption that substitution rights are *not* substantive when the customer cannot readily make that determination. Accordingly, a customer does not have to exert undue effort to prove that a substitution right is not substantive. [ASU 2016-02.BC130–BC132]

3.2.330 The specific guidance provided in Topic 842 on substitution rights, especially the condition that the supplier must benefit economically from substituting the asset in order for a substitution right to be substantive (see 3.2.150), may mitigate structuring opportunities to include substitution clauses solely to avoid there being an identified asset in the contract.

KPMG observation – Interaction between paragraphs 842-10-15-13 and 842-10-15-11

3.2.340 Paragraph 842-10-15-13 addresses whether a supplier has the practical ability to substitute alternative assets throughout the period of use. As discussed in 3.2.180, if the supplier has the right or obligation to substitute an alternative asset only on or after a specified date, or after the occurrence of a specified event, the supplier does not have the practical ability to substitute alternative assets; therefore, the substitution right is not substantive. [842-10-15-13]

3.2.350 Paragraph 842-10-15-11 applies when the supplier *has* the practical ability to substitute an alternative asset throughout the period of use and the entity (customer or supplier) is considering whether exercising that right will economically benefit the supplier. If a supplier with the practical ability to exercise a substitution right will only benefit economically from exercising that right under circumstances that are not 'likely to occur', that substitution right is not substantive. [842-10-15-11]

3.2.360 Consider the following contrasting scenarios.

- A supplier leases a group of similar assets maintained at its premises to a customer. The supplier has the right, throughout the period of use, to substitute the leased assets and has a pool of readily available alternative assets. Relevant experience demonstrates that (1) the supplier benefits economically from being able to deploy alternative assets as necessary to fulfill customer needs, and (2) that the conditions that make substitution economically beneficial (e.g. the nature and mix of different customer needs for the supplier's assets) are likely to continue throughout the period of use. In this scenario, the supplier's substitution right is substantive.
- A supplier leases a piece of equipment to a customer. The supplier has the substantive right at any time to substitute an alternative, but generally equivalent, piece of equipment and has readily available alternative assets. However, the supplier will only benefit economically from doing so if events and circumstances change from those at lease commencement; for example, a new customer wants to lease or buy the specific piece of equipment being leased in this example and is willing to pay a premium to get it. The necessary circumstance in this case is not 'likely to occur' because it depends on factors substantially outside of the supplier's control and there is not relevant history to suggest this is likely to occur.

Comparison with current US GAAP

Identified asset concept aligns with current guidance

3.2.370 The concept of an identified asset is generally consistent with the concept of a specified asset under current US GAAP. This includes the concept that an asset is implicitly identified if the supplier does not have a substantive substitution right. The Board decided not to revise this concept because it works well in practice. However, because concluding that a contract is or contains a lease will have a more significant effect on customers' accounting compared to the current guidance, the Board also decided to provide additional guidance about when there is, or is not, an identified asset; in particular, providing significant new guidance about whether a substitution right is substantive. [840-10-15-15]

Determining whether substitution rights are substantive

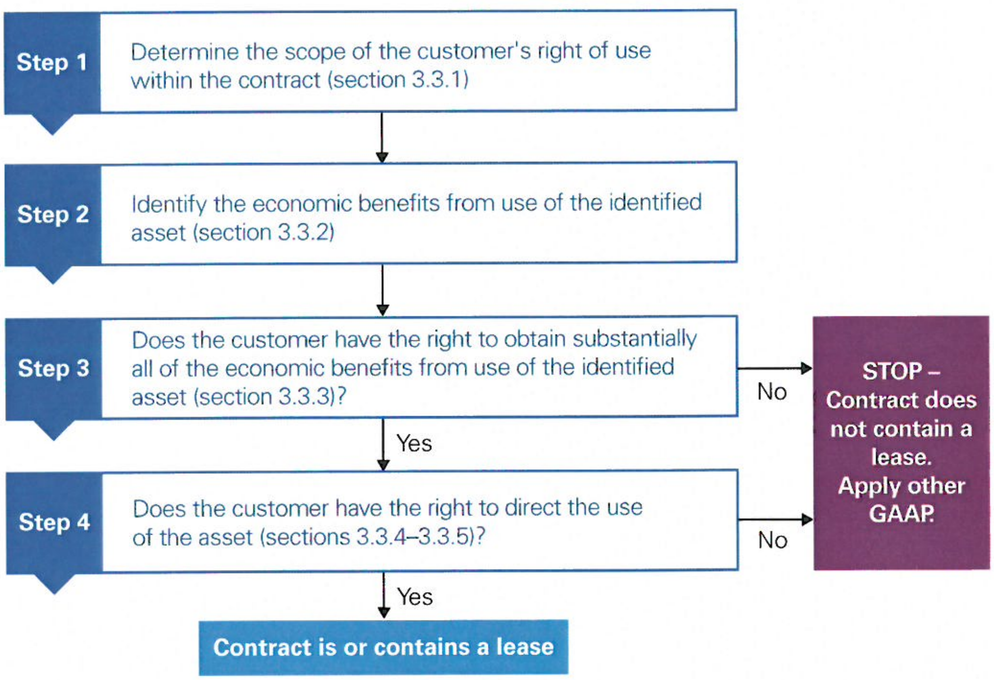
3.2.380 The requirement that a substitution right must economically benefit the supplier to be substantive is a new concept. Current US GAAP focuses only on the supplier's right and ability to substitute goods or services using other property, plant, and equipment. Therefore, entities will need to consider this additional criterion under Topic 842 to determine if a supplier has a substantive substitution right. [840-10-15-5]

3.3 Does the customer control the use of the identified asset?

3.3.10 If an entity determines that a contract depends on the use of an identified asset (see section 3.2), it then evaluates whether the customer has the right to control the use of that asset for a period of time. This occurs when the customer has the right, *throughout the period of use*, to:

- obtain substantially all of the economic benefits from the use of the identified asset; and
- direct the use of the identified asset. [842-10-15-4]

3.3.20 Topic 842 introduces important concepts to determine whether a customer controls the use of an identified asset. The following chart depicts the decision process that an entity considers in this evaluation. [842-10-15-4, 15-20]

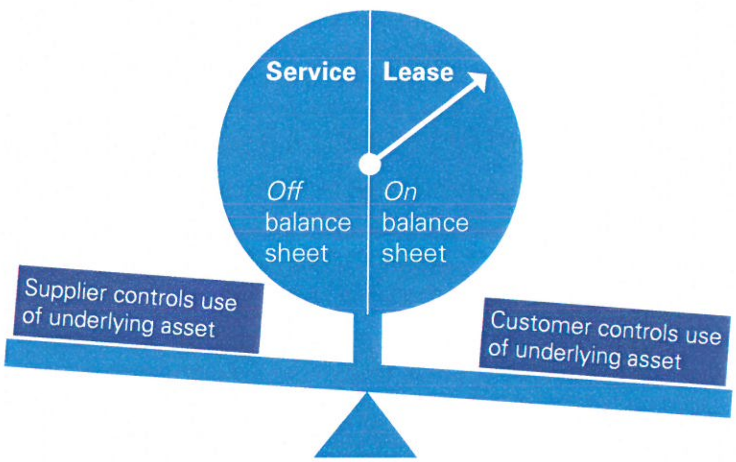


3.3.30 In many situations, this analysis will be straightforward and will require little to no judgment. However, for more complex situations, significant judgment may be needed.

KPMG observation – Who has control over the use of an asset differentiates a lease from a service

3.3.40 A lease exists when a customer has the right to make those decisions about the use of an asset that significantly affect the economic benefits to be derived from its use in a manner similar to the way in which an entity can make decisions about its owned property, plant, and equipment. This concept of control, which is based on two elements (power over directing the use of the asset, and control of the economic benefits to be derived from use of the asset), is similar to how control is defined in Topic 606.

3.3.50 The Board observed that control of the use of the asset requires the customer to have decision-making rights over the use of the asset to influence the economic benefits derived from use of the asset – and this must be throughout the period of use. Without these rights, the Board concluded that the customer would have no more rights than if it were simply buying supplies or services, and the customer would not control the asset. This may be a change for certain arrangements that are currently accounted for as leases only because the customer obtains substantially all of the output (or other utility) from an asset. [ASU 2016-02.BC134]



KPMG observation – The control concept in Topic 810 is relevant

3.3.60 Although they are not the same, there are similarities between some aspects of the control concept in Topic 842 and the controlling financial interest concept in Topic 810 (consolidation). Both concepts comprise a power characteristic and a benefits characteristic. The power characteristic in Topic 810 is highly consistent with the power characteristic in Topic 842, but the benefits characteristics are significantly different.

3.3.70 We believe that one of the aspects of the power characteristic in Topic 810 that is particularly relevant to Topic 842 is when some, but not all, decisions that significantly affect economic performance are shared. Topic 810 requires one party to be identified as the party with power in these situations. We believe that this is essentially the same approach that the Board decided to require in Topic 842 when *some, but not all*, of the relevant decisions that affect the economic benefits to be derived from use of the underlying asset are predetermined. [810-10-25-38E]

3.3.80 Under Topic 842, either the supplier or the customer would be identified as the party with power in those circumstances – i.e. the guidance in paragraph 842-10-15-20(b) on how to identify whether the customer has power when the relevant decisions about how and for what purpose an asset is used are predetermined in Topic 842 would not apply. For further discussion about how to determine whether the customer has control when some or all of the how and for what purpose decisions are predetermined, see section 3.3.5.

3.3.1 Step 1: What is the scope of the customer's right to use the asset?

3.3.90 A lease may not grant a customer an unlimited or unrestricted right to use an asset. For example, a contract may limit the customer's use of a motor vehicle or an aircraft to only one particular territory, or up to a particular number of miles, during the period of use. These limits or restrictions define the scope of the customer's right to use the identified asset. While limits or restrictions of this nature affect what economic benefits can be derived from use of the asset during the period of use, a lease still exists:

- if the customer has the right to obtain substantially all of those economic benefits; and
- substantive relevant decision-making rights about the use of the asset remain unrestricted that the customer controls (e.g. when and where the motor vehicle or aircraft travels within the unrestricted territory). [842-10-15-18]

3.3.100 A contract may include terms and conditions designed to protect the supplier. Protective rights are provisions in the contract that, for example, are intended to:

- protect the supplier's interest in the underlying asset (e.g. by preventing a customer from transporting particular types of goods, such as explosives) or other of its owned assets (e.g. a larger asset of which the identified asset is a physically distinct portion);
- protect its personnel (e.g. restrictions preventing the customer from sailing a ship in high risk waters when the supplier's personnel operate the asset); or
- ensure the supplier complies with laws and regulations (e.g. legal restrictions on where an aircraft can fly).

3.3.110 The Board concluded that protective rights generally define the scope of the rights that a customer obtains rather than affecting the existence of a right to use an asset. Contractual restrictions of this nature are known and agreed to by the customer and are an inherent part of the contract pricing – i.e. the contractual consideration reflects the economic substance of the right-of-use. [ASU 2016-02.BC141]

KPMG observation – Protective rights versus decision-making rights in the scope of the contract

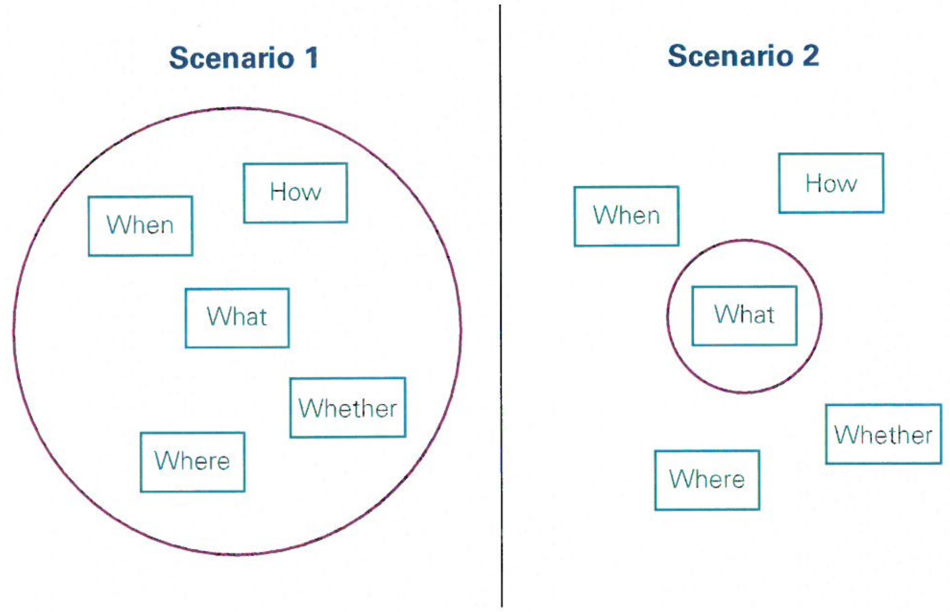
3.3.120 Topic 842 describes rights to specify the maximum amount of use of an asset or where or when the customer can use the asset as supplier protective rights; however, it also describes similar rights as examples of decision-making rights that grant the customer the right to direct how and for what purpose the underlying asset is used. Accordingly, at various points during the Board's project, some suggested that an entity would need to evaluate whether restrictions in a contract are merely protective in nature or whether they are so restrictive that they preclude the customer from controlling the use of the underlying asset. [842-10-15-23, 15-25]

3.3.130 It is possible that in an extreme circumstance, the restrictions imposed on the customer could be so restrictive that they leave the customer with *no* substantive decision-making authority over the use of the asset. If the customer has *no* substantive decision-making authority over the use of the asset during the period of use, there is not a lease.

3.3.140 However, in general we believe that contractual restrictions define the scope of the customer's right to use the underlying asset, and that restrictions on the use of the asset agreed to by the customer and the supplier reflect just another form of predetermined decision. Therefore, in the vast majority of arrangements, including those with significant contractual restrictions, restrictions do not prevent the customer from having the right to direct the use of the asset as long as there are substantive decisions about the use of the asset that are still available to be made and the customer controls those remaining decisions that will most significantly affect the economic benefits to be derived from use of the asset during the period of use (see sections 3.3.4 and 3.3.5).

3.3.150 The following scenarios illustrate the principle of only looking at the rights that are within the scope of the contract. [842-10-15-24 – 15-25]

- In Scenario 1, none of the possible, relevant decision-making rights in relation to the underlying asset are predetermined (e.g. by restrictions in the contract). Therefore, in assessing whether the customer controls the use of the asset, all of these rights are considered; this does not mean, however, that the customer must have *all* of those decision-making rights for there to be a lease (see section 3.3.4).
- In Scenario 2, the contract encompasses only *what* the underlying asset can be used for – i.e. what output the asset can produce. Therefore, in assessing whether the customer controls the use of the asset, only these *what* rights are considered. This scenario assumes that the 'what' decisions are substantive and significantly affect the economic benefits that can be derived from the use of the asset.



XX Universe of relevant decision-making rights related to the use of an underlying asset

Scope of the contract

Example 3.4
Scope of the customer's right of use

3.3.160 Customer enters into a contract with Supplier for the use of an aircraft for a specified period of time. The contract includes a number of restrictions on the use of the aircraft. It restricts:

- where the aircraft may fly – in the US only for regulatory purposes;
- what the aircraft may transport – passengers and passenger luggage only; and
- when the aircraft may fly – Customer is prohibited from operating the aircraft in certain weather conditions.

3.3.170 Notwithstanding these restrictions, there are substantive decisions about the use of the aircraft that Customer has the right to make (and change) throughout the period of use that are within the scope of its right to use the aircraft (i.e. that are not predetermined through restriction). For example, Customer can decide whether the aircraft flies, when it flies (subject to the bad weather restriction), where it flies within the US, and the passengers it carries.

3.3.180 In this example, the usage restrictions in the contract do not preclude Customer from having the right to direct the use of the aircraft.

3.3.2 Step 2: What are the economic benefits from using the asset?

3.3.190 Once the scope of a customer's right to use an asset is determined (see section 3.3.1), an entity should only consider the *economic* benefits arising from the *use* of that asset. Topic 842 further explains that this includes direct benefits (e.g. from using, holding or subleasing the asset) and other economic benefits relating to the use of the asset (e.g. renewable energy credits received, or by-products arising from the use of an asset) that could be realized in a commercial (arm's length) transaction. [842-10-15-17]

3.3.200 The Board reasoned that a lease conveys a right to use the underlying asset; it does not convey ownership. Accordingly, benefits derived from *ownership* of the asset (e.g. income tax credits) are excluded from the evaluation. While certain tax credits may be indirectly related to the underlying asset's use (e.g. production tax credits), we believe that *all* benefits related to tax attributes should be excluded from the population of economic benefits to be considered in determining whether there is a lease. [ASU 2016-02.BC135]

KPMG observation – Government priorities can drive whether there is a lease

3.3.210 Governments establish and change incentives or subsidies, such as renewable energy credits, for reasons that may often be unrelated to the value of the output produced by an asset. These governmentally established incentives or subsidies are not a result of the underlying asset's utility and are artificial – i.e. because they can be established, revoked, or changed by governments at any time.

3.3.220 Therefore, we believe that over time, equivalent arrangements granting a customer the right to use an asset could meet or not meet the definition of a lease based solely on government priorities (e.g. whether government is currently trying to encourage one activity or another) at contract inception.

3.3.3 Step 3: Does the customer have the right to obtain substantially all of the economic benefits?

3.3.230 Evaluating whether a customer has the right to obtain *substantially all* of the economic benefits from use of an asset throughout the period of use will be straightforward in many situations, generally because the customer in a lease frequently has exclusive use of the asset. However, in some situations, a contract may provide a party other than the customer the right to more than a minor amount of the economic benefits from use of the same asset.

3.3.240 A contract may require a customer to pay a portion of the cash flows derived from the use of an asset to the supplier (or another party) as consideration; this does not prevent the customer from obtaining substantially all of the economic benefits from use of that asset. For example, a customer may be required to pay the supplier a percentage of sales as consideration for use of the retail space. The cash flows from those sales are considered economic benefits that the customer receives, a portion of which it then pays to the supplier as consideration for the right to use the retail space. [842-10-15-19]

Example 3.5

Right to obtain the economic benefits from use – Outsourcing arrangement

Scenario 1: Supplier can use the factory to supply other customers

3.3.250 Customer enters into a 10-year agreement with Supplier to purchase a particular type and quantity of airbags. The following facts are relevant.

- Supplier has only one factory that can meet the needs of Customer.
- Supplier is unable to supply the airbags from another factory and does not have the right or ability to source the airbags from a third-party supplier.
- The capacity of the factory significantly exceeds the output for which Customer has contracted, and the factory is used to fulfill contracts with a number of Supplier's customers.
- There are no other substantive economic benefits that can be derived from use of the facility other than those that are derived from its production of airbags.

3.3.260 In this example, Customer does not control the use of the factory because it does not have the right to obtain substantially all of the economic benefits from use of the factory. This is because Supplier can obtain more than an insignificant portion of the economic benefits from use of the factory by producing parts and selling them to other customers. Therefore, the arrangement is not a lease of the factory that will produce the airbags.

Scenario 2: Supplier cannot use the factory to supply other customers

3.3.270 Changing the facts of Scenario 1, Supplier designed and constructed the factory that will produce the airbags specifically to meet Customer's demand. The factory is specified in the contract and Supplier does not have the practical ability to source the airbags from another factory. The factory's capacity to produce airbags is the only way in which the factory can produce economic benefits from its *use*.

3.3.280 The existing capacity of the factory will be used to produce only the particular type and quantity of airbags requested by Customer, and Customer has the right to purchase all of the airbags produced by the facility – i.e. Supplier cannot use the factory to supply other customers. Supplier has the right to expand the facility in the future if it wishes to, and therefore expand its capacity; however, at contract inception it is not likely that it will do so.

3.3.290 In this example, Customer has the right to obtain substantially all of the economic benefits from use of the factory. Supplier's right to expand the facility, at which point the facility would be able to generate additional economic benefits from use that Customer might not control, is not considered in arriving at this conclusion. This is because an expanded facility would be a different asset from the one identified in the contract. Therefore, the arrangement is a lease if Customer also has the right to direct the use of the factory throughout the period of use (see section 3.3.4).

KPMG observation – No definition of 'substantially all'

3.3.300 The Board did not define what 'substantially all' means in the context of the definition of a lease. However, Topic 842 uses the same terminology in one of the criteria used to determine lease classification: whether the present value of the sum of the lease payments and residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the asset (see section 6.2). In that case, the standard includes implementation guidance that states that one reasonable approach to assessing that criterion is to conclude that 90 percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset. [842-10-55-2]

3.3.310 In addition, 'substantially all' is used elsewhere in US GAAP and is interpreted on a mostly consistent basis to mean approximately 90 percent. As a result, we believe that an entity should generally use 90 percent as its benchmark in evaluating whether the customer has the right to obtain substantially all of the economic benefits from use of an asset.

KPMG observation – Contracts requiring a customer to pay a portion of the cash flows derived from use of the asset

3.3.320 As noted in 3.3.240, when a customer is required to pay a portion of the cash flows derived from the use of the asset to the supplier or another party as consideration (e.g. rent based on a percentage of retail store sales), those cash flows are considered economic benefits that the customer obtains. However, given that the concept of control in the new leases definition requires both a 'power' element (the right to direct the use of the underlying asset) and a 'benefits' element (the right to obtain substantially all of the potential economic benefits from use of the asset), some might question whether the benefits requirement is met when a customer is required to pay a significant portion of the cash flows derived from use of the asset to the supplier as additional rent.

3.3.330 However, we believe that the Board's intent was to establish that the customer obtaining the economic benefits from use of the asset (e.g. the cash flows obtained from selling products in a leased retail store) generally is separate from its payment of a portion of those cash flows to the supplier as additional rent. Variable payments of this nature should generally not affect the identification of a lease any differently from fixed payments that are often made with cash flows generated from use of the asset. Fixed *or* variable payments may be significant compared to the economic benefits generated by use of the asset (e.g. in high rent locations), and we believe that the Board intended that the amount or significance of the payments for the right to use the asset (compared to the economic benefits to be derived from the use of that asset) generally should not affect the conclusion about whether a lease exists.

3.3.340 It is not clear, however, whether a contract contains a lease when the customer obtains a fixed rate of return and the supplier receives/absorbs all of the variability in net operating profits, particularly if the supplier also receives most of the economic benefits from use of the asset; for example, most of the cash flows from the use of the asset, such as from a casino or hotel operation. In that situation, we believe that careful consideration should be given to the substance of the contract, including the nature of the arrangement between the parties, when determining whether the customer has the right to obtain substantially all of the economic benefits from use of the identified asset; for example, whether the nature of the arrangement is that the customer is in effect an agent of the supplier rather than the principal in the operation that is using the asset.

KPMG observation – Capacity does not necessarily equal economic benefits

3.3.350 Example 3.5 considers the facility's capacity to produce airbags as the only substantive means to derive economic benefits from use of the facility. However, a facility's capacity to produce output may not always be the only means from which to derive economic benefit from its use. For example, the economic benefits that an entity can derive from a renewable energy power plant stems from more than the electricity produced; for example, the plant may also produce economic benefits in the form of renewable energy credits.

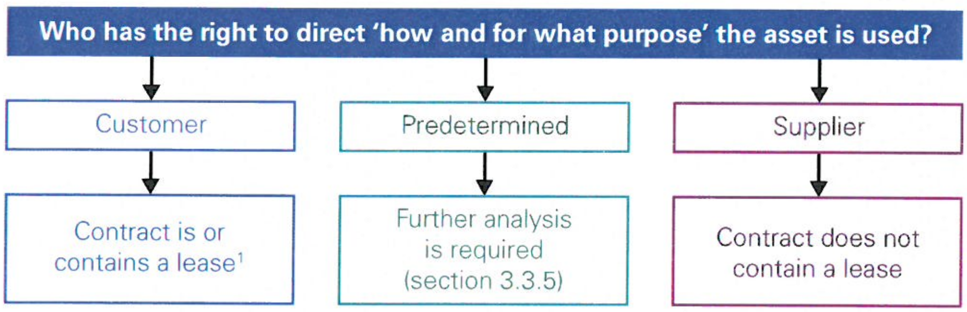
3.3.360 Another example might be a production facility such as that in Example 3.5, but where the steam from the manufacturing process is sold as a by-product to a power generation company. In that case, the economic benefits to be derived from the facility include not just those related to the facility's capacity to produce airbags, but also the facility's production of steam as a by-product.

3.3.370 In evaluating whether the customer has the right to obtain substantially all the economic benefits from use of an asset, entities will need to ensure that they appropriately capture the complete population of economic benefits that can be derived from use of the asset.

3.3.4 Does the customer have the right to direct the use of the asset?

3.3.380 This section looks at the general considerations that are relevant in determining whether the customer has the right to direct the use of the asset throughout the period of use, while section 3.3.5 looks more closely at situations in which the substantive decision making about how and for what purpose the asset will be used is predetermined.

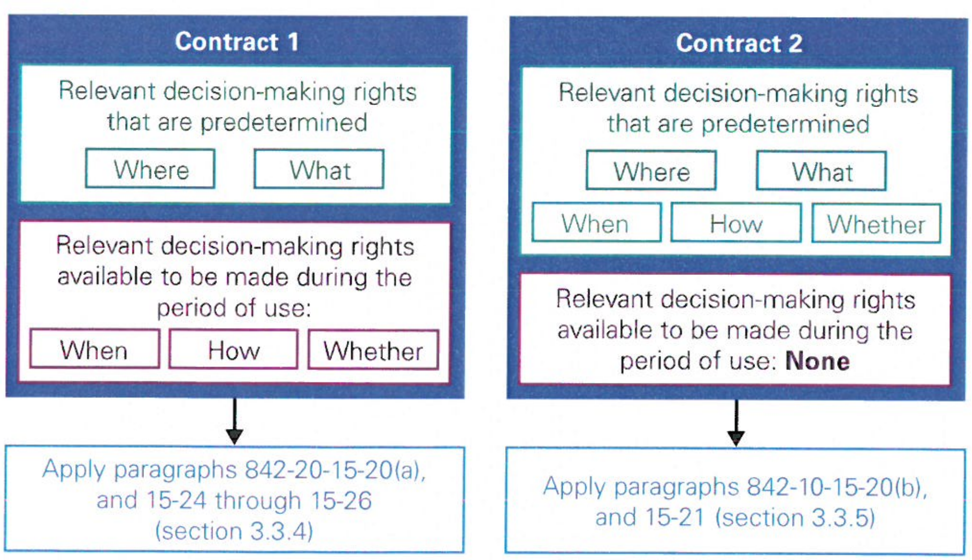
3.3.390 A customer has the right to direct the use of an identified asset when it has the right to direct (*and* change) how and for what purpose the asset is used throughout the period of use; for example, the ability to decide how leased space in a retail unit is used, or where and when a leased ship sails and what cargo it transports. [842-10-15-20, 15-24]



Note 1:

If other criteria are met (see sections 3.2 and 3.3.3).

3.3.400 When the relevant decisions about how and for what purpose the asset will be used throughout the period of use – i.e. those how and for what purpose decisions that significantly affect the economic benefits to be derived from use of the asset – are predetermined, an entity applies the guidance in section 3.3.5 to determine if the customer directs the use of the identified asset. If only some of the relevant decisions about how and for what purpose the asset will be used are predetermined, an entity considers whether the customer has the right to make those remaining, relevant 'how and for what purpose' decisions throughout the period of use. The following diagram illustrates this point.



3.3.410 The evaluation focuses on whether the customer has control over those decision-making rights that are most relevant to (i.e. those that most significantly affect) the economic benefits to be derived from the asset's use. Topic 842 notes that the relevant decision-making rights are likely to vary by contract, depending on the nature of the asset and the terms and conditions of the contract, and that some decisions about the use of an asset may be predetermined (e.g. through restrictions or other provisions in the contract). [842-10-15-24]

3.3.420 An entity should only consider which party (i.e. the customer or the supplier) has the right to make decisions about the use of the asset *during the period of use* – i.e. in evaluating whether a lease exists or not, an entity ignores decisions that are predetermined in the contract – unless the customer designed the asset or specific aspects thereof (see section 3.3.5). [842-10-15-22]

3.3.430 Topic 842 provides examples of decision-making rights that do and do not grant an entity the right to direct how and for what purpose an identified asset is used (within the scope of its right of use). [842-10-15-25 – 15-26]

Rights in the contract			
Example rights to direct how and for what purpose asset is used throughout period of use		**Other rights**	
Right to change the type of output produced by the asset	Right to change when the output is produced	Supplier protective rights	Maintaining the asset
Right to change where the output is produced	Right to change whether output is produced and, if so, quantity produced	Insuring the asset	Operating the asset[1]

Note 1:

Except when decision-making rights are predetermined.

3.3.440 A contract may include provisions that are intended to protect the supplier's interest in the asset or other assets, protect its personnel, or comply with laws or regulations – 'supplier protective rights' in the diagram in 3.3.430. [842-10-15-23]

3.3.450 Such rights typically define the scope of the customer's right to use the asset but do not, in isolation, prevent the customer from having the right to direct the use of the asset (see section 3.3.1).

KPMG observation – Decision-making rights are relevant when they affect the economic benefits from use of an asset

3.3.460 Relevant decisions about the use of an asset affect what and how much economic benefit is derived from the asset's use. An entity controls the use of an asset when it has the right to make those relevant decisions that most significantly affect what and how much economic benefit is derived from the asset's use. The Board concluded that decisions about how and for what purpose an asset is used are more important in determining who has control over the use of an asset than other decision-making rights (such as maintenance or operational decisions) that are dependent on, and typically subordinate to, the decisions about how and for what purpose an asset is used. [ASU 2016-02.BC137]

3.3.470 Examples of relevant decision-making rights that affect how and for what purpose an asset is used are provided in Topic 842, and include decision-making rights about whether to produce outputs from the underlying asset (e.g. whether to produce widgets from a machine or electricity from a power plant) and if so, what, when, and/or where to produce that output. Rights that give a customer the ability to specify the output of an asset at or before the beginning of the period of use (such as the amount and/or type of goods or services produced by the asset) in isolation do not give the customer the ability to direct the use of that asset. If a customer has no other decision-making rights relating to the use of the asset, the customer has the same rights as any customer that purchases similar goods or services. [842-10-15-25]

KPMG observation – Right to direct (and change) how and for what purpose an asset is used

3.3.480 The Board views the right to direct how and for what purpose an asset is used as a single right (i.e. a singular concept). That is, 'how' an asset is used is not evaluated separately from the 'purpose' for which the asset is used. 'How' in this context does not refer to purely operational decisions. As outlined in 3.3.430, the Board considers operational decisions to be subordinate to those decisions that affect how and for what purpose an asset is used. [ASU 2016-02.BC137]

3.3.490 When considering whether a customer has the right to direct how and for what purpose an asset is used, an entity would not consider whether the customer:

- has the right to make *every* decision about how and for what purpose the asset is used; or
- had the right to make those decisions that affect how and for what purpose the asset will be used that were made before the beginning of the period of use (except as discussed in section 3.3.5).

3.3.500 Instead, an entity considers the narrower population of whether the customer has the right to make (and change) those decisions about how and for what purpose the asset is used throughout the period of use that both:

- significantly affect the economic benefits to be derived from use of the asset; and
- are available to be made during the period of use.

3.3.510 Therefore, a customer need not have *all* of the decision-making rights in 3.3.430 to have the right to direct how and for what purpose the asset is used. This principle is illustrated in Example 3.6, Scenarios 1 and 2.

3.3.520 There are also multiple examples in Subtopic 842-10 that illustrate this concept. Those include (but are not limited to):

- Example 9, Case C, illustrates a scenario in which the customer cannot change the type of output produced; the power plant can only produce electricity, which was predetermined by the design of the asset before the period of use. However, the customer directs how and for what purpose the asset is used because it controls those substantive decisions about how and for what purpose the power plant will be used (which significantly affect the economic benefits to be derived from use) that are available to be made during the period of use (i.e. whether, when, and how much output will be produced). [842-10-55-117 – 55-123]
- In contrast, Example 8 illustrates a scenario in which some decision-making rights about how and for what purpose the asset is used are unavailable to be made during the period of use – i.e. because of the contract, the supplier cannot change the type of output the factory will produce. However, the supplier, rather than the customer, directs how and for what purpose the asset is used because it has the remaining relevant decision-making rights about when and how much the factory produces, while the customer has no substantive decision-making rights during the period of use. [842-10-55-100 – 55-107]

3.3.530 Identifying not only the relevant decisions (i.e. those decisions that can significantly affect the economic benefits to be derived from use of the asset), but only those relevant decisions that are available to be made during the period of use, may prove challenging for some contracts. For example, in a contract for the use of retail space in a shopping center, many of the decision-making rights that affect how and for what purpose the retail space is used may not be readily apparent or may not be available to be made during the period of use (i.e. those decisions may be predetermined).

3.3.540 For example, the contract may stipulate what type of retail store the customer may operate (e.g. a store that sells shoes, jewelry, or video games), when the retailer may operate (e.g. by prohibiting the customer from selling when the shopping center is not open), and/or that the retailer must operate when the shopping center is open. Because those decisions are predetermined, they are not considered in determining whether there is a lease. In determining whether there is a lease, the entity considers only those relevant decisions that are available to be made during the period of use.

3.3.550 Example 4 in the standard illustrates what some of the relevant decisions available to be made during the period of use might be (e.g. deciding upon the mix of goods, and the sale prices of those goods in the store) and concludes that the customer controls those remaining substantive decisions that significantly affect the economic benefits that can be derived from use of the retail space. In contrast, the supplier has no substantive decision-making rights about how and for what purpose the retail space will be used during the period of use. [842-10-55-63 – 55-71]

Example 3.6
Right to direct the use – Outsourcing arrangement

Scenario 1: Customer can change the mix and quantity of output during the period of use

3.3.560 Continuing Example 3.5, Scenario 2, Supplier designed and constructed the factory that will produce the airbags specifically to meet Customer's demand. The factory is specified in the contract and Supplier does not have the practical ability to source the airbags from another factory.

3.3.570 In addition, the factory is designed to manufacture various types and quality of airbags and Customer has the right to direct (and change) the mix and quantity of airbags that the factory produces during the period of use. Because Customer controls the mix and quantity of airbags produced, it also implicitly controls when the factory produces airbags.

3.3.580 Customer has the right to direct the use of the factory because it directs (and can change) how and for what purpose the factory is used – Customer can change the type and quantity of output produced by the factory. Because the factory is an identified asset and Customer also has the right to obtain substantially all of the economic benefits from the use of the factory (see Example 3.5, Scenario 2), the arrangement contains a lease.

Scenario 2: Customer can change the output quantity only during the period of use

3.3.590 Changing the facts of Scenario 1, the factory, as designed, can only produce the particular type and quality of airbag requested by Customer in the contract – i.e. the factory cannot produce other types of output. However, consistent with the facts in Scenario 1, Customer has the right to decide (and change) the quantity of airbags produced by the factory during the period of use.

3.3.600 Neither Customer nor Supplier can change *what* the factory produces, because the factory was designed to produce only the particular type and quality of airbags requested by Customer in the contract. However, Customer decides how much output the factory will produce and when, which are the relevant decisions about how and for what purpose the asset will be used that are *available to be made* during the period of use.

3.3.610 Supplier has no substantive decision-making rights about how and for what purpose the factory will be used during the period of use – i.e. it has no decision-making rights about the type, quantity, or timing of output from the factory.

3.3.620 Because Customer has the right to make the relevant decisions about how and for what purpose the factory will be used throughout the period of use that are not predetermined by the design of the factory, Customer has the right to direct the use of the factory. The factory is an identified asset and Customer controls its use – i.e. it has the right to both direct its use and obtain substantially all of the economic benefits from use; therefore, the arrangement contains a lease.

Example 3.7
Is there a lease (storage warehouse)?

3.3.630 Continuing from Example 3.1, Customer enters into a five-year arrangement with Supplier for a climate-controlled storage warehouse to store its coffee beans and/or other products. The storage warehouse is specified in the contract (storage warehouse 3C), Customer has exclusive use of the warehouse, and Supplier has no right to substitute it. Therefore, there is an identified asset.

3.3.640 Customer determines throughout the period of use what to store in the warehouse (e.g. coffee, tea, etc., subject to a restriction on the storage of hazardous materials), the quantity to be stored (up to a maximum quantity), and how much of the warehouse it will utilize. Supplier operates and maintains the storage warehouse.

3.3.650 In this example, the contract contains a lease. Customer has the right to obtain substantially all of the economic benefits from the use of the identified storage warehouse because it has exclusive use of it. Customer also has the right to direct the use of the storage warehouse because it has the right to direct how and for what purpose it is used throughout the period of use. That is, Customer has the right to determine the type and quantity of output that the asset produces throughout the period of use, which in the case of the warehouse is what and how much it stores.

Example 3.8
Is there a lease (truck and tractor trailers)?

3.3.660 Supplier provides Customer with a truck and three trailers for its exclusive use for a period of three years. The following facts are relevant.

- Supplier cannot substitute the truck or any of the trailers except for servicing or repair.
- Customer keeps the truck and trailers at its location when not in transit or at a delivery point so that it can use the trucks and trailers that are not in transit. For example, Customer can load one of the trailers that is not in transit with cargo so that it is ready for transit upon return of the truck.
- Customer can use the truck with a trailer not provided by Supplier, and any one of the trailers with a truck not provided by Supplier.
- Customer is responsible for providing a driver for the truck and can decide when and where the truck and trailers go.
- The contract limits Customer's use of the truck to 120,000 miles over the three-year period of use.
- The contract prohibits Customer from using any trailers with the Supplier truck larger than those provided by Supplier or hauling loads above a certain weight.

3.3.670 In this example, the contract contains a lease of the truck and three trailers because they are specifically identified assets that cannot be substituted except for reasons of servicing or repair. Customer has the right to control the use of the truck and each of the three trailers during the contract term within the scope of its right of use defined in the contract. Customer has the right to obtain substantially all of the economic benefits from use of the truck and each of the three trailers because it has exclusive use of those assets.

3.3.680 The contractual limits on truck usage are inherent features of the usage rights conveyed by the contract (i.e. supplier protective rights). Customer has the right to direct how and for what purpose the truck and trailers are used (i.e. when and where the truck and the trailers go or what they transport) within the scope of the contractually agreed right of use (i.e. subject to the supplier's protective rights).

KPMG observation – A customer must have relevant decision-making rights throughout the period of use

3.3.690 The criteria governing whether the customer has the right to direct the use of an identified asset refer to decision-making rights that exist throughout the period of use. This requirement prevents structuring to avoid the definition of a lease by including in the contract term periods during which the customer cannot make the decisions about how and for what purpose the asset is used, and/or obtain substantially all of the economic benefits from use of the identified asset.

3.3.700 Because of how *period of use* is defined and used in the guidance on identifying a lease, we believe that an arrangement to use an identified asset would not fail the definition of a lease solely because it is either contained within a contract with a longer overall term than the period during which the customer has the right to use the asset, or contains intermittent periods during which the customer does not have the right to control the use of the asset.

3.3.710 For example, a sports team that has the right to use an identified stadium for the months of September through January each year (during its playing season) for a period of 10 years would have a lease if it has the right to control the use of the stadium during the 10 five-month periods, even though it does not have the right to control the use of the stadium during the other seven months each year of the 10-year term of the contract. The *period of use* for purposes of evaluating control is the 50 non-concurrent months.

3.3.5 Control when the 'how and for what purpose' decisions are predetermined

3.3.720 It is possible that neither the customer, nor the supplier, controls the relevant decisions (i.e. those decisions that can significantly affect the economic benefits to be derived from use of the asset) to be made about how and for what purpose an identified asset will be used throughout the period of use (i.e. because those decisions are predetermined). In that case, the customer nevertheless has the right to direct the use of the asset if: [842-10-15-20]

- it has the right to operate the asset or direct others to operate it in a manner it determines throughout the period of use (and the supplier has no right to change those operating decisions); *or*
- it designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

3.3.730 The relevant decisions about use of an asset can be predetermined in a number of ways – e.g. by the design of the asset or by contractual restrictions on the use of the asset. [842-10-15-21]

Example 3.9

Right to direct the use predetermined – Outsourcing arrangement

3.3.740 Assume the same facts as in Example 3.5, Scenario 2, except that the type, quantity, and quality of the airbags to be produced are specified in the contract and neither Customer, nor Supplier, has the right to change any of those decisions absent a modification to the contract. Supplier has the right to make all of the operating decisions for the factory during the period of use. Customer has no right to hire another operator or to operate the factory itself.

3.3.750 Supplier and Customer analyze Customer's rights as follows to determine if the arrangement is a lease.

- The relevant decisions about how and for what purpose the factory will be used throughout the period of use (e.g. what and how much it will produce) are predetermined by the contract. Customer has no right to make or change the relevant decisions about how and for what purpose the factory is used (e.g. Customer has no right to change what, whether, how much, or when the factory produces).
- Because how and for what purpose the factory will be used is predetermined, Supplier and Customer consider whether Customer has other rights of use that extend beyond the receipt of output (i.e. airbags) from the factory. Customer does not have the right to operate the factory or to direct Supplier (or others) to operate it in a manner that Customer determines. Customer also did not design the factory or cause it to be designed in a way that predetermines throughout the period of use the relevant decisions about how and for what purpose the factory will be used.

3.3.760 As a result of this analysis, Supplier and Customer conclude that the contract does not contain a lease.

Example 3.10

Right to direct the use predetermined – Storage warehouse

3.3.770 Continuing Example 3.2, Customer enters into a five-year arrangement with Supplier for a climate-controlled storage warehouse to store its coffee beans. The storage warehouse is specified in the contract (storage warehouse 3C), Customer has exclusive use, and Supplier has no right to substitute it. Therefore, there is an identified asset.

3.3.780 The contract includes a list of items (coffee) agreed on by Customer and Supplier, and a specific quantity of coffee that may be stored in the warehouse. Customer is not permitted to change the types or quantity of coffee stored or use the storage warehouse for any purpose other than storing coffee during the period of use. Customer has no right to operate (or direct others to operate) the storage warehouse and did not design it.

3.3.790 In this example, the contract does not contain a lease. Although Customer has the right to obtain substantially all of the economic benefits from use of the storage warehouse (because it has exclusive use of the warehouse), it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the storage warehouse is used; instead, it is predetermined in the contract. Customer also does not have the right to operate the warehouse and did not design it.

KPMG observation – Decisions about how and for what purpose the asset is used are predetermined in the contract

3.3.800 The Board expects relatively few cases where all of the substantive decisions about how and for what purpose the asset will be used will be predetermined in the contract. During deliberations of Topic 842, some Board members observed that someone must control the use of an asset; therefore, if all of the substantive how and for what purpose decisions have been predetermined, it is reasonable to ascribe control over the use of the asset to the customer if it effectively predetermined those decisions by control over the design of the asset, or it controls the operational decisions that remain after the relevant how and for what purpose decisions have already been made. [ASU 2016-02.BC138–BC140]

3.3.810 After the Board reached this decision, some entities suggested that the supplier should be considered to control the use of the asset if its right to operate the asset more significantly affects the economic benefits to be derived from use of the asset than the customer's involvement in design. However, the final guidance is clear that the customer will be deemed to control the use of the asset if it either has the right to operate the asset *or* designed those aspects of the asset that predetermine how and for what purpose it will be used throughout the period of use (see 3.3.720). We believe that it was the Board's intent to, in effect, create a bias toward the customer in close-call situations to mitigate structuring opportunities. [842-10-15-20]

3.3.820 We believe that all facts and circumstances should be considered in determining who controls the use of an identified asset when the substantive decision-making rights about how and for what purpose the asset will be used are predetermined. For example, a contract may stipulate that the supplier operates the asset but the customer has the right to remove the supplier *without cause* at any time during the contract term and to hire someone else to operate the asset. In this situation, we believe that the customer controls the use of the asset.

3.3.830 This is supported by several examples included as illustrations in Subtopic 842-10. For example, in Example 6, Case A, the supplier operates the asset and the example adds that the customer is prohibited from hiring another operator or operating the asset itself – i.e. the customer does not have kick-out rights and accordingly the supplier controls the use of the asset. We believe that the Board was intending to highlight that if the customer *did* have the right to replace the supplier as the operator of the asset or had the right to operate the asset itself, the contract would be a lease because how and for what purpose the asset will be used is predetermined in the contract. [842-10-55-79 – 55-84]

3.3.840 While it appears that the Board attempted to mitigate structuring opportunities (e.g. by creating an apparent bias toward the customer in close-call situations), the guidance about when rights are predetermined may still provide some structuring opportunities because an entity might be able to avoid meeting the definition of a lease by carefully specifying what is predetermined versus what is not, and who makes what decisions. The following are examples.

- When the operation of the asset will be outsourced, the decision of which party will operate could be predetermined in the contract.
- In many situations, the customer may not unilaterally design the asset (e.g. an investor might have real expertise in renewable energy and play an active role in the design). In other cases, the design may involve no significant decisions because construction of the asset is straightforward such that the customer does not need to participate in the design of the asset.
- In other contracts, there may be, or the parties may be able to create, joint decision-making rights that neither party to the contract controls.

Comparison with current US GAAP – New control concept differs from current US GAAP

3.3.850 The concept of control over the use of the identified asset in Topic 842 is based on both a power element (the right to control the use of the identified asset) and a benefits element (the right to obtain substantially all of the economic benefits from use of that asset). While a lease could exist under current US GAAP solely on the basis of the customer having the right to obtain substantially all of the output or other utility from an identified asset, the customer will need to have decision-making rights over the use of the asset for there to be a lease under Topic 842. The Board concluded that without the right to control the use of the identified asset, the customer has no more control over the asset than any customer purchasing goods or services from the supplier. [840-10-15-6]

3.3.860 Under current US GAAP, the right to control the use of an asset is conveyed if:

1. the purchaser has the ability to operate the asset in a manner it determines while obtaining or controlling more than a minor amount of the asset's output;
2. the purchaser has the ability or right to control physical access to the asset while obtaining or controlling more than a minor amount of the asset's output; or
3. it is remote that one or more parties other than the purchaser will take more than a minor amount of the output and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output. [840-10-15-6]

3.3.870 Under either criterion (2) or (3), control over the use of a specified asset does not require that the customer have the right to *direct the use of* the asset. The control concept in Topic 842 also differs from criterion (1) because the right to operate the asset is not considered relevant unless the substantive decisions about how and for what purpose the asset will be used are predetermined in the contract. In addition, not only must the customer be able to direct the use of the asset, but the customer must *also* have the right to obtain substantially all (rather than only more than a minor amount) of the economic benefits from use of the asset throughout the period of use.

3.3.880 This change to the concept of control will mean that some contracts that were previously considered to be leases will no longer meet the definition. This is most likely to be the case for arrangements where the customer receives substantially all of the output or utility of an identified asset, regardless of the price the customer pays for the output, as illustrated in Example 3.11. However, in general, we believe that most arrangements that meet the definition of a lease under current US GAAP will continue to meet the definition of a lease in Topic 842.

Example 3.11

Outsourcing arrangement that is a lease under current US GAAP but not a lease under Topic 842

3.3.890 Customer enters into a 10-year agreement for Supplier to supply parts to Customer's manufacturing plant. Customer builds its facility adjacent to Supplier's manufacturing plant. Customer will make an equity investment in the entity formed by Supplier to own the facility but does not participate in the design of the facility.

3.3.900 The following additional facts are relevant.

- Customer and Supplier agree that the parts facility will produce constant-velocity (CV) joints for Customer.
- The initial capacity of the facility will be used to produce only CV joints and Customer will purchase all of the CV joints produced by the facility.
- The price paid by Customer will be determined based on Supplier's actual operating costs plus a profit margin.
- Supplier has the right to expand the facility in the future if it wishes to produce other parts (but does not expect to do so) and has the right to make all operating decisions for the facility.

Current US GAAP

3.3.910 Under current US GAAP, the arrangement contains a lease because Customer is expected to obtain substantially all of the facility's output during the term of the arrangement for a price that is not fixed per unit of output or equal to the market price per unit of output at the time it is delivered.

Topic 842

3.3.920 Under Topic 842, the arrangement does not contain a lease. Customer does not have the right to direct the use of the facility throughout the 10-year period of use because it cannot direct how and for what purpose the facility is used.

3.3.930 Even though Supplier built the facility for the express purpose of supplying parts to Customer, Customer has no right to change how the facility is used or to change what, how much, or when it produces. Because how and for what purpose the facility will be used is predetermined by the terms of the contract, Supplier and Customer also consider whether the arrangement meets either of the criteria for directing the use of the asset when the 'how and for what purpose' decisions are predetermined (see 3.3.720):

- Customer does not have the right to operate the facility or direct Supplier to operate it in a manner that Customer determines.
- Customer also did not design the facility (or specific aspects of the facility) in a way that predetermines how and for what purpose the facility will be used throughout the period of use.

3.3.940 Consequently, Customer is not leasing the facility.

3.3.950 Customer will need to separately evaluate whether to consolidate the entity that owns the facility and, if it is required to consolidate the entity, the inventory acquisition accounting will be eliminated in Customer's consolidated financial statements.

3.3.960 There are a number of alternative fact patterns related to this example that would have resulted in a conclusion that Customer has the right to direct the use of the facility, and therefore that the arrangement contains a lease. The following are examples:

- If Customer had the right to change the parts produced by the facility throughout the period of use (e.g. to require that the facility produce axles rather than, or in addition to, CV joints), then Customer would have the right to direct the use of the facility. This is because it would be able to direct how and for what purpose the facility is used by virtue of being able to change what the facility produces.
- If Customer had the right to determine when and how many CV joints the facility produces throughout the period of use (i.e. Customer controls how much output the facility produces, even if it cannot change the nature of the output produced), then Customer would have the right to direct the use of the facility. This is because it would be able to direct how and for what purpose the facility is used by virtue of being able to effectively control whether, when, and how much economic benefit is derived from use of the facility.
- If Customer had designed the facility, or those specific aspects of the facility that predetermined how and for what purpose it would be used throughout the period of use, Customer would be deemed to have the right to direct the use of the facility.

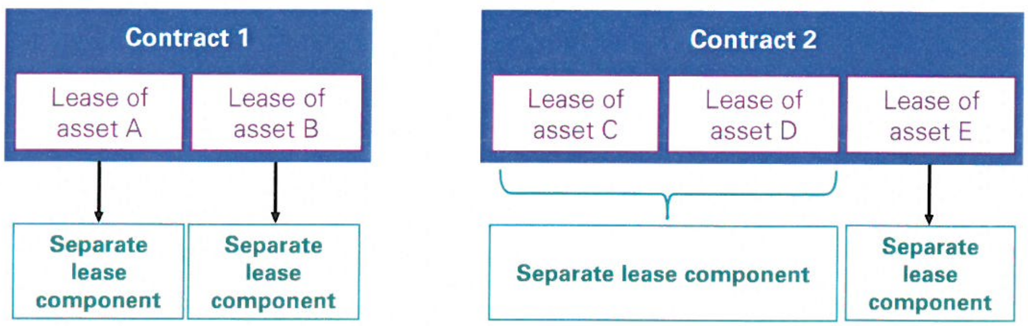
4 Separating components of a contract

How the standard works

- If a contract is, or contains, a lease, the entity follows these steps in accounting for the components of the contract:
  - » **Step 1:** Identify the separate lease components. In many cases there will be a single lease component, but in some cases there will be multiple lease components.
  - » **Step 2:** Identify any non-lease components – e.g. a maintenance or operating service.
  - » **Step 3:** Measure the 'consideration in the contract'. This calculation is different for the lessee versus the lessor.
  - » **Step 4:** Separate and allocate the consideration in the contract between the lease and non-lease components. This process differs slightly for the lessee and the lessor, but in both cases requires the entity to maximize the use of observable data.

4.1 Step 1: Identify the separate lease components

4.1.10 Lessees often contract with lessors for the right to use multiple underlying assets – i.e. the contract contains multiple leases. However, the unit of account in applying Topic 842 is not each lease in the contract – it is each 'separate lease component'. A contract with multiple leases may contain many or only one separate lease component. The diagram illustrates this principle. [842-10-15-28, 15-30]



4.1.20 On the basis that the requirements of Topic 842 for lessees and lessors apply to each separate lease component, an entity:

- assesses lease classification for the separate lease component – i.e. not for each of the leases that comprise that component (see sections 6.2 and 7.2); and
- applies the recognition and measurement requirements of Topic 842 to each separate lease component (see chapters 6 and 7).

4.1.30 The guidance about what constitutes a separate lease component is the same for lessees and lessors.

Separating lease components

4.1.40 A right to use an underlying asset (i.e. a lease), or a bundle of such rights is a separate lease component if both of the following criteria are met:

- the lessee can benefit from the lease (or bundle of leases) either on its own or together with other resources that are readily available to the lessee; and
- the lease (or bundle of leases) is neither highly dependent on, nor highly interrelated with, the other leases in the contract. [842-10-15-28]

4.1.50 In interpreting the first criterion, 'readily available' resources are goods or services that are sold or leased separately by the lessor or other suppliers (e.g. office furniture), or that the lessee has already obtained from the lessor or from other transactions or events. [842-10-15-28(a)]

4.1.60 In interpreting the second criterion, a lease is highly dependent on or highly interrelated with another lease if *each* lease significantly affects the other. This is illustrated in Examples 4.1 and 4.2. [842-10-15-28(b)]

KPMG observation – Separate lease components similar to separate performance obligations in Topic 606

4.1.70 The Board intended the separate lease components guidance in Topic 842 to align with the separation model for identifying performance obligations in Topic 606. In the Board's view, identifying separate lease components in a lease contract is similar to identifying separate performance obligations in a revenue contract. Although the separation guidance in Topic 842 is not as extensive as the separation guidance in Topic 606, the Board expects the guidance to be applied similarly. [ASU 2016-02.BC146]

4.1.80 This means that an entity applying the separate lease components guidance is, fundamentally, deciding whether the lessee has contracted for multiple leases (e.g. to use multiple pieces of similar office equipment) or is, instead, leasing a combined item (e.g. a production facility or a data center comprising multiple underlying assets). This evaluation focuses primarily on the level of integration, interrelation, and/or interdependence between the rights of use that are conveyed under the contract – i.e. whether those multiple rights to use underlying assets significantly affect each other. [ASU 2016-02.BC146]

Additional considerations for land

4.1.90 For leases that include a land element (e.g. a lease of land and a building, or land and integral equipment), the right to use the land is considered a separate lease component unless the accounting effect of separately accounting for the land element would be 'insignificant'. [842-10-15-29]

4.1.100 Topic 842 provides the following examples of circumstances in which the accounting effect of accounting for the land element separately would be insignificant:

- separating the land element would have no effect on lease classification; for example, it would not affect whether the land or the related building (or integral equipment) is classified as a finance or an operating lease; or
- the amount that would be recognized for the land lease component is insignificant. [842-10-15-29]

KPMG observation – Judgment required in determining when to separate a land lease element

4.1.110 The examples in 4.1.100 are not exhaustive, and Topic 842 does not define 'insignificant'. Consequently, determining whether the effect of accounting for a land lease element as a separate lease component would be insignificant may require significant judgment in some cases. [ASU 2016-02.BC147]

Example 4.1

Leases of multiple underlying assets – Separation criteria met

4.1.120 Lessor LR leases a bulldozer, a truck, and an excavator to Lessee LE to be used in LE's land development operations.

4.1.130 The equipment that LR leases is leased and sold separately by other suppliers and LR regularly leases each of these types of equipment separately. For example, LR regularly leases customers a bulldozer without also leasing that same customer a truck or an excavator.

4.1.140 Despite the fact that LE is leasing all three machines for one purpose (i.e. to engage in land development), LR and LE each conclude that the lease of each underlying machine is a separate lease component for accounting purposes (i.e. there are three separate lease components).

4.1.150 This conclusion is based on the following:

- LE can benefit from each lease on its own, or together with other readily available resources; for example, LE could readily lease or purchase an alternative truck or excavator to use with the bulldozer; and
- The leases are not highly dependent on, or highly interrelated with, each other. The ability of LR to fulfill each lease obligation (i.e. to make each underlying asset available for LE's use) is not affected by the other leases in the contract; LR could fulfill its lease obligation for any one of the three pieces of equipment even if the customer did not enter into a lease for either of the other two pieces of equipment. In addition, LE's ability to derive benefit from each lease is not significantly affected by its decision to lease or not lease the other equipment from LR.

Example 4.2

Leases of multiple underlying assets – Separation criteria not met

4.1.160 Lessor LR leases a production facility to Lessee LE for LE to produce its widgets for five years.

4.1.170 The production facility includes the building, the land on which the building sits, and several pieces of manufacturing equipment that are installed within the building. The building was designed to house manufacturing equipment, and it would be difficult and costly to remove the manufacturing equipment from the facility. The remaining economic lives of the building and the equipment are substantially longer than the lease term.

Identify the separate lease component(s)

4.1.180 LE could lease or purchase each of the underlying assets independently; for example, it could acquire a piece of equipment to put into the production line or could relocate the equipment to a substantially equivalent vacant building. Therefore, LE can benefit from each lease on its own or together with other readily available resources.

4.1.190 However, the leases in this contract are highly interdependent and highly interrelated. The nature of this arrangement is the lease of an in-place production facility with which LE can produce its widgets. The land, the building, and the installed equipment are, in effect, inputs to the combined item that LE contracted to lease.

4.1.200 The multiple leases significantly affect each other because, absent significant time and expenditure, LR would not be able to fulfill its obligation to lease the land, the building, or any of the pieces of installed equipment without also conveying a right to use those other assets. For example, to grant a lease of the land only, LR would have to uninstall and relocate the manufacturing equipment and demolish the building.

4.1.210 Consequently, there is only a single lease component.

Additional consideration of the land element

4.1.220 The above conclusion notwithstanding, because the contract contains a lease of land, LR and LE also need to consider the guidance specific to leases that include a land element.

4.1.230 Applying that guidance in 4.1.90–100, LR and LE each conclude that the accounting effect of separately accounting for the land lease would be insignificant, and therefore they do not account for the land as a separate lease component. This is because, given the five-year lease term (which is the same for all of the elements), and the lease payments LR and LE expect that each lease (land, building, equipment), if evaluated independently, would be an operating lease. Therefore, separating the land element from the single lease component would not affect the lease accounting.

US GAAP different from IFRS – Differences in the second criterion for identifying separate lease components

4.1.240 In identifying separate lease components, both Topic 842 and IFRS 16 include a requirement for the lease (or bundle) to be neither highly dependent on, nor highly interrelated with, the other leases in the contract (see 4.1.40). However, this requirement is explained differently in the two standards.

- Under Topic 842, a lease (or bundle of leases) is highly dependent on or highly interrelated with another lease (or bundle) if each lease significantly affects the other. [842-10-15-28(b)]
- IFRS 16 provides the example of a lessee being able to decide not to lease the underlying asset without significantly affecting its rights to use other underlying assets in the contract; under IFRS 16, this might indicate that the underlying asset is not highly dependent on, or highly interrelated with, those other underlying assets. [IFRS 16.B32(b)]

4.1.250 The FASB and the IASB reached converged technical decisions about identifying separate lease components at a joint Board meeting. However, this difference arises from the Boards' different decisions about how to revise the separation guidance applicable to identifying performance obligations in Topic 606 and IFRS 15, from which the separate lease components guidance was derived, as a result of feedback from the FASB-IASB Joint Transition Resource Group on Revenue Recognition (the TRG).

4.1.260 After the issuance of IFRS 16, the IASB decided to amend the separation guidance applicable to identifying performance obligations guidance in IFRS 15 so that it is converged with the same guidance in Topic 606. However, presently it is our understanding that IFRS 16 will not be revised as a result of the amendments to IFRS 15.

4.1.270 Despite the apparent decision of the IASB not to amend the separate lease components guidance in IFRS 16, we expect the separate lease components guidance in Topic 842 and IFRS 16 to be applied similarly given both Boards' assertions that the separate lease components guidance is derived from converged separation guidance in Topic 606 and IFRS 15.

Comparison with current US GAAP

Separating land lease components

4.1.280 Current US GAAP requires separate accounting for the land and building elements of a lease when the fair value of the land is 25 percent or more of the total fair value of the property at lease inception. [840-10-25-38(b)(2)]

4.1.290 The method by which lease payments are allocated between the land and building represents a change from current US GAAP, which requires lease payments equal to the product of the fair value of the land multiplied by the lessee's incremental borrowing rate to be allocated to the land element and the remaining portion of the lease payments (i.e. the residual portion) to be allocated to the building element. [840-10-25-38(b)(2)]

4.1.300 This difference could change the pattern of expense or income for leases of land and buildings in some cases. However, this potential outcome is mitigated by the relatively high proportion of situations in which the lease classification tests (see sections 6.2 (lessees) and 7.2 (lessors)) likely will result in operating lease classification for both the land and the building lease elements if they were accounted for separately.

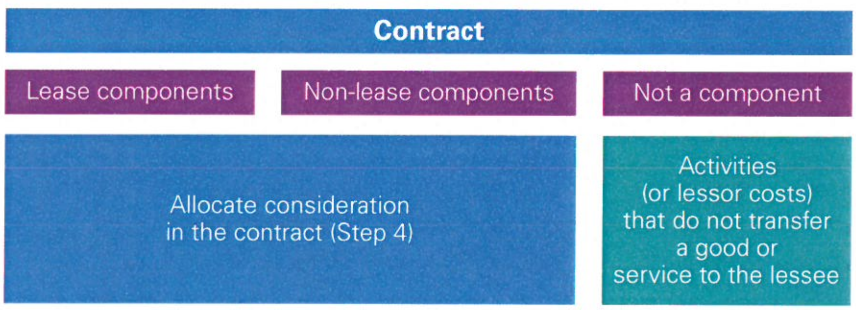
Separating other lease components

4.1.310 Current US GAAP requires the equipment element(s) of a lease of both real estate and equipment to be accounted for separately from the real estate element(s). However, lessees and lessors generally account for leases of multiple underlying assets of the same nature (i.e. buildings or equipment) in the aggregate if the separate leased assets are functionally interdependent (e.g. a mainframe computer system, associated terminals, servers, and other peripheral and output devices may be considered functionally interdependent). Conversely, under current US GAAP, lessees and lessors generally account for leases of multiple underlying assets of the same nature separately if the separate leased assets are functionally independent (e.g. a manufacturing facility and an office building typically would be considered functionally independent).

4.2 Step 2: Identify any non-lease components

4.2.10 A contract might contain non-lease components in addition to lease components – e.g. an arrangement to lease a machine with the lessor responsible for machine maintenance, or to lease office space with the lessor responsible for common area maintenance. In these examples, the maintenance is a non-lease component of the contract. The consideration in the contract is allocated between the lease and non-lease components in Step 4 (see section 4.4). [842-10-15-31]

4.2.20 Not every element of a contract that contains a lease is necessarily a 'component'. While it may be intuitive to assume that any activity or payment that is not a lease component or an explicit 'lease payment' must be a non-lease component, this is not how Topic 842 works. Instead, some elements of a contract may not be components at all because they do not transfer a good or service to the lessee. [842-10-15-30]



4.2.30 Examples of activities (or costs of the lessor) that do not transfer a good or service to the lessee include a lessee's reimbursement or payment of the lessor's property taxes and insurance. Such payments are discussed in section 4.6, which highlights the application of Step 4 (allocation) when certain elements of the contract are not components. [842-10-15-30]

KPMG observation – Lease versus non-lease components evaluation separate from determination of whether a contract is or contains a lease

4.2.40 The guidance in Topic 842 on separating lease from non-lease components of a contract applies only once an entity has determined that a contract is or contains one or more leases (see chapter 3). No aspect of the separation or allocation guidance for lease and non-lease components affects the conclusion already reached that the contract is or contains one or more leases. For example, a determination that the contract involves a very significant service component, on which effective use of the underlying asset depends, does not change the conclusion that there is a lease. [842-10-15-30]

KPMG observation – Components in Topic 842 equivalent to promised goods or services in Topic 606

4.2.50 The guidance on activities or costs that do not transfer a good or service to the lessee (e.g. payments of the lessor's property tax and insurance) is intended to be consistent with the guidance in Topic 606 relating to set-up or other activities that do not transfer a good or service to the customer. In both cases, no consideration is allocated to such activities; consideration is only allocated to promised goods or services. [ASU 2016-02.BC159]

4.2.60 The Board concluded that defining components as only those items that transfer a good or service to the lessee provides a clearer way in which to identify the components of a contract that is likely to be operable for both lessees and lessors. It also prevents entities from structuring how payments are written into a contract to avoid their classification as lease payments, and therefore their inclusion in the lessee's lease liability. [ASU 2016-02.BC160]

KPMG observation – Common area maintenance

4.2.70 Real estate leases that require the lessee to pay the lessor's property taxes and insurance often also require the lessee to pay common area maintenance fees. In contrast to payments for the lessor's property taxes or insurance, common area maintenance generally transfers a good or service to the lessee other than the right to use the underlying asset, and therefore it is a non-lease component of the contract. As a result, a portion of the consideration in the contact is allocated to common area maintenance (non-lease component). [842-10-55-144 – 55-145]

KPMG observation – Residual value guarantees are not a component of a contract

4.2.80 Under current US GAAP, a lessee residual value guarantee is outside the scope of Topic 460 (guarantees) if the lessee accounts for the lease as a capital lease. Subsequent to the adoption of ASU 2016-02, *any* lessee residual value guarantee is outside the scope of Topic 460 – i.e. regardless of the classification of the lease (or whether the lease is an unrecognized short-term lease). Residual value guarantees are discussed further in section 5.4.6

4.3 Step 3: Measure the consideration in the contract

Lessee

4.3.10 The starting point for a lessee measuring the consideration in the contract is the defined payments in paragraph 842-10-30-5 relating to the use of the underlying asset (see section 5.4), which are then adjusted as follows: [842-10-15-35]

Payments relating to use of the underlying asset

+

Other fixed or in-substance fixed payments

+

Other variable payments that depend on an index or rate[1]

−

Incentives paid or payable to the lessee[2]

=

Consideration in the contract (lessee)

Notes:

1. The payments are calculated using the commencement date index or rate (see section 5.4.1).
2. Other than those included in paragraph 842-10-35-5.

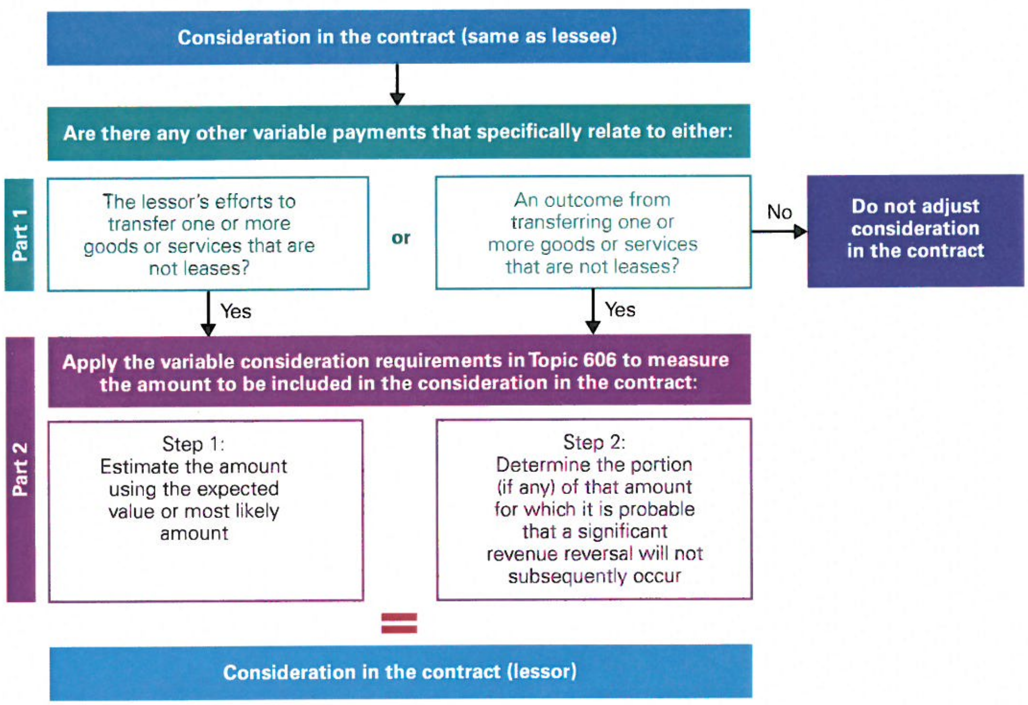
4.3.20 As the above calculation illustrates, not all payments contemplated in the contract are included. For example, a fixed monthly service charge is included, but a variable monthly service charge that does not depend on an index or rate is not included. The following concepts that apply to determining the lease payments also apply to determining whether other payments should be included in the consideration:

- Determining whether a payment is in-substance fixed – see section 5.4.2.
- Determining whether a payment is based on an index or a rate, and calculating the amount to include in the calculation – see section 5.4.1.
- The approach to, and logic for, adjusting for incentives – see section 5.4.3.

4.3.30 Once the amount of consideration has been measured, it is allocated to the lease and non-lease components of the contract in Step 4 (see section 4.4). The accounting for amounts payable under the contract that are not included in the consideration in the contract is discussed in section 4.4.3. [842-10-15-30]

$ Lessor

4.3.40 As a starting point, a lessor measures the consideration in the contract in the same way as a lessee. However, further adjustments are made as follows. [842-10-15-38 – 15-39, 606-10-32-8 – 32-14]



4.3.50 In considering whether any variable payments should be included in the consideration in the contract, the objective in Part 1 of the above diagram is to establish whether such payments vary solely on the performance of the non-lease component(s); for example, do the payments depend solely on the lessor's performance of non-lease services or the quality of consumables to be used with the leased asset? This is explored in Example 4.3. [842-10-55-153 – 55-156]

4.3.60 Once the consideration in the contract has been measured, it is allocated to the lease and non-lease components of the contract in Step 4 (see section 4.4). The accounting for amounts payable under the contract that are not included in consideration is discussed in section 4.4.3. [842-10-15-30]

Example 4.3
Measuring the consideration in the contract – Variable payments

Scenario 1: Variable payments not based solely on non-lease component

4.3.70 Lessee LE and Lessor LR enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the lease term.
LE will pay LR:

- a fixed payment of $110,000 per year; and
- a variable payment of $7,700 each year that the equipment is operational for a minimum number of hours at a specified level of productivity (i.e. the equipment is not malfunctioning or inoperable).

Lessee

4.3.80 LE does not include the variable payments in the consideration in the contract. This is because the variable payments do not depend on an index or rate (and are not in-substance fixed).

4.3.90 Therefore, the consideration in the contract is $330,000 ($110,000 x 3).

Lessor

4.3.100 LR starts with the amount of consideration determined in the same way as LE (i.e. $330,000).

4.3.110 Next, LR considers the link between the variable payments of $23,100 ($7,700 x 3) and the performance of the maintenance services. LR concludes that the variable payments are not solely related to performance of the maintenance services. The quality and condition of the leased equipment also substantively affects whether LR will earn the variable amounts.

4.3.120 Therefore, the variable payments are excluded, and the consideration in the contract is $330,000.

4.3.130 This scenario is continued in Example 4.6, Scenario 1, which illustrates how LR allocates the consideration in the contract (step 4 – see 4.4.20).

Scenario 2: Variable payments specifically relate to non-lease component – No amounts constrained

4.3.140 Changing the facts of Scenario 1, the maintenance services are highly specialized and no entity would expect the leased equipment to meet the specified performance metrics without the related maintenance services.

Lessee

4.3.150 This change in fact pattern makes no difference for LE. The consideration in the contract remains at $330,000.

$ Lessor

4.3.160 LR starts with the amount of consideration determined in the same way as LE (i.e. $330,000).

4.3.170 Next, LR considers the link between the variable payments of $23,100 and the performance of the maintenance services. LR concludes that the variable payments relate specifically to an outcome dependent on LR's satisfactory performance of its maintenance services. This is because the maintenance services are highly specialized and critical to the operation of the equipment.

4.3.180 Next, LR applies the variable consideration requirements in Topic 606 to calculate the amount that should be included in the consideration in the contract:

1. LR estimates that the amount to which it expects to be entitled is $23,100.
2. LR concludes that it is probable that including that amount in the transaction price for the maintenance services will not result in a significant revenue reversal when the uncertainty is resolved.

4.3.190 Therefore, the consideration in the contract is $353,100 ($330,000 + $23,100).

4.3.200 This scenario is continued in Example 4.6, Scenario 2, which illustrates how LR allocates the consideration in the contract (step 4 – see 4.4.20).

Scenario 3: Variable payments specifically relate to non-lease component – Amounts partially constrained

4.3.210 Changing the facts of Scenario 2, LE will pay LR:

- a fixed payment of $102,700 per year; and
- a variable payment of $15,000 each year that the equipment is operational for a minimum number of hours at a specified level of productivity (i.e. the equipment is not malfunctioning or inoperable).

Lessee

4.3.220 LE does not include the variable payments in the consideration in the contract. This is because the payments do not depend on an index or rate.

4.3.230 Therefore, the consideration in the contract is $308,100 ($102,700 x 3).

$ Lessor

4.3.240 LR starts with the amount of consideration determined in the same way as LE (i.e. $308,100).

4.3.250 Next, LR considers the link between the variable payments of $45,000 ($15,000 x 3) and the performance of the maintenance services. As in Scenario 2, LR concludes that the variable payments relate specifically to an outcome dependent on LR's satisfactory performance of its maintenance services.

4.3.260 Next, LR applies the variable consideration requirements in Topic 606 to calculate the amount that should be included in the consideration in the contract.

1. LR estimates that the amount to which it expects to be entitled is $45,000.
2. LR concludes that only $30,000 of that amount is probable of not resulting in a significant revenue reversal when the uncertainty is resolved.

4.3.270 Therefore, the consideration in the contract is $338,100 ($308,100 + $30,000).

4.3.280 This scenario is continued in Example 4.6, Scenario 3, which illustrates how LR allocates the consideration in the contract (step 4 – see 4.4.20).

KPMG observation – Timing of measurement

4.3.290 The 'consideration in the contract' for both lessees and lessors *starts* with the payments relating to use of the underlying asset. Those payments are measured at the lease commencement date (see chapter 5). Topic 842 does not provide guidance about how an entity would measure the consideration in the contract if the lessor provides a non-lease component – i.e. other goods or services – before commencement of the lease. For example, assume a lessor agrees to lease a lessee a new piece of IT equipment, the term of which commences in two months when the requested piece of equipment can be delivered and made available to the lessee. The lease includes a lessee renewal option, a lessee purchase option, and the lessee provides the lessor with a residual value guarantee. In addition to the lease, the lessor also agrees to immediately begin maintaining the lessee's existing IT equipment that will remain in service together with the new leased equipment. The lessee should begin recognizing expense, and the lessor income, for the maintenance services being provided; however, it is unclear what amount they should be recognizing because the payments relating to use of the underlying asset are measured at lease commencement. The assessment of whether the lessee is reasonably certain to exercise the renewal or the purchase option or is probable of owing an amount under the residual value guarantee is based on facts and circumstances at lease commencement. [842-10-15-35, 30-5]

4.3.300 This timing issue could also arise for a contract that includes only lease components, but for which the commencement date of those leases differs. Consider an example whereby a lessee leases two pieces of equipment and each lease is a separate lease component. The lessee and the lessor are required to allocate the consideration in the contract to those two separate lease components, and will begin recognizing lease cost or lease income upon commencement of the first lease. However, consistent with the lease and non-lease component example in 4.3.290, they cannot measure the total consideration in the contract before commencement of the second lease.

4.3.310 In the absence of guidance in Topic 842 to resolve this issue, we believe that an entity would be required to make a preliminary estimate of the consideration in the contract. For example, the entity would need to, at the point in time at which it must begin to recognize expense or income in the examples above, measure the consideration in the contract. This would include doing all of the following at that point in time:

- measuring any variable lease payments that depend on an index or rate based on the index or rate at that point in time;
- assessing the likelihood of lessee option exercises (renewal, termination, and/or purchase options) based on the current facts and circumstances; and
- assessing amounts probable of being owed under a residual value guarantee based on the current facts and circumstances.

4.3.320 However, because Topic 842 requires measurement as of the commencement date, we believe that an entity would be required to true up this initial accounting at the commencement date (or the final commencement date in the multiple separate lease components example).

KPMG observation – Differences between Topic 842 and Topic 606 for lessors

4.3.330 The accounting for variable payments by lessors under Topic 842 is different from how variable consideration is accounted for under Topic 606 by vendors/suppliers.

4.3.340 Therefore, the Board decided that guidance was necessary for lessors to navigate the differences. The guidance is intended to help clarify whether and, if so, when the consideration in the contract for a lessor includes variable consideration (subject to the constraint in Topic 606) – Step 2 in the diagram in 4.3.40. [ASU 2016-02.BC161–BC163]

4.3.350 Paragraph 606-10-15-4 states that if other Topics (e.g. Topic 842) provide separation and measurement guidance, then an entity applies that guidance first. The entity then excludes amounts allocated to items covered by the other Topics from the Topic 606 transaction price that applies to the performance obligations within the scope of Topic 606. In the context of Topic 842, this means that a lessor separates lease from non-lease components (as required by Topic 842), measures the consideration in the contract in accordance with Topic 842, and allocates consideration to the lease and non-lease components in accordance with Topic 842. As a result, the consideration in the contract allocated to a non-lease (e.g. service) component in the scope of Topic 606 may differ from the transaction price that would be determined for that component if it were not associated with a lease. Consequently, applying the separation and measurement guidance in Topic 842 to a non-lease component in the scope of Topic 606 may result in an entity accounting for the same good or service obligation to a customer differently depending solely on whether it is (or is not) provided in conjunction with a lease. [ASU 2016-02.BC163, 842-10-55-150 – 55-156, 606-10-15-4]

4.3.360 Example 4.6 (Scenarios 1 and 2) illustrates the effect of this; namely, that lessors will recognize income attributable to variable amounts that are partially, but not solely, attributable to a non-lease component in the same manner as variable lease payments – i.e. as income when earned – even though the entity's revenue recognition might differ for that service component if it were being provided separately or in conjunction with a sold (rather than leased) piece of equipment.

US GAAP different from IFRS 16 – Consideration in the contract

Definition

4.3.370 While Topic 842 defines consideration in the contract for lessees and lessors and provides examples of the application of that definition (Example 14 in Subtopic 842-10), IFRS 16 does not define consideration in the contract. Therefore, it is possible that entities applying IFRS will interpret what constitutes the consideration in the contract to be allocated to the separate lease and non-lease components of a contract differently from how it is defined in Topic 842. [IFRS 16.12–17, B32–B33]

Lessee allocation of consideration in the contract

4.3.380 While Topic 842 specifically notes that in some limited circumstances, the use of a residual approach for estimating the stand-alone price of a separate lease or non-lease component may be appropriate for lessees, IFRS 16 is silent. However, given the Boards' discussion of this topic and the publicly available FASB/IASB staff paper on allocating the consideration in the contract to lease and non-lease components, we do not believe that there is an intended difference between Topic 842 and IFRS 16 in this regard.

Comparison with current US GAAP – Lessor accounting for variable payments affected by definition of consideration in the contract

4.3.390 Under current US GAAP, contingent payments are recognized as lease or related non-lease income only when such amounts are earned. While, in general, most variable payments in a lease contract will continue to be recognized only when earned, the requirement for lessors to include variable payments in the consideration in the contract in some cases could affect the pattern of income recognition for lessors.

4.3.400 For example, if a lessor applying Topic 842 includes a performance bonus that it expects to earn from providing a service to the lessee in the consideration in the contract, it generally would recognize that amount as income over the period the service is provided. In contrast, under current US GAAP, that same lessor generally would not recognize the performance bonus until it is earned. [840-10-25-4, 840-20-25-2, 840-30-25-3]

4.4 Step 4: Separate and allocate consideration between the lease and non-lease components

4.4.1 Allocate the consideration in the contract – In proportion to stand-alone prices

4.4.10 Non-lease components are separated from related lease components unless a lessee elects the practical expedient (see 4.4.30–40). Lease components are accounted for under Topic 842; non-lease components are accounted for under other applicable US GAAP (e.g. Topic 606 for lessors). [842-10-15-31]

4.4.20 The consideration in the contract is allocated between the lease and non-lease components of a contract using different methodologies for the lessee and lessor. [842-10-15-33, 15-38]

	Lessee	Lessor
When there is an observable stand-alone price for each component:	Unless the practical expedient is elected (see 4.4.30–40), separate and allocate based on the relative stand-alone price of components.	Always separate and allocate following the Topic 606 transaction price allocation guidance – i.e. generally on a relative stand-alone selling price basis.
When there is not an observable stand-alone price for some or all components:	Estimate the stand-alone price, maximizing the use of observable information.	

Remember:

Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components of the contract (see sections 4.2 and 4.6). Therefore, no consideration is allocated to such items.

Practical expedient for lessees only

4.4.30 As a practical expedient, a lessee may elect not to separate the non-lease components of a contract from the lease component to which they relate. This means that the components will be treated as a single lease component. For example, in a lease of a machine with the lessor responsible for machine maintenance, the lessee may account for a single lease component – i.e. the payments that would otherwise be attributed to the maintenance will be accounted for as lease payments and included in the measurement of the lessee's right-of-use asset and lease liability. [842-10-15-37]

4.4.40 A lessee elects this practical expedient by class of underlying asset – e.g. office equipment, automobiles, office space.

KPMG observation – Practical expedient for lessees not limited to insignificant non-lease components

4.4.50 The availability of the practical expedient for lessees not to separate non-lease components from the lease components to which they relate is not limited to situations in which the non-lease component is insignificant in comparison to the related lease component. [ASU 2016-02.BC150]

4.4.60 Providing lessees with the practical expedient by class of underlying asset could reduce comparability between entities. However, the Board concluded that lessees will typically elect the practical expedient only for leases with insignificant non-lease components. That is, a lessee will generally not elect the practical expedient if it will significantly increase the amount of lease liabilities that it has to recognize.

4.4.70 Combining a non-lease component with a lease component will generally result in straight-line recognition of the cost for the non-lease component. This pattern of expense recognition might differ in some cases from the pattern of expense recognition that would apply if the non-lease component were accounted for separately from the lease.

Lessee allocation of the consideration in the contract

4.4.80 The consideration in the contract is allocated to the separate lease and non-lease components on a relative stand-alone price basis. The stand-alone price of a component is the price at which a customer would purchase that component separately. Lessees are required to use observable stand-alone prices when they are available and to estimate stand-alone prices if observable prices are not available. [842-10-15-33, 842 Glossary]

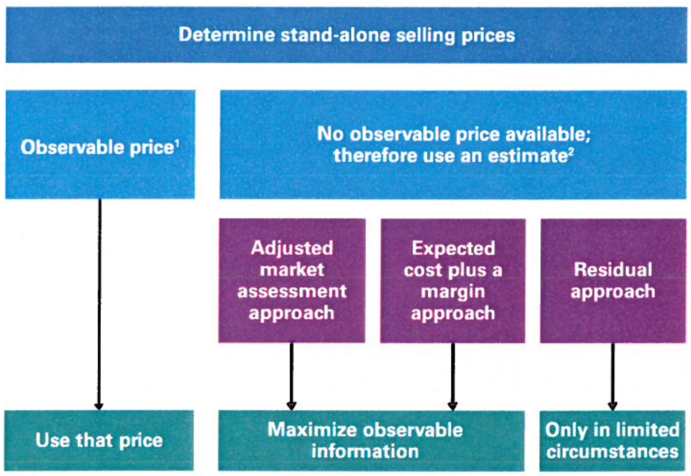
4.4.90 'Initial direct costs' are allocated to the separate lease components on the same basis as the lease payments. The definition of and accounting for initial direct costs is discussed in section 5.5.

4.4.100 An observable stand-alone price is the price charged by the lessor or similar suppliers for a similar lease or non-lease component – i.e. a lease of a substantially similar asset or non-lease component under similar terms and conditions; for example, with respect to duration and payment terms – on a stand-alone basis. When estimating stand-alone prices, lessees are required to maximize the use of observable information. In some circumstances, the use of a residual approach for estimating the stand-alone price of a separate lease or non-lease component may be appropriate (see Example 4.5). For example, a residual estimation approach may be appropriate if the stand-alone price for a component is highly variable or uncertain. [842-10-15-33 – 15-34]

Lessor allocation of the consideration in the contract

4.4.110 In following the guidance in Topic 606, a lessor allocates the consideration in the contract to each separate lease and non-lease component to depict the amount of consideration to which the lessor expects to be entitled (the 'allocation principle' in Topic 606). [842-10-15-38, 606-10-32-28]

4.4.120 The lessor will generally allocate the consideration in the contract to each separate lease component and each non-lease component on a relative basis in proportion to its stand-alone selling price, which is determined as follows. [606-10-32-29 – 32-35]



Notes:

1. An observable price is the price at which the lessor sells *that* component separately in similar circumstances and to similar customers.
2. A lessor considers all information that is reasonably available when estimating a stand-alone selling price – e.g. market conditions, entity-specific factors, and information about the lessee. A lessor also maximizes the use of observable inputs and applies consistent methods to estimate the stand-alone selling price of components with similar characteristics.

4.4.130 In some circumstances, the transaction price allocation guidance in Topic 606 requires the lessor to allocate a bundled discount or variable consideration on an other-than-relative basis to the components of the contract – i.e. a bundled discount or variable consideration may be allocated entirely to only one or some, but not all, of the components. [606-10-32-36 – 32-41]

4.4.140 Topic 606 does not preclude or prescribe any particular method for estimating the stand-alone selling price of a good or service when observable prices are not available, but describes the following estimation methods as suitable approaches. [606-10-32-34]

Approach	Description
Adjusted market assessment approach	Evaluate the market in which goods or services are sold and estimate the price that customers in the market would be willing to pay.
Expected cost plus a margin approach	Forecast the expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
Residual approach (limited circumstances – consistent with Topic 606)	Subtract the sum of the observable stand-alone selling prices of other goods or services promised in the contract from the total transaction price.

Example 4.4

Allocating the consideration in the contract – Observable inputs

4.4.150 Lessor LR leases a bulldozer to Lessee LE to be used in LE's mining operations. LR also provides maintenance services for the bulldozer for the entire lease term. Total consideration for the use of the bulldozer and the maintenance services over the term of the contract is $125,000. There is no variable consideration.

4.4.160 LR and LE each consider stand-alone prices.

- LR regularly leases bulldozers separately for comparable lease terms under similar terms and conditions. Therefore, both LE and LR have access to observable stand-alone prices for the lease component ($100,000).
- Although LR does not provide maintenance services separately from its equipment leases, there are many other service providers that do under similar terms and conditions (e.g. for similar periods and with similar payment terms). Both LR and LE arrive at a stand-alone price of $40,000, but their approaches differ.
  - » LE is able to obtain an observable stand-alone price for the maintenance services. The prices of service providers other than LR for similar services constitutes an observable stand-alone price for LE.
  - » The price charged by other service providers does not constitute an observable stand-alone selling price for LR; instead, LR utilizes the rates charged by other service providers to estimate a stand-alone selling price for the maintenance services (i.e. using a market assessment approach).

4.4.170 In this example, the allocation of consideration is the same for both LR and LE.[1]

Component	Stand-alone price	Allocation	Calculation
Bulldozer lease	$100,000	$ 89,286	(100,000/140,000) x 125,000
Maintenance	40,000	35,714	(40,000/140,000) x 125,000
	$140,000	**$125,000**	

Note 1:

LE does not apply the practical expedient to its mining equipment leases (see 4.4.30–40).

Example 4.5

Allocating the consideration in the contract – Observable and estimated stand-alone prices

4.4.180 Lessor LR leases a specialized machine for two years to Lessee LE, and provides consulting services to help LE effectively use the machine in its production processes. The machine is not sold or leased separately by LR and there are no similar machines for sale or lease from other suppliers.

4.4.190 The contract consideration is $100,000 for the first year and $80,000 for the second year. LR priced the contract in this way assuming that it will provide more consulting services in the first year.

Lessee

4.4.200 Because LR does not sell or lease the specialized machine, or provide substantially equivalent consulting services separately, LE allocates the consideration in the contract based on observable and estimated relative stand-alone selling prices.

4.4.210 LE determines the stand-alone prices for the lease and the consulting services as follows.

- There are no similar machines for sale or lease from suppliers other than LR, and therefore LE cannot obtain an observable stand-alone price or use a market-based assessment estimation approach. In addition, LE also does not have the information needed to apply an expected cost-plus-margin approach. Consequently, LE concludes that a residual approach is reasonable and appropriate in the circumstances.
- LE obtains an observable stand-alone price for the consulting services based on similar services offered in the marketplace ($40,000).

4.4.220 On this basis, LE allocates the consideration as follows.

Component	Stand-alone price	Allocation	Calculation[1]
Machine lease	$140,000	$140,000	Residual (180,000 - 40,000)
Consulting	40,000	40,000	Observable price
	$180,000	**$180,000**	

Note 1:

This calculation relates to determining the stand-alone prices, which are then allocated to the components of the contracts.

$ Lessor

4.4.230 Because LR does not sell or lease the specialized machine, or provide substantially equivalent consulting services separately, LR allocates the consideration in the contract based on *estimated* relative stand-alone selling prices.

4.4.240 LR estimates stand-alone selling prices as follows.

- The specialized nature of the machine precludes the use of a market assessment approach – i.e. there are no similar machines for lease by other suppliers to assess. Consequently, LR uses another estimation technique to arrive at a stand-alone selling price of $160,000 for the machine lease.
- LR uses a market-based assessment approach to arrive at a stand-alone selling price of $40,000 for the consulting services based on similar services offered in the consulting marketplace.

4.4.250 On this basis, LR allocates the consideration as follows.

Component	Stand-alone price	Allocation	Calculation
Machine lease	$160,000	$144,000	(160,000/200,000) x 180,000
Consulting	40,000	36,000	(40,000/200,000) x 180,000
	$200,000	**$180,000**	

KPMG observation – Lessees and lessors apply different separation and allocation guidance

Practical expedient to not separate lease and non-lease components

4.4.260 While lessors are always required to separate lease from non-lease components, lessees may elect, by class of underlying asset, a practical expedient not to separate non-lease components from the lease component to which they relate. [842-10-15-37]

Lessees always allocate on relative basis; lessors do not

4.4.270 Lessees will always allocate the consideration in the contract on a relative stand-alone price basis. In contrast, because lessors will apply the transaction price allocation guidance in Topic 606, they will allocate a discount or variable consideration that is accounted for as consideration in the contract to only one or some of the separate lease or non-lease components of the contract in some cases. [842-10-15-33, 15-38]

Different perspectives on observable stand-alone prices

4.4.280 For the **lessee**, observable stand-alone prices include those charged not only by the lessor but also by other suppliers for the same or a similar component – e.g. the price charged for the lease of a similar piece of equipment or for similar services. [842-10-15-34]

4.4.290 For the **lessor**, the definition of observable stand-alone selling price is more restrictive, both in terms of using similar goods or services and considering suppliers other than the lessor. Taken from Topic 606, an observable stand-alone selling price is the price for which the *entity* sells *that* good or service separately in similar circumstances and to similar customers. [606-10-32-32]

4.4.300 However, applying a market assessment approach under Topic 606 might include referring to prices from the lessor's competitors for similar goods or services (and adjusting those prices as necessary to reflect the lessor's costs and margins) as an acceptable technique for estimating the stand-alone selling price. Therefore, while the lessor might use similar information to the lessee to determine the stand-alone price of a component, that stand-alone price will be considered 'observable' for the lessee, but 'estimated' for the lessor. [606-10-32-34]

Burden of proof for observable stand-alone prices

4.4.310 Both lessees and lessors are required to maximize the use of observable information in determining the stand-alone price of components. However, we believe that the Board generally intended for lessees to be able to resort to estimation for stand-alone prices more frequently than would be permitted for lessors. This is evidenced by the fact that Topic 842 requires a lessee to estimate stand-alone prices when observable stand-alone prices are not 'readily available'. We believe that it was the Board's intent that lessees should not have to exhaustively search for observable stand-alone prices, particularly when such a requirement might put significant pressure on lessors to provide proprietary information to lessees.

Different estimation techniques

4.4.320 Lessees may rely on estimation techniques different from those used by lessors, because lessors will frequently have greater access to observable information – e.g. its incurred cost data or non-public industry information on the pricing of lease or related non-lease components. Even so, it will generally not be appropriate for a lessee to default to the residual approach when another approach would yield a more representative result. We believe that estimation techniques used should be reasonable and not developed with a bias to reducing amounts allocated to lease components. [ASU 2016-02.BC156]

Allocating consideration when there are multiple lease and multiple non-lease components

4.4.330 For **lessors**, we believe that each separate lease and non-lease component needs to be identified *before* allocating the consideration in the contract, which is the methodology followed in the examples in Topic 842. This means that each separate component – whether lease or non-lease – is a separate unit of account for the purpose of determining stand-alone prices and allocating consideration. This is relevant because a bundle of two or more components may have a different stand-alone price (e.g. a bundled discount) that would affect allocation if components were grouped. [842-10-55-132 – 55-137]

4.4.340 We believe that the Board intended for **lessees** to identify the separate lease components of the contract and then account for non-lease components that relate to *different* separate lease components as separate units of account.

4.4.350 It is not clear whether a lessee would be required to separately account for multiple non-lease components that relate to a single lease component. In such cases, it may be reasonable for a lessee to determine the stand-alone price for multiple non-lease components that relate to a single lease component as a bundle. However, because Topic 842 requires that stand-alone prices be observable (when readily available) and maximize the use of observable data when estimated, that might limit lessees' choices in this regard. For example, the requirement to maximize the use of observable prices or data would generally mean that it is not appropriate to estimate the stand-alone selling price of a bundle that is not regularly sold separately if there are readily available observable prices for the non-lease components individually.

Comparison with current US GAAP – Separating lease from non-lease components

4.4.360 Topic 842 and current US GAAP are consistent with respect to accounting for non-lease components (or elements) separately from lease components. For example, current US GAAP, like Topic 842, requires services or goods, such as consumables, provided by the lessor to be accounted for separately from the lease elements of a contract. However, unlike Topic 842, current US GAAP does not permit a lessee to *not* separate non-lease components from the lease component to which they relate. [840-10-15-19]

4.4.370 The guidance in Topic 842 with respect to separating lease from non-lease components of a contract is significantly more consequential to a lessee's accounting than the similar guidance in current US GAAP. This is because while operating lease elements and service elements are accounted for similarly under current US GAAP, lease components are subject to substantially different accounting requirements (i.e. the recognition of lease assets and lease liabilities) under Topic 842 than non-lease components. [840-10-15-19]

Determining the stand-alone price of components and allocating consideration

4.4.380 The requirements of Topic 842 differ from those in current US GAAP in the following key respects.

- Under Topic 842, executory costs that do not transfer a good or service to the customer (e.g. payment of the lessor's property taxes or insurance) are allocated to both the lease and the non-lease components of the contract on the same basis as the other *consideration in the contract* and are not, therefore, excluded from the *lease payments*. Under current US GAAP, all executory costs are excluded from the *minimum lease payments* for a lease.
- While the relative fair value allocation method under current US GAAP is substantially the same as the relative stand-alone price allocation method applicable to lessees under Topic 842, additional rigor is prescribed for determining the stand-alone price of the components of the contract. For example, in no case does Topic 842 permit an entity to default to amounts specified in the contract when determining the stand-alone price for a component. An entity determines the stand-alone price of a lease or a non-lease component based on its observable stand-alone price (if readily available), and estimated stand-alone prices if observable prices are not readily available. Use of contractually stated amounts for lease or non-lease payments as the stand-alone price for components generally will be rare as such amounts should not be presumed to represent the stand-alone price for a component. [840-10-15-19, 15-30]

4.4.2 Allocate variable consideration in the contract – Lessor

4.4.390 If variable payment amounts are included in the consideration in the contract (see section 4.3) for a lessor, they are allocated entirely to the non-lease component(s) to which they relate if that would be consistent with the transaction price allocation objective in Topic 606. [842-10-15-39]

Transaction price allocation objective

The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer. [606-10-32-28]

4.4.400 If the lessor does not allocate those variable payments entirely to the non-lease component(s) to which they relate, it allocates them on the same basis as the remainder of the consideration in the contract. [606-10-32-39]

Example 4.6

Allocating the consideration in the contract – Variable payments

4.4.410 This example is a continuation of Example 4.3, which measured the consideration in the contract in three scenarios. This example takes the consideration that was calculated for the *lessor*, and allocates it to components following the guidance in Topic 606. In all three scenarios, the stand-alone prices are assumed to be $315,000 (equipment) and $40,000 (maintenance).

Scenario 1: Variable payments not based solely on non-lease component

4.4.420 Lessee LE and Lessor LR enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the lease term. LE will pay LR.

- a fixed payment of $110,000 per year; and
- a variable payment of $7,700 each year that the equipment is operating a minimum number of hours at a specified level of productivity (i.e. the equipment is not malfunctioning or inoperable).

4.4.430 In Example 4.3, Scenario 1, the consideration in the contract was measured at $330,000, which excluded any variable payments. LR allocates the consideration in proportion to stand-alone prices as follows.

Component	Stand-alone price	Allocation	Calculation
Equipment lease	$315,000	$292,817	(315,000/355,000) x 330,000
Maintenance	40,000	37,183	(40,000/355,000) x 330,000
	$355,000	**$330,000**	

Scenario 2: Variable payments that specifically relate to a non-lease component – Allocation to lease and non-lease components

4.4.440 Changing the facts of Scenario 1, the maintenance services are highly specialized and no entity would expect the equipment to meet the specified performance metrics without the related maintenance services.

4.4.450 In Example 4.3, Scenario 2, the consideration in the contract was measured at $353,100, which included $23,100 of variable payments related to the maintenance (non-lease) component.

4.4.460 Next, following the allocation objective in Topic 606 (see 4.4.390), LR considers whether allocating the entire variable amount of $23,100 to the maintenance component would depict the amount of consideration to which LR expects to be entitled in exchange for providing the lease and maintenance services to LE. If it does, total consideration would be allocated in one of the two following ways.

Approach 1:

Component	Stand-alone price	Allocation	Calculation
Equipment lease	$315,000	$292,817	(315,000/355,000) x 330,000
Maintenance	40,000	60,283	(40,000/355,000) x 330,000 + 23,100
	$355,000	**$353,100**	

Approach 2:

Component	Stand-alone price	Allocation	Calculation
Equipment lease	$315,000	$330,000	All of the fixed consideration
Maintenance	40,000	23,100	Only the variable consideration
	$355,000	**$353,100**	

4.4.470 However, in this Scenario LR concludes that allocating $60,283 (or $23,100) to the maintenance services would not depict the consideration to which LR expects to be entitled for each component. This is because these two amounts are significantly higher (lower) than the amount to which LR expects to be entitled for the maintenance services. Therefore, LR allocates the total consideration in proportion to the components' stand-alone prices as follows.

Component	Stand-alone price	Allocation	Calculation
Equipment lease	$315,000	$313,314	(315,000/355,000) x 353,100
Maintenance	40,000	39,786	(40,000/355,000) x 353,100
	$355,000	**$353,100**	

Scenario 3: Variable payments that specifically relate to a non-lease component – Allocation only to non-lease component

4.4.480 Changing the facts of Scenario 2, LE will pay LR:

- a fixed payment of $102,700 per year; and
- a variable payment of $15,000 each year that the equipment is operating a minimum number of hours at a specified level of productivity.

4.4.490 In Example 4.3, Scenario 3, the consideration in the contract was measured at $338,100, which included $30,000 of variable payments related to the maintenance (non-lease) component.

4.4.500 Next, LR concludes that allocating the entire variable amount of $45,000 to the maintenance component (full value of the estimated variable payments, without consideration of the constraint on variable consideration) and the entire fixed amount of $308,100 to the lease would reasonably depict the amount of consideration to which LR expects to be entitled in exchange for providing the lease and maintenance services to LE. The $308,100 and the $45,000 approximate the stand-alone prices of the lease ($315,000) and the maintenance services ($40,000), respectively.

4.4.510 Because the variable payments are allocated entirely to the maintenance services, if the consideration in the contract changes because LR concludes it is now probable that it will earn the full $45,000 in variable payments, that change is allocated entirely to the maintenance services component.

Comparison with current US GAAP – Allocation differences

4.4.520 The transaction price allocation guidance in Topic 606 that must be applied by lessors will not always result in an allocation of the consideration in the contract consistent with the relative fair value allocation method in current US GAAP. In some cases, the lessor allocation guidance in Topic 842 will allocate a discount or variable consideration entirely to only one or some of the components of the contract, rather than on a relative basis. [840-10-15-19, 606-10-32-37, 32-40]

4.4.3 Variable payments not included in the consideration in the contract

4.4.530 Following from the discussion of Step 3 (see section 4.3), the following types of payments are *not* included in the consideration in the contract.

Lessee:

- Variable payments specifically or partially related to the lease component(s) that do not depend on an index or rate. [842-10-15-35]
- Variable payments specifically related to the non-lease component(s) that do not depend on an index or rate. [840-10-15-35]

Lessor:

- Variable payments specifically or partially related to the lease component(s) that do not depend on an index or rate. [840-10-15-40]

4.4.540 Variable payments not included in the consideration in the contract are recognized in profit or loss when incurred (lessee) or earned (lessor) and are generally allocated to the lease and/or non-lease components consistent with the allocation decisions made in Step 4. Recognition of variable lease payments not included in the consideration in the contract is addressed in section 6.4 (lessees) and sections 7.3–7.4 (lessors). [842-10-15-35, 15-40, 842-20-25-5 – 25-6, 55-1 – 55.2, 842-30-25-2, 25-9, 25-11]

Example 4.7
Variable lease payments not included in the consideration in the contract

4.4.550 Lessee LE leases a specifically identified space in a building and a printing press from Lessor LR for three years.

4.4.560 The following additional facts are relevant.

- LE and LR each conclude that the building space and the printing press are separate lease components.
- The contractual lease payments for the building space are fixed at $300,000 per year, which is considered to be a market rate.
- The contractual lease payments for the printing press are based entirely on the level of usage, at $50 for each hour operated, which is considered to be a market rate.

  LE and LR each predict that the printing press will be operated for 2,000 hours per year over the three-year lease term, resulting in total expected variable payments of $300,000 over the three-year lease term.
- There are no non-lease components of the contract and the variable payments are not based on an index or rate. Therefore, the consideration in the contract is $900,000 ($300,000 x 3) for LE and LR, and all of the fixed payments are 'lease payments' (see section 5.4).

Lessee

4.4.570 LE allocates the lease payments of $900,000 ($300,000 x 3) to the two lease components as follows.

Component	Stand-alone price	Allocation	Calculation
Building space	$ 900,000	$675,000	(900,000/1,200,000) x 900,000
Press	300,000	225,000	(300,000/1,200,000) x 900,000
	$1,200,000	**$900,000**	

4.4.580 LE recognizes the variable lease cost as incurred, and each variable amount that will be paid is allocated between the building space lease and the printing press lease in the same proportion as the lease payments were originally allocated – 75% to the building space lease and 25% to the printing press lease. This means that if the total variable lease payments ultimately owed by LE are $300,000, they will have been allocated as follows over the term of the lease.

Component	Stand-alone price	Allocation	Calculation
Building space	$ 900,000	$225,000	(900,000/1,200,000) x 300,000
Press	300,000	75,000	(300,000/1,200,000) x 300,000
	$1,200,000	**$300,000**	

Lessor

4.4.590 LR allocates the $900,000 in fixed lease payments entirely to the building space lease and the $300,000 in expected variable lease payments entirely to the printing press lease.

4.4.600 LR concludes this is appropriate because:

- the variable amounts relate specifically to LE's use of the printing press; and
- this allocation of the fixed and variable lease payments to the building space lease and the printing press lease reasonably depicts the amounts to which LR expects to be entitled for each lease component – i.e. this allocation meets the transaction price allocation objective in Topic 606 (see 4.4.390).

4.4.610 The lease payments used by LR in its evaluation of the lease classification and in accounting for the printing press lease (see chapter 7) are nil because only variable lease payments are allocated to that lease component.

4.4.620 LR recognizes the variable payments when earned, and each amount is allocated entirely to the printing press lease.

4.5 Subsequent changes to the consideration in the contract

Lessee

4.5.10 Lessees remeasure and reallocate the consideration in the contract when:

- there is a remeasurement of the lease liability – e.g. a change in the *lease payments* resulting from a change in the lease term or a change in the amount probable of being owed under a residual value guarantee; or
- there is a contract modification that is not accounted for as a separate contract. [842-10-15-36]

4.5.20 The accounting for changes in consideration in the contract from the lessee's perspective is discussed in sections 6.6 and 6.7.

$ Lessor

4.5.30 Lessors remeasure and reallocate the consideration in the contract only when a contract modification occurs that is not accounted for as a separate contract. [842-10-15-41]

4.5.40 Changes in the consideration in the contract not resulting from a modification are accounted for in accordance with the changes in the transaction price guidance in Topic 606. An example is changes in the lessor's estimate of variable payments to which it will be entitled specifically for a non-lease component or changes in the estimated amount that are unconstrained. [842-10-15-42, 606-10-32-42 – 32-45]

4.5.50 In many cases, changes in the consideration in the contract will be allocated to the separate lease and non-lease components of the contract on the same basis as was done initially. However, in some cases, changes may be allocated to only one (or some) of the components of the contract. Example 4.6, Scenario 3 describes how the lessor will account for a change in the consideration in the contract – i.e. a change resulting from estimated amounts becoming unconstrained.

KPMG observation – Variable payments and the 'consideration in the contract'

4.5.60 Other than when a variable payment specifically relates to a non-lease component (or to an outcome resulting from transferring or providing a non-lease component) for a lessor (see 4.3.40), variable payments are never part of the 'consideration in the contract' – even when they are subsequently earned. Therefore, as variable payments become owed (by a lessee) or earned (by a lessor) – see 4.4.540 – they do not change the consideration in the contract. In contrast, if a variable payment specifically relates to a non-lease component, changes to that variable payment (e.g. changes to the estimated amount to which the lessor expects to be entitled or changes to the amount of that estimate that is constrained) *is* a change to the consideration in the contract.

4.5.70 This distinction between what is and is not part of the consideration in the contract matters for lessors because there is specific guidance in Topic 606 applicable to changes in the 'transaction price' that lessors are required to consider when there are changes to the consideration in the contract. That specific guidance does not apply to variable payments that are not part of the consideration in the contract. [842-10-15-42]

KPMG observation – Allocating subsequent changes to the consideration in the contract after a modification or remeasurement

4.5.80 While not explicitly stated, we believe that the Board intended that if the consideration in the contract has been reallocated as a result of a contract modification or remeasurement of the lease liability, changes to the consideration in the contract subsequent to the reallocation should be allocated on the same basis as the most recent reallocation.

4.6 Property taxes and insurance – Gross versus net leases

4.6.10 As discussed in 4.2.20–30, a lessee's reimbursement or payment of the lessor's property taxes and insurance is an example of activities (or costs of the lessor) that do *not* transfer a good or service to the lessee. Therefore, although *fixed* payments attributable to such activities or costs are part of the consideration in the contract, in Step 4 they are allocated only to the separate lease and non-lease components. [842-10-15-30]

4.6.20 This section builds on the concepts in Step 3 (section 4.3) and Step 4 (section 4.4) to explore the different outcomes of a gross lease versus a net lease.

- In a gross lease, payments of lessor costs such as property taxes and insurance are fixed as part of the rental payment specified in the contract.
- In a net lease, the lessee makes variable payments, either to the lessor or to a third party, for items like property taxes and insurance.

Example 4.8
Property taxes and insurance in gross versus net leases

4.6.30 Two companies enter into similar leases of retail space, but with the underlying contracts structured differently.

Scenario 1: Gross lease

4.6.40 Lessee LE1 leases space in a shopping center from Lessor LR1 for 24 months.

4.6.50 LE1 pays CP $20,000 per month with no separate obligation with respect to LR1's property taxes or property insurance (i.e. the lease is a gross lease).

4.6.60 The contract has a single component, which is the lease of the retail space. The consideration in the contract (see section 4.3) is $480,000 ($20,000 x 24). As outlined in Step 4 (see section 4.4), that amount is allocated entirely to the single component of the contract.

Scenario 2: Net lease

4.6.70 Lessee LE2 leases space of a similar size and condition in a different shopping center from Lessor LR2.

4.6.80 LE2 pays LR2 $18,000 per month, and must reimburse LR2 for LE2's portion of LR2's actual property tax assessments and building insurance costs during the lease term (i.e. the lease is a net lease). Costs of the insurance and property taxes are expected to approximate $2,000 per month.

4.6.90 Although the contract includes an explicit requirement for LE2 to pay LR2's property taxes and insurance, these are not components of the contract. Therefore, as in Scenario 1, the contract has a single lease component (i.e. the lease of the retail space).

4.6.100 There are two types of payments in the contract:

- The fixed payments of $18,000 per month are included in the consideration in the contract.
- The variable payments (approximately $2,000 per month) are not included in the consideration in the contract. Because there are no non-lease components of the contract, the additional considerations applicable to lessors for variable payments are not applicable (see 4.3.40). The payments as they are incurred are variable lease payments.

4.6.110 Like Scenario 1, the contract has a single component, which is the lease of the retail space. The consideration in the contract (see section 4.3) is $432,000 ($18,000 x 24). As outlined in Step 4 (section 4.4), that amount is allocated entirely to the single component of the contract.

Comparing Scenarios 1 and 2

4.6.120 This example illustrates the following points.

- Property taxes and insurance obligations of the lessor are not lease or non-lease components of a contract.
- Variable payments not dependent on an index or rate are excluded from the consideration in the contract.
- Consideration in the contract is allocated only to the lease and non-lease components of a contract.

KPMG observation – Different accounting for gross versus net leases

4.6.130 Example 4.8 demonstrates the different accounting that will result for gross leases (i.e. payments of lessor costs are fixed as part the rental payment) as compared with net leases (i.e. those for which lessees make variable payments to the lessor or a third party). Lessees will generally recognize smaller lease assets and lease liabilities for a net lease than for a gross lease, because lessees will not include estimates of variable payments in those amounts. [842-10-55-141 – 55-143]

4.6.140 Variable payments for property taxes and insurance will not be excluded from lease accounting in a net lease scenario. Depending on whether the contract also includes non-lease components, either all (or a portion) of the variable payments for the property taxes or insurance will be accounted for as 'variable lease payments' (see sections 6.3 and 7.3–7.4). Lessees and lessors will need to track such amounts for disclosure purposes – i.e. disclosures of variable lease cost and variable lease income, respectively (see sections 12.2–12.3). [842-20-50-4(d), 842-30-50-5(c)]

4.6.150 We believe that the Board recognized that economically similar contracts will be accounted for differently on the balance sheet as a result of its decision on variable payments. However, that different accounting result will not be unique to gross lease versus net lease scenarios. Similarly, a retail lessee required to make fixed payments of $10,000 per month will recognize a significantly different lease asset and lease liability than a substantially similar retail lessee that is required to make a fixed payment of $5,000 per month plus a variable payment of 2% of store sales for the previous month.

Comparison with current US GAAP – Accounting for property taxes and insurance

4.6.160 Topic 842 differs from current US GAAP in two important respects:

- Current US GAAP explicitly excludes executory costs such as insurance, maintenance, and taxes from the definition of minimum lease payments. In contrast, under Topic 842, all or a portion of fixed payments for such costs will be allocated to the lease component(s) of the contract and consequently classified as lease payments. As a result, the lease payments determined in accordance with Topic 842 will exceed what the minimum lease payments would have been under current US GAAP in gross leases.
- Second, while current US GAAP excludes executory costs from minimum lease payments, those amounts are not allocated between the lease and non-lease elements of the contract. That is, those costs are generally considered entirely related to the lease for purposes of classification and presentation. However, under Topic 842, fixed *and variable* payments for items like property taxes and insurance that are not components of the contract are allocated to the lease *and* non-lease components on the same basis as all of the other consideration in the contract. [840-10-15-19, 25-5]

4.7 Combining two or more contracts

4.7.10 Two or more contracts (at least one of which is or contains a lease) entered into at or near the same time with the same counterparty (or related party) are combined as a single transaction if:

- 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; or
- the leases in the contracts (or some of the leases) are a single lease component. [842-10-25-19]

Example 4.9
Combination of contracts

4.7.20 Lessee LE leases a specifically identified space in a building and a printing press from Lessor LR for three years. The following additional facts are relevant.

- LR leases the building space and printing press to LE in two separate contracts, executed within a few calendar days of each other.
- The contractual lease payments for the building space are fixed at $250,000 per year, compared to an estimated market rate of $300,000 per year
- There are no non-lease components of the building contract and the variable payments are not based on an index or a rate. Therefore, the consideration in the contract is $750,000 ($250,000 x 3) for LE and LR, and all of the fixed payments are lease payments (see section 5.4).
- The contractual lease payments for the printing press are entirely based on the level of use ($75 for each hour operated), compared to an estimated market rate of $50 for each hour operated.
- LE and PS each predict that the printing press will be operated for 2,000 hours per year over the three-year lease term, giving total expected variable payments of $450,000 over the three-year lease term.
- Total expected fixed and variable consideration is $1,200,000 over the three-year lease term. However, the stated $250,000 per year for the building space lease is a below market rate, and the $75 per hour variable payment for the use of the printing press is considered to be an above market rate. LR agrees to a lower fixed payment to incentivize LE, with the expectation of making up the difference with the above market variable payments.

4.7.30 In this example, the contracts should be combined and considered a single contract for the purpose of applying Topic 842. This is because the two contracts are executed near the same time, and together they fulfill a single commercial objective. As noted, LR agrees to a lower fixed payment in the first contract to incentivize LE, with the expectation of making up the difference with the above market variable payments in the second contract.

KPMG observation – Aligning contract combinations guidance in Topic 842 and Topic 606

4.7.40 Consistent with the Board's rationale for a number of other decisions in developing Topic 842, the Board concluded that, particularly for lessors, there would be a significant benefit to substantially aligning the guidance on combining contracts in Topic 842 to that in Topic 606. Since many contracts contain components that will be in the scope of both Topics, coming to generally consistent conclusions as to when two or more contracts should be combined will reduce complexity for lessors. [ASU 2016-02.BC165–BC167]

4.7.50 While the contract combinations guidance will be familiar to most entities because of its similarity to the contract combinations guidance in Topic 606, there will be some judgment involved in determining when two contracts must be combined. This judgment includes, but is not limited to, determining:

- what 'at or near the same time' means – some entities have interpreted that to mean within 90 days or within the same fiscal quarter or reporting period when applying that notion to other situations;
- when two or more contracts have the same commercial objective; and
- when consideration to be paid in one contract is dependent on the consideration to be paid in another.

4.7.60 These judgments are not unique to the contract combinations guidance in Topic 842 and Topic 606. Similar judgments are required in the current US GAAP revenue recognition guidance (e.g. within Subtopic 605-25 on multiple-element revenue arrangements, and Subtopic 985-605 on software revenue recognition) such that judgments made historically may continue to be reasonable in applying the new guidance.

KPMG observation – Allocation of consideration in a combined contract

4.7.70 A combined contract (i.e. one comprising two or more separately prepared contracts) may have multiple lease (and potentially non-lease) components. In this scenario, it is likely that the allocation of the consideration in the combined contract will be different from the stated consideration in the original, separately prepared contracts.

5 Concepts and definitions applicable to lessees and lessors

How the standard works

There are a number of key concepts and definitions that apply to both lessees and lessors that are integral to the guidance in Topic 842. The following are discussed in this chapter, as an introduction to the accounting in chapters 6 (lessees) and 7 (lessors).

Key concept or definition	Application within Topic 842
Commencement date	The date of initial recognition and measurement of a lease for lessees and lessors. In addition, lease classification is determined at lease commencement.
Reasonably certain	Determining whether a lessee is reasonably certain to exercise an option to either extend (or renew) a lease or purchase the underlying asset (or is reasonably certain *not* to exercise an option to terminate a lease) is integral to determining the 'lease term' and the 'lease payments'.
Lease term	The lease term is integral to determining: – lease payments; – lease classification; – the measurement of lease assets and lease liabilities; and – whether the lease is a 'short-term' lease (for lessees).
Lease payments	The lease payments are integral to determining: – lease classification; and – the measurement of lease assets and lease liabilities.

Key concept or definition	Application within Topic 842
Initial direct costs	Initial direct costs affect: – the discount rate for the lease, if the rate implicit in the lease is used; and – the measurement of lease assets and lease liabilities.
Discount rate for the lease	The discount rate for the lease affects: – lease classification; and – the measurement of lease assets and lease liabilities.
Economic life	The total and remaining economic life of the underlying asset affects lease classification.
Portfolio approach	Topic 842 may be applied on a portfolio basis to similar leases if the entity reasonably expects that the outcome will not differ from applying the standard to the individual leases.

This chapter addresses those concepts and definitions that are key to applying both the lessee and lessor accounting models. There are additional definitions and concepts that apply solely to lessees or solely to lessors that are discussed in chapter 6 (lessee accounting) and chapter 7 (lessor accounting), as well as definitions and concepts that are key to identifying a lease (see chapter 3) and identifying lease/non-lease components (see chapter 4) that are discussed in the respective chapters.

In addition to the concepts and definitions that are discussed in this chapter, Topic 842 uses a number of additional definitions that are defined elsewhere in US GAAP such that they are not specific to the leases guidance (e.g. useful life, probable, and remote). Those additional definitions are not discussed in this chapter.

5.1 Commencement date

5.1.10 The commencement date of a lease is the date on which the lessor makes the underlying asset available for use by the lessee. [842 Glossary]

5.1.20 A lessee may take possession of or be given control over the use of an underlying asset – i.e. the underlying asset may be made available for use by the lessee – before:

- the lessee begins operations (e.g. the lessee begins selling from a leased retail space);
- lease payments are required to be made under the contract; or
- a stated commencement date in the contract. [842-10-55-19]

5.1.30 A master lease agreement may cover a number of underlying assets, each of which is made available for use by the lessee on a different date. Although a master lease agreement may specify that the lessee must take a minimum number of units or dollar value of equipment, there will be multiple commencement dates unless all of the underlying assets subject to that minimum are made available for use by the lessee on the same date. [842-10-55-22]

Example 5.1
Lease commencement date

5.1.40 Lessee LE signs a lease with Lessor LR for retail space in a shopping mall on June 1, 20X1 – i.e. lease inception is June 1, 20X1.

5.1.50 On August 1, 20X1, LR provides LE with access to the location so that LE can begin constructing leasehold improvements in anticipation of opening the store on September 1, 20X1. On September 1, 20X1, LE opens the store for business and pays LR the first month's lease payment.

5.1.60 In this example, the lease commencement date is August 1, 20X1. This is the date on which LR makes the underlying asset (i.e. retail space) available for use by LE. That LE will commence operations and begin making lease payments only on September 1, 20X1 does not affect determination of the commencement date.

KPMG observation – Properly identifying the commencement date is key

5.1.70 An improperly-determined commencement date could result in one or more of the following. [ASU 2016-02.BC182–BC184]

- Misstated lease assets and lease liabilities – i.e. the recognition of lease assets and lease liabilities that do not yet exist or not recognizing lease assets and lease liabilities that do exist.
- Improper measurement of lease assets and lease liabilities – key inputs that are used in the initial and subsequent measurement of lease assets and lease liabilities (e.g. the lessee's incremental borrowing rate or the fair value of the underlying asset) change over time such that determining those inputs as of an incorrect date could result in the inaccurate measurement of lease assets and lease liabilities throughout the lease term.
- In the case of sales-type lessors (see section 7.3), selling profit or selling loss that is recognized in the wrong period.

Comparison with current US GAAP – Inception versus commencement date

5.1.80 Under current US GAAP, the initial measurement of a lease (e.g. determination of the discount rate for a capital lease) and the assessment of lease classification occur at inception of the lease, rather than at the commencement date. While the recognition date for leases is consistent between current US GAAP and Topic 842 (commencement date), because inputs such as the fair value of the underlying asset and the lessee's incremental borrowing rate might be different between those two dates, entities might reach different conclusions about initial measurement and lease classification for some leases using the commencement date versus the inception date. [840-10-25-1]

5.2 Reasonably certain

5.2.10 The concept of 'reasonably certain' is integral to determining the 'lease term' (see section 5.3) and the 'lease payments' (see section 5.4).

5.2.20 Leases often include options that permit the lessee to extend or renew the lease (including by *not* exercising a termination option) or to purchase the underlying asset. Such options are accounted for (i.e. included in the measurement of lease assets and lease liabilities) only when it is 'reasonably certain' that the lessee will exercise the option. It is assumed a lessee termination option will be exercised unless the lessee is reasonably certain *not* to do so. [842-10-30-1]

5.2.30 'Reasonably certain' is a high threshold of probability that must be met to include optional lessee payments in the measurement of lease assets and lease liabilities. When combined with the economic nature of the evaluation, the Board intended the parties to account for lessee options only when the lessee has a compelling *economic* reason to exercise the renewal or purchase option (or not to exercise a termination option). [ASU 2016-02.BC194, BC197, BC218]

5.2.40 An entity assesses whether a lessee is reasonably certain to exercise or not to exercise an option by considering all economic factors relevant to that assessment: contract-based, asset-based, market-based, and entity-based factors. An entity's assessment will often require the consideration of a combination of factors because they are interrelated. Therefore, an expectation of exercise alone (e.g. based on relevant history in similar arrangements or management's intent) does not result in a conclusion that the lessee is reasonably certain to exercise an option if there is not a compelling economic reason to do so. [842-10-55-26, ASU 2016-02.BC193]

5.2.50 All factors are considered together and the existence of any one factor does not necessarily indicate that a lessee is reasonably certain to exercise the option. Although not exhaustive, the following are examples of factors to consider. [842-10-55-26]

Type of factor	Examples
Contract-based	– Amount of the lease payments (including variable lease payments) in any optional period as compared to market rates – Existence and amount of any variable lease payments or other contingent payments – Existence and terms of options (renewal or purchase) – Costs associated with an obligation to return the leased asset in a specified condition or to a specified location
Asset-based	– Location of the asset – Existence of significant leasehold improvements that would be lost if the lease were terminated or not extended – Non-contractual relocation costs – Costs associated with lost production – Costs associated with sourcing an alternative item
Entity-based	– Financial consequences of a decision to extend or terminate a lease – Nature of the leased asset (specialized versus non-specialized; the extent to which the asset is crucial to the lessee's operations, etc.) – Tax consequences of terminating or not extending the lease
Market-based	– Statutory law and local regulations – Market rentals for a comparable asset

Example 5.2
Assessment of a lessee renewal option

Scenario 1: Not reasonably certain to exercise either of the renewal options

5.2.60 Lessee LE enters into a five-year warehouse lease with Lessor LR.

5.2.70 As part of the contract, LE has the option to renew the five-year lease for two additional five-year terms (i.e. for 15 years in total) at the market price at the date of exercising each renewal option. If LE does not renew the lease, it is responsible for its costs to vacate the facility, relocate to a new facility, and return the warehouse to its pre-lease condition.

5.2.80 LE has a track record of remaining in leased warehouse facilities for at least 10 years. It was in each of its previous three facilities for 15, 10, and 15 years, respectively.

5.2.90 In this scenario, both LE and LR conclude that LE is not reasonably certain to exercise either of the five-year renewal options for the warehouse facility.

5.2.100 LE's history of renewing its warehouse leases may suggest that there is an intent on the part of LE to exercise at least the first of the two five-year renewal options. However, the fact pattern does not suggest that LE is reasonably certain to do so.

5.2.110 The fact that LE will have to incur costs (e.g. relocation, restoration, etc.) if it does not renew the lease also does not make it reasonably certain that LE will renew the lease to avoid those costs. This is because LE will likely incur those costs at some point given the terms of the lease and it is also not reasonably certain that LE will not, five years into the future, offset those costs through favorable lease terms for a replacement facility or other economic factors relevant to the new lease.

Scenario 2: Significant leasehold improvements

5.2.120 Changing the facts of Scenario 1, prior to moving into the leased facility, LE constructs expensive leasehold improvements with an economic life of 15 years.

5.2.130 These leasehold improvements will have significant economic value to LE at the end of both five and 10 years that it will not be able to recover if it vacates the facility. LE will have to remove those improvements and they are not portable to another location.

5.2.140 The construction of the significant leasehold improvements and the economic factors surrounding those improvements (e.g. that a significant portion of their economic value will be lost if LE relocates before the end of 15 years) provides a compelling economic reason for LE to remain in the facility for the full 15 years permitted.

5.2.150 Therefore, in this scenario, both LE and LR conclude that it is reasonably certain that LE will exercise both of its five-year renewal options.

Scenario 3: Specialized facility

5.2.160 Again changing the facts of Scenario 1, the warehouse is a highly specialized facility. There are only a limited number of facilities of this nature, no two of which (presently or historically) are in the same geographic area. Constructing a facility of this nature is expensive and requires a significant period of time. Having access to a specialized facility of this nature and in this geographic area is vital to LE's core operations.

5.2.170 Between now and the end of the non-cancellable period of the lease (i.e. five years), it is highly unlikely that LR or another entity will construct a suitable alternative facility in the same geographic area as the warehouse being leased. The investment of time and resources that would be required, together with the fact that doing so would invite one of LE's competitors to operate in the area (i.e. by leasing the specialized warehouse from LR), creates a significant economic disincentive for LE to construct its own specialized facility. Therefore, in this scenario, both LE and LR conclude that it is reasonably certain, based on an evaluation of the relevant economic factors, that LE will exercise the first five-year renewal option.

5.2.180 However, both LE and LR conclude that it is *not* reasonably certain, at lease commencement, that LE will exercise the second five-year renewal option. While the same economic circumstances considered in determining that LE is reasonably certain to exercise the first five-year renewal option *might* exist 10 years from now, reasonably certain is a high threshold of probability. The extended period of time between lease commencement and the exercise date for that option (i.e. approximately 10 years) means that it is not *reasonably certain* that those same economic circumstances will exist.

Example 5.3

Assessment of a lessee purchase option with strike price below expected fair value

Scenario 1: Fair values volatile

5.2.190 Lessee LE enters into a five-year lease with Lessor LR to use a piece of equipment in an evolving area of the technology sector; there are no renewal or termination options. LE has the option under the contract to purchase the underlying asset at the end of the non-cancellable lease term for $500,000. The expected fair value of the asset at the end of the non-cancellable lease term is $650,000.

5.2.200 Both LE and LR conclude that it is *not* reasonably certain that LE will exercise the option. The underlying asset is in an evolving area of the technology sector, and the duration of the non-cancellable period of five years (i.e. the five-year period of time between the assessment of the option at lease commencement and the option exercise date) is significant in that context. Therefore, each party concludes that there is too much uncertainty about what the fair value of the underlying asset will be at the option exercise date to conclude at lease commencement that LE is reasonably certain to exercise the option; for example, newer, better alternative assets may be introduced during the five-year lease term.

5.2.210 In this scenario, the lease term (five years) and specific environment (technology sector) are important factors in reaching the conclusion. A shorter lease term (e.g. one or two years) or a different environment might lead to a different conclusion.

Scenario 2: Fair values historically stable

5.2.220 Changing the facts of Scenario 1, the underlying asset is conventional real estate (e.g. a building that could be used for a variety of purposes) in a market that historically has been highly predictable to within a narrow range – that is, prices have been predictable to within +/- 10 percent over a long period of time.

5.2.230 In this scenario, given the extent of the discount between the strike price ($500,000) and the reasonably predictable expected fair value of the underlying asset ($650,000), each of the parties concludes that it is reasonably certain that LE will exercise the purchase option.

5.2.240 As with Scenario 1, changes to this fact pattern could influence the conclusion reached. For example, if the strike price of the option were $600,000 instead of $500,000, it might not be reasonably certain that LE would exercise the option.

5.2.250 At that strike price, either (1) the $50,000 forecasted discount may not be significant enough to conclude that LE is reasonably certain to exercise the option, or (2) there may be uncertainty, even within the highly predictable real estate market in the example, about whether the strike price will in fact represent a discount from the actual fair value of the building at the option exercise date.

KPMG observation – 'Reasonably certain' synonymous with 'reasonably assured'

5.2.260 While Topic 842 uses the term 'reasonably certain', current US GAAP uses the term 'reasonably assured' to describe the probability threshold that must be met for including lessee options in the measurement of lease assets and lease liabilities and in considering lease classification. The Board views these terms as synonyms that should be applied in the same way. Therefore, the probability threshold for including lessee options in the measurement of lease assets and lease liabilities, and in considering lease classification, is the same as in current US GAAP. The Board selected the term 'reasonably certain', rather than retaining the term 'reasonably assured', to converge with IFRS 16 terminology in this respect. [ASU 2016-02.BC195]

KPMG observation – Consideration of specific facts and circumstances in assessing 'reasonably certain'

5.2.270 We believe that the particular facts and circumstances of a lease can significantly affect an entity's assessment of a lessee option such that an entity might reach different conclusions for two options with seemingly very similar terms (e.g. the same strike price and the same expected fair value of the underlying asset) based on different underlying facts and circumstances.

5.2.280 For example:

- The further out into the future the option exercise date, the more compelling the evidence must be, on an economic basis, that the lessee will exercise the option. This is because an entity's estimates about conditions that will exist at the option date will be less precise the further out the option date is; these estimates include, but are not limited to, the fair value of the underlying asset, the availability of suitable alternatives to the underlying asset, and the tax environment in a particular jurisdiction.
- The nature of the underlying asset may significantly affect an entity's assessment of a lessee option. Depending on the nature of the underlying asset, it may be more difficult for an entity to predict its fair value or the availability of suitable alternative resources. This is illustrated in Example 5.3.
- The location of the underlying asset could significantly affect relocation costs or the availability of alternative resources. For example, even for two identical underlying assets, considerations about relocation costs or available alternative resources could vary widely if one is deployed in a remote area and the other in a readily-accessible area.
- The jurisdiction governing the lease could significantly affect the assumptions about laws and regulations (including tax consequences) affecting the assessment of the option; for example, laws and regulations in some countries may be more stable and predictable than in other countries.

KPMG observation – Lessees and lessors may reach different conclusions

5.2.290 The nature of the assessment of 'reasonably certain' means that lessees and lessors may make different assessments about whether it is reasonably certain that a lessee will exercise a renewal or a purchase option, or not exercise a termination option.

US GAAP different from IFRS – Interpreting 'reasonably certain'

Effect of a lessee's past practices on the assessment of lessee options

5.2.300 Generally, the FASB's and the IASB's respective guidance on determining whether a lessee is reasonably certain to exercise an option is converged. The two Boards reached converged decisions in this area, including the decision to use the same words to describe the threshold of evidence necessary to include a lessee option in the measurement of lease assets and lease liabilities (reasonably certain).

5.2.310 However, IFRS 16 includes additional application guidance that states "a lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option." We believe that entities could read the Boards' respective guidance on determining whether a lessee is reasonably certain to exercise an option differently. This is because the application guidance in IFRS 16 states that "a lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option." [IFRS 16.B40]

5.2.320 In contrast, the authoritative guidance in Topic 842 makes no mention of considering past practices when assessing lessee options, and the basis for conclusions suggests that the assessment of lessee options should *not* consider management estimates or intent and that the key consideration is whether the lessee has "economically little or no choice" but to exercise (or not to exercise) the option. [ASU 2016-02.BC193, BC197]

5.2.330 However, the reference in the IFRS 16 application guidance to 'economic reasons' for the past practices may mitigate the extent of any potential differences in application because it does not appear that an entity's past practice (e.g. of renewing a particular lease or a particular type of lease) is intended to be considered in isolation from the economic reasons for those practices.

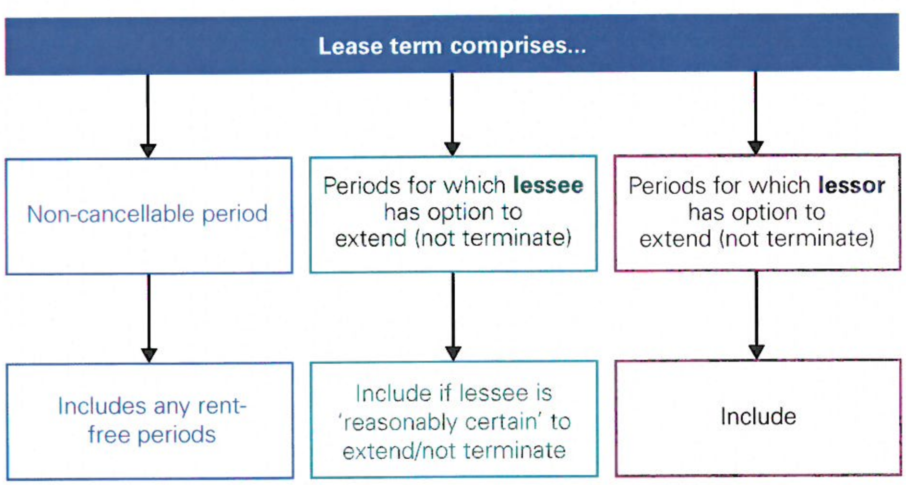
Minimum or fixed cash return

5.2.340 IFRS 16 has application guidance stating that if the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether an option is exercised, an entity assumes that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease. For example, the lessee might provide a residual value guarantee in the event that a renewal option is not exercised that would effectively prepay to the lessor, on a present value basis, the cash flows the lessor would otherwise receive from the lease payments during the renewal period. [IFRS 16.B38, BC158(b)]

5.2.350 Topic 842 does not provide explicit comparable guidance. However, we believe that this situation is no different in substance from a termination penalty because, in either case of non-renewal (i.e. residual value guarantee of the nature described above or an explicit termination penalty), the lessee is effectively making a payment to the lessor in return for *not* extending the lease. Both IFRS 16 and Topic 842 include the same guidance with respect to termination penalties (see section 5.4.5). Therefore, we believe that an entity applying Topic 842 should not come to a different conclusion about the effect of a minimum or fixed return scenario on the lease term than an entity applying IFRS 16.

5.3 Lease term

5.3.10 Beginning at the commencement date, the lease term always includes the non-cancellable period and may include one or more optional periods. [842-10-30-1, 55-25]



5.3.20 A contract is an agreement between two or more parties that creates enforceable rights and obligations. When assessing the non-cancellable period of a lease, an entity applies that definition to determine the period for which a contract exists. A lease is no longer enforceable beyond the point that both the lessee and the lessor have the unilateral right to terminate the lease, without permission from the other party and with no more than an insignificant penalty. [842 Glossary, 842-10-55-23]

5.3.30 If only a *lessee* has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers in determining the lease term. [842-10-55-24]

5.3.40 If only a *lessor* has the right to terminate a lease or controls the lessee's ability to exercise an option to terminate the lease, the lease term should assume that the lease will *not* be terminated. [842-10-55-24]

5.3.50 When *both* the lessee and the lessor have the substantive right to terminate a lease, the lease term excludes periods after which both parties' termination rights are exercisable. This is because neither party has enforceable rights *or* obligations. The lessee neither has the right to continue to use the underlying asset (after the lessor's termination rights become exercisable), nor an obligation to make lease payments (after its termination rights become exercisable). The lessor neither has a right to receive lease payments (after the lessee's termination rights become exercisable) or an obligation to extend the lessee's right to use the underlying asset (after its termination rights become exercisable). This principle is illustrated in Example 5.5. [842-10-55-23]

5.3.60 Under a fiscal funding clause, a lease is cancellable if the legislature or other funding authority does not appropriate the funds necessary for the governmental unit (as lessee) to fulfill its obligations under the lease agreement. The existence of such a clause requires an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If it is more than *remote* that the fiscal funding clause will be exercised, the lease term should include only those periods for which funding is reasonably certain. [842 Glossary, 842-10-55-27]

Example 5.4
Lease term (lessee renewal options)

5.3.70 Assume the same facts as in Scenarios 1, 2, and 3 in Example 5.2. That example, illustrates whether Lessee LE is, or is not, reasonably certain to exercise one or both renewal options provided. This example concludes on the 'lease term' for each of those scenarios based on the conclusions in Example 5.2.

5.3.80 For each of the scenarios in Example 5.2, the lease term equals the non-cancellable period of five years *plus* the periods covered by renewal options that LE is reasonably certain to exercise. That results in lease terms for each scenario as follows.

Example 5.2 Scenario	Lease term
Scenario 1	5 years
Scenario 2	15 years
Scenario 3	10 years

Example 5.5
Termination rights

5.3.90 Lessee LE and Lessor LR enter into a two-year lease of equipment. There are no renewal options in the contract.

Scenario 1: Lessee and lessor both have right to terminate

5.3.100 Both LE and LR have the unilateral right, without penalty and without cause, to terminate the lease at the end of Year 1.

5.3.110 The non-cancellable period of the lease and the lease term are both one year.

- LE does not have a right to extend the lease beyond the end of Year 1 because LR has the right to terminate the lease at the end of Year 1, and does not have an obligation to make lease payments beyond the end of Year 1 because it can terminate the lease.
- LR does not have the right to receive lease payments (i.e. by requiring LE to extend the lease) beyond the end of Year 1 because LE has the right to terminate the lease at the end of Year 1, and does not have an obligation to extend LE's right to use the underlying asset beyond the end of Year 1.

Scenario 2: Lessor has right to terminate

5.3.120 Unlike in Scenario 1, only LR has the right to terminate the lease at the end of Year 1, which it can do without penalty and without cause. The non-cancellable period of the lease is, therefore, one year.

5.3.130 However, the lease term is two years because only the lessor can elect to terminate the lease prior to the end of the two-year stated term. The lease term always includes optional periods controlled by the lessor.

Example 5.6
No stated term

5.3.140 Lessor LR agrees to lease equipment to Lessee LE. There is no stated duration for the lease in the contract; however, the contract stipulates that LE is required to return the underlying asset to LR's location when it no longer wishes to use the equipment. For each day that the asset remains in LE's possession, LE will pay a fixed fee to LR for the right to use that asset.

5.3.150 The non-cancellable period of the lease is one day, because LE could elect to return the asset to LR's location before the start of Day 2.

5.3.160 Next, LE and LR each consider whether LE is reasonably certain to continue to use the asset beyond the non-cancellable period. Unless LE is reasonably certain to continue the lease beyond the first day, the lease term is only one day.

5.3.170 We believe that the extremely short non-cancellable period of the lease (one day) will likely influence the consideration of whether LE is reasonably certain to renew the lease beyond the non-cancellable period. The costs to LE of terminating the lease (e.g. returning the underlying asset to LR's location) and entering into a new lease (e.g. identifying another asset, entering into a different contract, and training employees to use a different asset) may provide a compelling economic reason for LE to continue to use the same asset for a period that is longer than the non-cancellable period.

KPMG observation – Non-cancellable period is a question of law

5.3.180 Determining whether and for what period a contract creates enforceable rights and obligations on the parties is a question of law, and the factors that determine enforceability may differ among jurisdictions.

5.3.190 However, as a practical matter, in most cases a contract is no longer enforceable after it can be cancelled by either party, assuming that the cancellation/ termination option is substantive.

- Once the lessee has the right to cancel the lease, the lessee no longer has an enforceable obligation to make lease payments and the lessor no longer has an enforceable right to receive lease payments.
- Similarly, once the lessor has the right to cancel the lease, the lessee no longer has an enforceable right to use the underlying asset and the lessor no longer has an enforceable obligation to permit the lessee use of the underlying asset.

KPMG observation – Determining the lease term for cancellable ('evergreen') leases may be difficult

5.3.200 In defining a 'short-term lease', the Board considered that many evergreen leases (i.e. those on a day-to-day, week-to-week, or month-to-month basis) would meet that definition. However, to qualify for the short-term lease exemption (see section 6.3.1) and to determine whether the disclosure requirement for short-term lease costs is applicable (the disclosure requirement applies only to short-term leases with a term greater than one month – see section 12.2), lessees must nonetheless assess the lease term for such leases. [ASU 2016-02.BC379]

5.3.210 The lease term for evergreen leases is established in the same manner as for all other leases, which means considering whether the lessee is reasonably certain to exercise one or more available renewal options.

5.3.220 As highlighted by Example 5.6, determining whether a lessee is reasonably certain to exercise a renewal option in an evergreen lease may involve significant judgment. We believe that, in general, the shorter the non-cancellable period of a lease, the greater the likelihood that the lessee is reasonably certain to exercise one or more lease term renewal options. This is because, in many cases, it may be cost prohibitive to continually substitute leased assets. For example, if a lessee is leasing a piece of construction equipment on a weekly basis, and expects to need a substantially similar piece of equipment for the duration of a four-month project, there may be a compelling economic reason not to continually substitute that asset throughout the period.

5.4 Lease payments

5.4.10 At lease commencement, the lease payments consist of all of the following payments relating to the use of the underlying asset during the 'lease term' (see section 5.3). [842-10-30-5]

Type of payment during the lease term	Section
– Fixed payments	–
– Variable lease payments that depend on an index or rate.	5.4.1
– Adjustments to fixed payments:	
» in-substance fixed payments (added); and	5.4.2
» lease incentives paid or payable by the lessor to the lessee (subtracted).	5.4.3
– The exercise price of a lessee option to purchase the underlying asset that the lessee is reasonably certain to exercise.	5.4.4
– Penalties for terminating the lease if the lease term reflects the lessee exercising a termination option.	5.4.5
– For lessees only, amounts probable of being owed by the lessee under residual value guarantees.	5.4.6
– Payments by the lessee to the owners of a special-purpose entity for structuring the transaction.	–

5.4.20 Lease payments do *not* include:

- variable lease payments other than those that depend on an index or rate;
- any guarantee by the lessee of the lessor's debt; or
- amounts allocated to non-lease components (see chapter 4). [842-10-30-6]

5.4.30 Obligations to return an underlying asset to its original condition if it has been modified by the lessee (e.g. a requirement to remove lessee-installed leasehold improvements) do not generally meet the definition of lease payments or variable lease payments. They are accounted for in accordance with Subtopic 410-20 (asset retirement obligations). [842-10-55-37]

5.4.40 Costs to dismantle and remove an underlying asset at the end of the lease term that are imposed by the lease agreement are generally considered lease payments or variable lease payments. Lease payments are included in the measurement of lease assets and liabilities – see chapter 6 (lessees) and chapter 7 (lessors). [842-10-55-37]

5.4.50 Section 6.6 outlines when and how a lessee remeasures the lease payments.

5.4.60 A *lessor* remeasures the lease payments only if the lease is modified and that modification is not accounted for as a separate contract (see section 7.7). A lease modification includes a change to the terms and conditions of the contract that contains the lease if that contract modification changes the 'consideration in the contract', and therefore the lease payments (see KPMG observation at 5.4.80–120). [842-10-35-6]

5.4.70 In addition to remeasurements in accordance with 5.4.60, the lease payments for a lessor may also change if there is a change in the 'consideration in the contract' not resulting from a contract modification that is not allocated entirely to the non-lease component(s) of the contract. A change in the contract consideration can result if an estimate of variable consideration was included in that consideration initially (see section 4.3) and either (1) that estimate changes or (2) there is a change in the lessor's consideration of the constraint on variable consideration. In many of the cases where an estimate of variable consideration will be included in the contract consideration, a portion of that estimated variable consideration is included in the 'lease payments', and therefore a change in that estimate, or a change in the amount of that estimate that is constrained, will change the 'lease payments'. [842-10-35-6]

KPMG observation – Lease payments might be an allocated amount

5.4.80 Chapter 4 deals with the components of a contract, and outlines the following steps:

- Step 1: Identify the separate lease components.
- Step 2: Identify any non-lease components – e.g. a maintenance component.
- Step 3: Measure the 'consideration in the contract'.
- Step 4: Separate and allocate the consideration in the contract between the lease and non-lease components.

5.4.90 The process outlined in chapter 4 highlights that the 'lease payments' for a lease component might be an allocated amount when there are multiple lease components, or when there is at least one non-lease component. The following is a simplified example to highlight this general principle, which is explained in full in chapter 4.

Example – Allocated lease payments

5.4.100 Lessee LE and Lessor LR enter into a three-year lease for a piece of equipment. The following additional facts are relevant.

- LR will maintain the equipment over the three-year term.
- In return for the right to use the equipment and LR's maintenance services, LE will make fixed payments of $100 in Year 1, $110 in Year 2, and $120 in Year 3 ($330 in total).
- The stand-alone price for the lease component is $280, and for the maintenance services is $70.

5.4.110 On the basis of these stand-alone prices, the payments of $330 are allocated between the lease and non-lease components as follows.

Component	Stand-alone price	Allocation	Calculation
Lease (equipment)	$280	$264	(280/350) x 330
Non-lease (maintenance)	70	66	(70/350) x 330
	$350	**$330**	

5.4.120 On the basis of this calculation, the total lease payments are $264, or 80% of the total. The breakdown of this amount into the different years is calculated using the same proportion as for the total lease payments.

Year	Lease payment	Calculation
1	$ 80	100 x 80%
2	88	110 x 80%
3	96	120 x 80%
	$264	

5.4.1 Variable lease payments

5.4.130 In applying Topic 842, there are two types of variable lease payments.

- Variable lease payments that depend on an index or rate (such as the Consumer Price Index or a market interest rate) are *included* in the lease payments. [842-10-30-5(b)]
- Other variable lease payments are *excluded* from the lease payments. [842-10-30-6(a)]

5.4.140 The amount of variable lease payments that depend on an index or a rate that is included in the lease payments is derived using the index or rate at lease commencement. This is because such payments are considered unavoidable. However, the entity does not attempt to forecast future changes in the index or rate. Consequently, the amount included in the lease payments is just the amount of the initial payment times the lease term. This principle is illustrated in Example 5.7. [842-10-30-5(b)]

5.4.150 A *lessee* remeasures variable lease payments that depend on an index or a rate only when the lease payments are remeasured for another reason – e.g. a change in the lease term (see section 5.3) or a change in the estimate of amounts probable of being owed under a residual value guarantee (see section 5.4.6). The remeasurement is based on the index or rate at the date of remeasurement. [842-10-35-5]

5.4.160 A *lessor* remeasures variable lease payments that depend on an index or a rate only if the lease is modified and that modification is not accounted for as a separate contract. [842-10-35-6]

5.4.170 Some leases contain indemnification clauses that indemnify lessors on an after-tax basis for certain tax benefits that the lessor may lose if a change in the tax law precludes realization of those tax benefits. Although the indemnification payments may appear to meet the definition of variable lease payments, those payments are not of the nature normally expected to arise under variable lease payment provisions. Because of the close association of the indemnification payments to specific aspects of the tax law, any payments should be accounted for in a manner that recognizes the tax law association. The lease classification should not be changed. [842-10-55-38 – 55-39]

Example 5.7
Variable lease payments that depend on an index or rate

5.4.180 Lessee LE enters into a 10-year lease of space in a shopping center from Lessor LR on January 1, 20X5.

5.4.190 The following facts are relevant.

- Annual payments are calculated as $100 times December CPI-U, with adjustments set once a year based on the latest December CPI-U. Once payments increase, they do not decrease, even if CPI-U were to decrease. There are no fixed lease payments.
- CPI-U was 230 in December 20X3, and 240 in December 20X4, and is expected to increase to 250 in December 20X5, 260 in December 20X6, and 270 in December 20X7.

5.4.200 The annual payment is measured at $24,000 ($100 x 240) – i.e. based on CPI-U at the commencement date. The lease payments over the 10-year lease term are therefore $240,000 ($24,000 x 10). The lease payments do not include any expected increase due to changes in CPI-U during the lease term.

5.4.210 The lease payments will not be remeasured for changes in CPI-U unless they are required to be remeasured for another reason (e.g. a change in the lease term). Therefore, unless the lease payments are remeasured for another reason, the remaining lease payments for the following three years will be:

- at December 31, 20X5: $216,000 ($24,000 x 9 remaining payments);
- at December 31, 20X6: $192,000 ($24,000 x 8 remaining payments); and
- at December 31, 20X7: $168,000 ($24,000 x 7 remaining payments).

KPMG observation – Balance sheet effect of excluding variable lease payments from lease payments

5.4.220 The Board's decision to exclude most variable lease payments from the definition of lease payments has the following implications for the balance sheet:

- Two leases with very similar economics, but one structured with variable lease payments instead of fixed lease payments (e.g. payments due based on the performance or usage of the underlying asset), will result in substantially different lease liabilities and right-of-use assets. The lessee with the fixed payment only lease will generally recognize a larger lease liability and right-of-use asset throughout the lease term.
- Leases with only variable lease payments will not give rise to any lease liability or right-of-use asset for the lessee upon lease commencement.

5.4.230 By excluding variable lease payments from the definition of lease payments, the right-of-use asset and lease liability are less than they would be had an estimate of the variable lease payments been included. As a result, lessees may wish to include a greater proportion of variable lease payments in their lease agreements to minimize the balance sheet impact of Topic 842. In addition, as a result of the variable lease payments being excluded, some investors and analysts may unwind the lease assets and lease liabilities recorded and estimate their own asset and liability to include variable lease payments, which may require significant effort to make relevant predictions and comparisons.

KPMG observation – Income statement and cash flow effect of excluding variable lease payments from lease payments

5.4.240 In addition to the balance sheet effect of variable lease payments, leases with variable lease payments are more likely to be classified as operating leases (by lessees and lessors) because variable lease payments will not factor into the lease classification test – see sections 6.2 (lessees) and 7.2 (lessors). Therefore, variable lease payments increase the likelihood that lessees and lessors will recognize lease cost or lease income on a straight-line basis (excluding the effect of the variable lease payments) and that lessees will recognize their cash payments for leases as operating cash outflows, rather than as a mixture of operating and financing cash outflows.

KPMG observation – Remeasurement of variable lease payments that depend on an index or rate

5.4.250 The Board's decision not to require the remeasurement of the lease payments for variable lease payments that depend on an index or rate whenever that index or rate changes, or when the contractual cash flows change (as required in IFRS 16 – see 5.4.290), was principally a cost-benefit decision. The decision was made as part of the Board's broader effort in the final stages of the project to limit the circumstances in which a lessee would be required to remeasure the lease liability for a lease. [ASU 2016-02.BC236–BC237]

5.4.260 While the Board's decision may reduce the effort necessary to apply Topic 842, it is clear that in many cases the result of this decision is that the lease liability will not reflect the remaining fixed payments required under the lease; this will potentially reduce the usefulness of that reported amount and increase the likelihood that investors and analysts will continue to make their own adjustments to reported lease assets and lease liabilities.

5.4.270 Using Example 5.7 as an illustration, at the end of December 20X7, if CPI-U increases as expected, the remaining lease payments that will be reflected in the lessee's lease liability in accordance with Topic 842 are $168,000 ($24,000 x 7 remaining payments) even though the lessee is required to make remaining payments of at least $189,000 ($27,000 x 7 remaining payments).

KPMG observation – Identifying variable lease payments is important for disclosures

5.4.280 Topic 842 includes guidance about items that do *not* result in variable lease payments (e.g. obligations to return an asset to its original condition, and tax indemnification clauses) because differentiating variable lease payments from other payments affects lessee and lessor disclosures. Lessees and lessors are required to disclose variable lease cost and variable lease income, respectively, such that those disclosures will be inaccurate if an entity misidentifies variable lease payments (see sections 12.2–12.3). [842-10-55-37 – 55-38]

US GAAP different from IFRS – Remeasurement of variable lease payments based on an index or rate

5.4.290 In contrast to Topic 842, IFRS 16 requires the lessee to remeasure its lease liability to reflect changes in an index or a rate used to determine variable lease payments whenever the change in the index or rate results in a change in the contractual cash flows – i.e. when the adjustment to the lease payments takes effect. At that point, the lessee determines the revised lease payments for the remainder of the lease term based on the revised contractual payments. [IFRS 16.42(b)]

5.4.300 Using Example 5.7 to illustrate, the following table shows the differences at each reporting date between IFRS 16 and Topic 842 in the lease payments included in the lessee's lease liability. For this purpose, assume that the CPI-U continues to increase by 10 points each year throughout the 10-year lease term.

Reporting date	Lease payments – IFRS 16	Lease payments – Topic 842
Dec. 31, 20X4	$240,000 (24,000 x 10)	$240,000 (24,000 x 10)
Dec. 31, 20X5	225,000 (25,000 x 9)	216,000 (24,000 x 9)
Dec. 31, 20X6	208,000 (26,000 x 8)	192,000 (24,000 x 8)
Dec. 31, 20X7	189,000 (27,000 x 7)	168,000 (24,000 x 7)
Dec. 31, 20X8	168,000 (28,000 x 6)	144,000 (24,000 x 6)
Dec. 31, 20X9	145,000 (29,000 x 5)	120,000 (24,000 x 5)
Dec. 31, 20Y0	120,000 (30,000 x 4)	96,000 (24,000 x 4)
Dec. 31, 20Y1	93,000 (31,000 x 3)	72,000 (24,000 x 3)
Dec. 31, 20Y2	64,000 (32,000 x 2)	48,000 (24,000 x 2)
Dec. 31, 20Y3	33,000 (33,000 x 1)	24,000 (24,000 x 1)

5.4.310 The FASB and the IASB reached different conclusions about the cost-benefit of remeasuring variable lease payments that depend on an index or a rate. We believe that the IASB's cost-benefit evaluation may have been influenced by the diverse make-up of the jurisdictions applying IFRS. Indices and rates on which variable lease payments can depend often vary by region or country and, in some countries that use IFRS, the periodic changes in indices like CPI or in interest rates can be much more significant than such changes in the US. Therefore, we believe that the IASB may have viewed the potential benefit of remeasurement to investors and analysts, both in terms of comparability between entities applying IFRS in different regions or countries and in terms of relevant information, as being more significant than the FASB.

5.4.2 In-substance fixed lease payments

5.4.320 In-substance fixed payments include payments that do not create genuine variability and the minimum payments the lessee is required to make when it has alternative payments that it can select from under the lease (e.g. due to optional features within the lease). In-substance fixed payments for a lessee or a lessor might include the following, for example:

- payments that result from clauses that do not have economic substance; or
- the lower of the payments to be made when a lessee has a choice about which set of payments it makes, although it must make at least one set of payments. [842-10-55-31]

5.4.330 Topic 842 does not include any explicit statements about remeasuring in-substance fixed payments. However, because such payments are lease payments, we believe that when the lease payments are required to be remeasured (e.g. because of a change in the lease term – see section 5.3), this would include evaluating whether any remaining variable lease payments are in-substance fixed lease payments.

5.4.340 Example 5.8 illustrates in-substance fixed lease payments in the context of a choice between two sets of payments. Examples 5.9 and 5.10 illustrate in-substance fixed lease payments in the context of variable lease payments.

Example 5.8

In-substance fixed lease payments – Two possible sets of payments

5.4.350 Lessee LE enters into a seven-year lease of land and a building.

5.4.360 The following facts are relevant.

- The lease requires monthly fixed lease payments of $14,000 and variable lease payments that are determined as 10% of LE's annual sales in excess of $1,000,000.
- At the end of the seven-year period, if sales are at least $1,500,000 in each of the last five years of the lease term, LE has the option to purchase the property for $400,000. At the lease commencement date, LE is not reasonably certain to exercise this purchase option.
- If restaurant sales are less than $1,500,000 in any of the last five years of the lease, LE is required to purchase the property for $400,000 at the end of the seven-year period.

5.4.370 The lease payments under each scenario are calculated as follows.

Payment	Sales ≥ $1.5m	Sales < $1.5m	Calculation
Fixed	$ 840,000	$ 840,000	14,000 x 12 months x 5 years
Minimum variable	250,000	–	(1,500,000 - 1,000,000) x 10% x 5 years
Purchase price	–	400,000	
Total	**$1,090,000**	**$1,240,000**	

5.4.380 The $1,090,000 (which assumes sales are at least $1.5 million per year in the last five years) is lower than $1,240,000 (which assumes sales are less than $1.5 million in any of the last five years, and therefore that LE must purchase the property for $400,000). Therefore, the lease payments are $1,090,000.

Example 5.9
Variable lease payments without economic substance

5.4.390 Lessee LE enters into a 10-year lease of a warehouse from Lessor LR.

5.4.400 The following facts are relevant.

- Lease payments are initially $200,000 per month in arrears.
- The lease payments increase by 1% annually for every 0.1% increase in CPI from the prior year (resulting in a leverage factor of 10 times the change in CPI), limited to a maximum increase of 2% per year.
- Once variable lease payments increase, they cannot decrease under the terms of the lease.
- The CPI increase has exceeded 1% in each of the previous 20 years and there is only a remote likelihood that annual CPI increases will be less than 0.2% during the term of the lease.

5.4.410 If payments under the CPI escalation provision are considered variable lease payments, no increase in rents over the lease term will be included in the lease payments. This is because, absent a remeasurement event (e.g. a change in the lease term), the measurement of the lease payments for the entire lease term would be performed using the CPI index at lease commencement – i.e. lease payments would be $200,000 per month over the 10-year lease term at lease commencement.

5.4.420 However, LE and LR each conclude that the payments under the CPI escalation provision are in-substance fixed payments, rather than variable lease payments, because of the remote likelihood that the change in CPI will be less than 0.2%. Therefore, both LE and LR include a 2% annual increase in the measurement of lease payments at the lease commencement date.

Example 5.10

Variable lease payments versus in-substance fixed lease payments – Payments based on performance or usage

5.4.430 Lessee LE and Lessor LR enter into a seven-year lease of retail space.

5.4.440 The following facts are relevant.

- The lease requires monthly variable lease payments equal to 5% of sales from the retail space. There are no fixed lease payments.
- LE has an established, successful brand and similar retail stores in similar shopping centers in many locations.
- Based on LE's extensive, relevant history of operating similar stores, LE and LR can reliably forecast, conservatively, that LE will generate *at least* $500,000 in sales from this store each year of the seven-year lease; therefore, it is highly certain that LE will make at least $25,000 in variable lease payments each year ($500,000 x 5%). LE and LR actually each have forecasts for a much greater amount of sales each year.

5.4.450 The lease payments are nil for this lease. This means that LE will have no right-of-use asset or lease liability for this lease at the commencement date; and if this were a sales-type or direct financing lease, LR would have no lease receivable.

5.4.460 Despite the fact that LE is highly certain to make at least $175,000 ($25,000 x 7) in variable lease payments over the lease term, those variable payments are not in-substance fixed payments. The variable terms have economic substance – i.e. they exist as a substantive way for LE and LR to share in the risks and benefits from use of the retail space – and create genuine variability in the lease payments to be made.

KPMG observation – Concept of in-substance fixed lease payments consistent with current practice

5.4.470 In-substance fixed lease payments are included in the measurement of lease payments because they are unavoidable, and therefore economically indistinguishable from fixed lease payments. Although such payments may appear to contain variability, in fact they do not. [ASU 2016-02.BC203]

5.4.480 The guidance in Topic 842 relies upon a principle rather than a series of more detailed requirements or examples, because the Board concluded that even an exhaustive list of requirements or examples could never be comprehensive. In addition, the Board concluded that introducing a new series of detailed requirements or examples might create new questions or issues for a concept that is generally understood and applied in current practice. Consistent with that thinking, the Board's intent is for the new guidance to be applied in substantially the same manner as it is applied currently; therefore, existing examples of what constitute in-substance fixed (or disguised or de facto) minimum lease payments are likely to continue to be relevant. [ASU 2016-02.BC204]

KPMG observation – Highly certain payments based on performance or usage of the underlying asset

5.4.490 As illustrated in Example 5.10, we believe that even variable lease payments that are highly (or even virtually) certain to occur are not in-substance fixed lease payments *if* the payments are based on performance or usage of the underlying asset. This is consistent with current practice under US GAAP, and therefore is consistent with the Board's statement that the concept of in-substance fixed lease payments under Topic 842 is intended to be consistent with current practice.

5.4.500 In addition, while not included in Topic 842, and therefore not authoritative, the publicly available FASB/IASB staff paper that guided the Board's discussion in April 2014 of in-substance fixed lease payments included an example substantially similar to Example 5.10; the Board discussion generally indicated support for the conclusion reached in that example presented by the staff.

5.4.3 Lease incentives

5.4.510 The lessor may offer incentives to the lessee to sign the lease agreement. Lease incentives include both:

- payments made to or on behalf of the lessee; and
- losses incurred by the lessor as a result of assuming a lessee's pre-existing lease with a third party. [842-10-55-30]

5.4.520 Regarding losses attributable to the lessor assuming a lessee's pre-existing lease, the lessor and lessee should prepare independent estimates. For example:

- The lessee's estimate of the incentive could be based on a comparison of the new lease with the market rental rate available for similar underlying assets, or the market rental rate from the same lessor without the lease assumption.
- The lessor should estimate any loss based on the total remaining costs reduced by the expected benefits from the sublease or use of the assumed underlying asset. [842-10-55-30]

Example 5.11
Effect of lease incentives on the lease payments

5.4.530 Lessee LE and Lessor LR enter into a 10-year lease with the following terms:

- Annual rent of $1,500, so $15,000 in total.
- LR agrees to provide LE with $1,000 to defray the cost of tenant improvements each of the first 3 years of the lease, so $3,000 in total. LE will simply reduce its annual payment for Years 1 through 3 by $1,000 each year.

5.4.540 The lease payments are $12,000 in this example ($15,000 less the $3,000 incentive). LE will need to factor in the timing and amount of its payments in determining lease classification, and in measuring its lease liability (see section 6.3). That is, the present value of those lease payments will need to factor in three initial net payments of $500, and seven subsequent annual payments of $1,500.

5.4.4 Purchase options

5.4.550 The exercise price of a lessee option to purchase the underlying asset is included in the lease payments if the lessee is reasonably certain to exercise the option. The analysis of whether a lessee is reasonably certain to exercise a purchase option considers the same economic factors that are evaluated in determining whether to include optional periods in the lease term (see section 5.2). [842-10-30-5(c)]

5.4.560 When there is a change in the assessment of whether it's reasonably certain that the lessee will exercise a purchase option, the lessee remeasures the lease payments. [842-10-35-4(c)(2)]

5.4.570 Reassessments of lessee purchase options and remeasurements of the lease payments resulting from a change in the assessment of a lessee purchase option are discussed in section 6.6 (lessees).

5.4.580 A *lessor* does not reassess whether the lessee is reasonably certain to exercise a purchase option unless the lease is modified and that modification is not accounted for as a separate contract (see section 7.7). [842-10-35-3]

Example 5.12
Purchase option price included in the lease payments

5.4.590 Lessee LE leases a warehouse and land. The following facts are relevant.

- The lease term is five years, with annual fixed lease payments of $1,000,000.
- The lease contract gives LE the option to purchase the warehouse and land at a fixed price of $10,000,000 at the end of the lease term.

5.4.600 Based on an analysis of the economic factors at lease commencement, LE is reasonably certain to exercise the purchase option. Therefore, the total lease payments are $15,000,000.

- $5,000,000 in total annual fixed payments for five years; plus
- $10,000,000 exercise price of the purchase option.

5.4.5 Termination penalties

5.4.610 The determination of the lease term governs whether a termination penalty is included in lease payments. Termination penalties are included in the lease payments unless it is reasonably certain that the lessee will *not* exercise an option to terminate the lease, and therefore will not incur the penalty. [842-10-30-5(d)]

Example 5.13

Termination penalty included in the lease payments

5.4.620 Lessee LE leases a floor in an office building from Lessor LR for five years for monthly payments of $20,000. The lease contract allows LE to terminate the lease after Year 3 for a lump sum payment of $120,000. At lease commencement, it is not reasonably certain that LE will continue the lease beyond the end of Year 3.

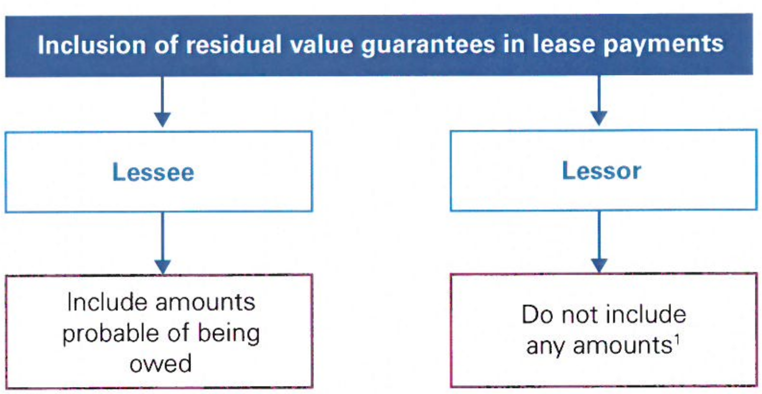
5.4.630 As a result, both LE and LR include the termination penalty in the lease payments. Therefore, the total lease payments are $840,000:

- $720,000 for three years of fixed payments ($20,000 x 36); plus
- $120,000 termination penalty.

5.4.6 Residual value guarantees

5.4.640 A residual value guarantee is 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. Residual value guarantees can be provided by the lessee or by a third party that is unrelated to the lessee or the lessor. [842 Glossary]

5.4.650 The following diagram highlights the different treatment of residual value guarantees for lessees versus lessors: [842-10-30-5]



Note 1:

No residual value guarantee amounts (whether provided by the lessee or by another unrelated third party) are included in the lease payments by a lessor. However, the lessor's 'lease receivable' for sales-type and direct financing leases includes the full amount of any residual value guarantee(s) (see section 7.3.1).

5.4.660 A provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is not a residual value guarantee. Amounts related to such a provision are variable lease payments (see section 5.4). [842-10-55-34]

5.4.670 However, if the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease term (i.e. a lessor put option), the stated purchase price is *included* in lease payments by both the lessee and lessor. Although it is not a residual value guarantee because the lessee receives the underlying asset, the amount is economically similar to a guaranteed residual value. [842-10-55-35]

5.4.680 In general, a lessee's lease payments should not be reduced for any amounts probable of being owed under a residual value guarantee that are covered by a residual value guarantee obtained from a third party by the lessee. However, an exception arises when the lessor explicitly releases the lessee from the residual value guarantee obligation, including a secondary obligation to perform if the third-party guarantor defaults. [842-10-55-36]

5.4.690 Amounts paid by a lessee for a third-party residual value guarantee are also not lease payments. They are executory costs. [842-10-55-36]

5.4.700 Residual value guarantees that are subject to the requirements of Topic 842 are not within the scope of Topic 815 (derivatives and hedging) – see section 2.2. [815-10-15-80]

5.4.710 When there is a change in the assessment of the amount probable of being owed under a residual value guarantee, the lessee remeasures the lease payments (see section 6.6). [842-10-35-4]

Example 5.14
Residual value guarantee included in the lease payments

5.4.720 Lessee LE leases a new semi-trailer truck from Lessor LR for four years for annual payments of $24,000. Under the contract, LE guarantees a residual value of $60,000 to LR at the end of the lease term.

5.4.730 In deciding whether the lease payments include any amount related to LE's residual value guarantee, LE observes that similar trucks are regularly sold in used condition, with detailed listings published on dealer sites. LE researches those listings and finds similar trucks around four years of age, for sale or with estimated values between $50,000 and $60,000.

5.4.740 Mileage is a key determinant in pricing different trucks of the same age. LE expects to drive the truck 120,000 miles per year, which is at the high end of the range of mileage noted in the used sale listings. Therefore, LE concludes that it is likely that the residual value of the truck will be closer to $50,000 than $60,000 at the end of the lease, and therefore that the probable amount that will be owed by LE at the end of the lease term will be $10,000. Consequently, LE's lease payments include the $10,000.

5.4.750 LR includes no amounts related the residual value guarantee in its measurement of the lease payments. However, if the lease were a sales-type or a direct financing lease, the full $60,000 residual value guarantee would be included in determining LR's *lease receivable* (see section 7.3).

Example 5.15
Lessee accounting for right to receive excess over guaranteed residual value

5.4.760 Continuing Example 5.14, in addition to the guarantee of a residual value of $60,000, the contract stipulates that:

- LR will sell the truck at the end of the four-year lease term; and
- if LR sells the truck for more than $60,000, LR will pay LE any surplus above that amount.

5.4.770 LE accounts for the potential gain on sale of the residual asset as a contingent gain under Subtopic 450-30. Therefore, LE recognizes a gain only when the sale is completed and to the extent that the sale price exceeds $60,000.

KPMG observation – Including only amounts probable of being owed under a residual value guarantee will increase complexity and judgment

5.4.780 The Board's decision for lessees to include in lease payments only amounts probable of being owed under a residual value guarantee, rather than the entire amount of the guarantee, will result in the recognition of smaller lease liabilities and right-of-use assets by lessees. However, the judgment that will be involved in determining and reassessing amounts probable of being owed and the requirement to remeasure the lease payments whenever that assessment changes, and potentially to allocate those changes to multiple components of the contract (including non-lease components), will add complexity to the lessee accounting model for leases that include a lessee residual value guarantee.

KPMG observation – No guidance on determining probable amounts owed

5.4.790 Topic 842 requires a lessee to estimate, and reassess, the amount probable of being owed under a residual value guarantee it provides to the lessor, but does not provide guidance about how to make this estimate. Example 5.14 demonstrates one way in which we believe that the lessee could estimate the amount probable of being owed in a scenario of that nature.

5.4.800 Another approach that we believe would be reasonable is to assign probabilities to potential outcomes and to include in the lease payments the minimum amount that exceeds the 'probable' threshold.[1] For example, a lessee might consider there to be multiple possible outcomes:

Amount lessee could owe	Probability
$ –	20%
10	25%
20	25%
30	20%
40	10%

5.4.810 Under this approach, the lessee would conclude that it is probable that it will owe at least $10 to satisfy the residual value guarantee. While it is possible that the lessee will owe $30 or $40, and it is more likely than not that the lessee will owe at least $20, the probability of those outcomes is not likely to occur.

5.4.820 However, both Example 5.14 and the above are illustrative only. Because Topic 842 does not prescribe how to make the estimate, there may be a number of acceptable approaches.

Note 1:

'Probable' is defined as the future event or events are likely to occur. [842 Glossary]

Comparison with current US GAAP – Full amount of residual value guarantees included in minimum lease payments

5.4.830 Under current US GAAP, the definition of *minimum lease payments* for a lessee includes the full amount of any residual value guarantee that it provides (i.e. the $60,000 in Example 5.14), rather than just the amount that it is probable of owing. This is one aspect of Topic 842 that will result in a difference in the accounting for finance leases as compared to capital leases. In general, the lease liability and the right-of-use asset will be lower under Topic 842 for a finance lease that includes a lessee residual value guarantee than what the capital lease obligation and capital lease asset are under current US GAAP. [840 Glossary]

5.4.840 While the definition of *minimum lease payments* applicable to lessors in current US GAAP includes the full amount of any residual value guarantee (provided by the lessee or any other unrelated third party) and the definition of *lease payments* includes no amounts related to residual value guarantees, this will not have any appreciable difference on a lessor's accounting. This is because:

- the full amount of any residual value guarantee(s) will still be included in the lessor's *lease receivable* (which is a component of the lessor's net investment in the lease, together with any unguaranteed residual value and deferred selling profit for direct financing leases, if any) for sales-type and direct financing leases; and
- operating lessors' lease income under current US GAAP was calculated based on the *minimum rental payments*, which excluded guaranteed residual values, rather than the *minimum lease payments*. *Lease payments*, as applicable to lessors, under Topic 842 is substantially the same as *minimum rental payments* in current US GAAP. [842 Glossary]

5.5 Initial direct costs

5.5.10 Initial direct costs are incremental costs of a lease that would not have been incurred if the lease had not been obtained (i.e. not been executed). [842 Glossary]

5.5.20 This section discusses the costs that meet the definition of initial direct costs, and the accounting is discussed in sections 6.3 (lessees) and 7.3–7.4 (lessors).The following are examples of costs that would typically be included in, or excluded from, initial direct costs. [842-10-30-9 – 30-10, ASU 2016-02.BC222, BC304]

Typical initial direct costs	
Include	**Exclude**
– Commissions – Payments made to an existing tenant to incentivize that tenant to terminate the lease	– Legal fees – Costs of evaluating the prospective lessee's financial condition – Costs of negotiating lease terms and conditions – General overheads

Example 5.16
Costs that are initial direct costs

5.5.30 Lessee LE and Lessor LR enter into a lease. The following are costs that they incur in connection with the lease:

	Incurred by:	
Cost	**LE**	**LR**
Allocation of employee costs to negotiate lease terms and conditions	$ 5,000	$10,000
External legal fees	12,000	20,000
Travel costs related to inspecting the underlying asset	4,000	–
Commission to tenant's agent (LE) / listing agent (LR)	20,000	30,000
Payment made to existing tenant to obtain the lease	–	20,000

5.5.40 LE has initial direct costs of $20,000 in connection with this lease that it includes in the initial measurement of the right-of-use asset for the lease:

- The $20,000 commission to the tenant's agent is an initial direct cost because it is only incurred upon obtaining the lease – i.e. it would not have been owed if the lease had not been executed.
- None of the other costs incurred by LE are initial direct costs, because they would have been incurred even if the lease had not been obtained. For example, employee salaries are paid regardless of whether the lease is obtained; therefore, the allocation of employee costs is not an initial direct cost. In addition, LE would be required to pay its attorneys for negotiating and drafting the lease even if the lease was not executed.

5.5.50 LR has initial direct costs of $50,000:

- The $30,000 listing agent commission is an initial direct cost for the same reason as it was for LE. In addition, the payment to the existing tenant of $20,000 is an initial direct cost because it is paid only as a consequence of executing the lease.
- None of the other costs incurred by LR meet the definition of initial direct costs, because they would have been incurred even if the lease had not been executed. The allocation of employee costs and the external legal fees are not initial direct costs to LR for the same reasons that they were not initial direct costs to LE.

KPMG observation – Initial direct costs might be an allocated amount

5.5.60 As noted in the KPMG observation at 5.4.80–100, lease payments might be an allocated amount when there are multiple lease components, or when there is at least one non-lease component. This might also be the case with initial direct costs (e.g. in a contract in which a commission is paid for the lease and the non-lease component). Judgment will be involved in determining whether costs, such as a commission paid to a broker, relate to a lease component, a non-lease component, or both. The following are two examples of how this allocation may work under Topic 842. [ASU 2016-02.BC222, BC306–BC307]

Example A – Allocated initial direct costs

5.5.70 Continuing the simplified example in the KPMG observation at 5.4.100, Lessor LR's standard practice is to pay a commission to its salesperson on the total value of the contract obtained. Therefore, LR concludes that the commission of $25 relates to both the lease and the maintenance services, and allocates the commission on the same basis as the consideration in the contract.

Component	Allocation	Calculation
Lease (equipment)	$20	25 x 80%
Non-lease (maintenance)	5	25 x 20%
	$25	

5.5.80 Therefore, LR has initial direct costs of $20. The $5 allocated to the maintenance services is accounted for in accordance with the contract costs guidance in Subtopic 340-40.

Example B – Initial direct costs

5.5.90 Lessee LE and Lessor LR enter into a five-year lease of retail space in a shopping center. In addition to providing a right to use the retail space, LR will provide common area maintenance. As a result, there are two components of the contract: a lease component comprising the right to use the retail space, and a non-lease component comprising common area maintenance.

5.5.100 Annual rent payments are fixed at $1,000, while charges for common area maintenance will be billed on a proportionate basis to all tenants of the shopping center on a monthly basis.

5.5.110 Both LE and LR pay a broker commission of $250, which equals five percent of the fixed rent payments in the contract. This percentage is the standard commission paid in this market for real estate leases, regardless of whether the lease is a gross lease or a net lease (see section 4.6), and regardless of whether the lease includes non-lease components like common area maintenance.

5.5.120 Consequently, both LE and LR conclude that the commission relates solely to the lease component of the contract. The commission was incurred only as a direct result of the lease being executed; therefore, the commission is an initial direct cost to both LE and LR.

KPMG observation – Narrowed definition of *initial direct costs* based on contract acquisition costs guidance in Topic 606

5.5.130 The Board's decisions on defining, allocating, and accounting for initial direct costs were intended to align the guidance on initial direct costs by a lessor with the guidance for costs to obtain a contract by a seller of similar goods. [ASU 2016-02.BC306–BC307]

5.5.140 Similar to the initial direct costs guidance in Topic 842, the contract cost guidance in Subtopic 340-40 (other assets and deferred costs – contracts with customers) similarly:

- recognizes as a contract cost asset only those incremental costs to obtain a contract that an entity incurs that would not have been incurred if that contract had not been obtained;
- allocates capitalized costs to the goods and services to which they relate, and similarly relies on judgment to make that determination; and
- amortizes contract cost assets on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the contract cost asset relates. The specific accounting for those costs that meet the definition of initial direct costs under Topic 842 is discussed in sections 6.3 (lessees) and 7.3–7.4 (lessors).

Comparison with current US GAAP – Fewer costs of lease origination are initial direct costs under Topic 842

5.5.150 An entity's initial direct costs for a lease will be substantially less for many leases under Topic 842 than they are under current US GAAP. This is because Topic 842 defines initial direct costs as only those incremental costs of a lease that would not have been incurred if the lease had not been obtained (i.e. not executed), while initial direct costs under current US GAAP also include:

- Other incremental costs that are incurred directly as a result of the lease, even if such costs were incurred to negotiate and arrange the lease and, therefore, would have been incurred even if the lease was not executed (e.g. external legal fees)
- A lessor's incurred costs, even if not incremental to the lease, directly related to fulfilling specified activities to negotiate or arrange the lease. Those specified activities are:
  - » evaluating the prospective lessee's financial condition;
  - » evaluating and recording guarantees, collateral, and other security arrangements;
  - » negotiating lease terms;
  - » preparing and processing lease documents; and
  - » closing the transaction.

The costs directly related to those activities include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for the lease. [840-20-25-17 – 25-19]

5.5.160 Because of the narrowed definition of initial direct costs, many entities will recognize significant origination costs for a lease when incurred that they do not recognize as incurred currently. Lessors in that situation will recognize greater margins on their lease income earned over the lease term (e.g. operating lease income or interest income on their direct financing leases) as compared to current US GAAP, while lessees will recognize less lease expense during the lease term as compared to current US GAAP.

5.5.170 The new, narrowed definition of initial direct costs that does not include allocated internal costs may be simpler to apply than the definition in current US GAAP because entities will no longer need to have processes and controls to track employee time spent on negotiating and arranging leases.

5.6 Discount rate for the lease

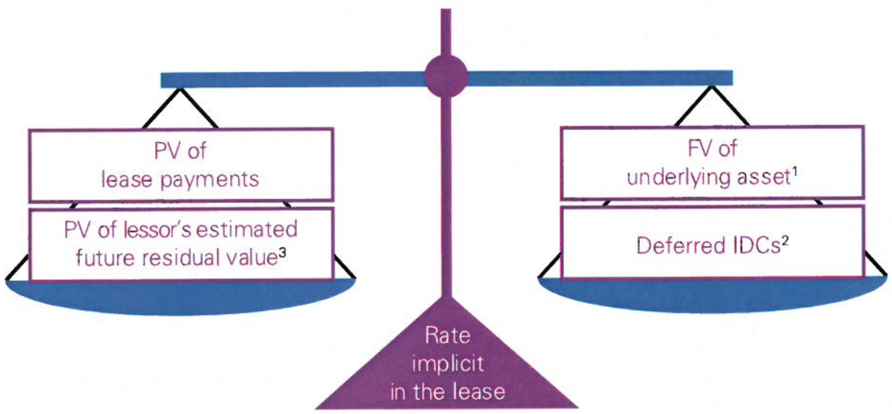
5.6.10 For a *lessee*, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate. For a *lessor*, the discount rate for the lease is the rate implicit in the lease. [842 Glossary, 842-20-30-3]

5.6.20 The discount rate for the lease is determined based on information available at lease commencement. [842-20-30-2]

5.6.30 A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable to that of the lease term, as an accounting policy election for all leases in which it is a lessee. [842-20-30-3]

Rate implicit in the lease

5.6.40 The rate implicit in the lease is the rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments, and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term *to equal* the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor, and (2) any deferred initial direct costs of the lessor. [842 Glossary]



Notes:

1. For purposes of determining the *rate implicit in the lease*, the fair value of the underlying asset is reduced by the amount of any investment tax credit related to the underlying asset that is retained and expected to be realized by the lessor. [842 Glossary]
2. Initial direct costs are not deferred (i.e. they are expensed at lease commencement) if the lease is a sales-type lease *and* the fair value of the underlying asset differs from its carrying amount at lease commencement (see section 7.3). [842-30-25-1(c)]
3. If a lessee uses the rate implicit in the lease, the estimated future residual value excludes amounts probable of being owed by the lessee to satisfy a residual value guarantee, which are included in the lease payments (see section 5.4.6).

5.6.50 For purposes of determining the rate implicit in the lease to assess the lease classification (e.g. to measure the present value of the lease payments and residual values guaranteed by the lessee or an unrelated third party), a lessor assumes that no initial direct costs will be deferred if, at lease commencement, the fair value of the underlying asset is different from its carrying amount. This is discussed in section 7.2. [842-10-25-4]

Lessee's incremental borrowing rate

5.6.60 The incremental borrowing rate is the rate of interest that a *lessee* would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment. [842 Glossary]

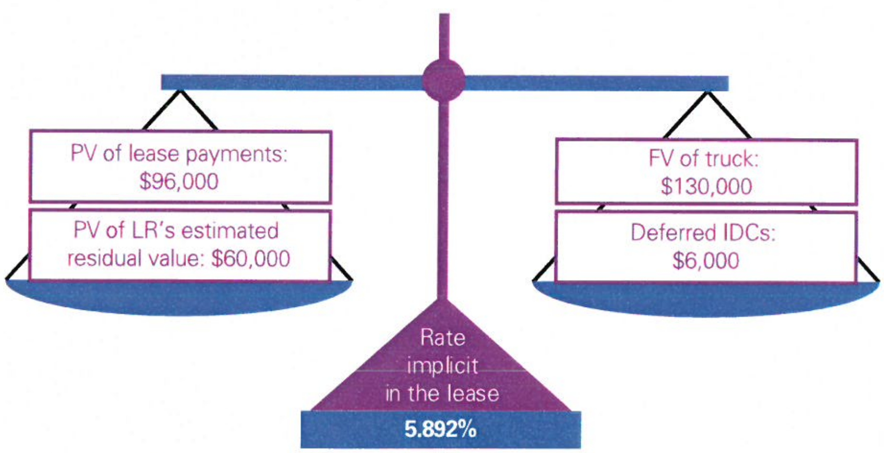
Example 5.17
Lessor determination of rate implicit in the lease

5.6.70 Lessee LE leases a new truck from Lessor LR for four years.

5.6.80 The following facts are relevant.

- Under the contract, LE pays $24,000 per year, payable annually in advance.
- The lease commencement date is January 1, 20x1.
- LR estimates that the residual value of the truck will be $60,000 at the end of the four-year lease term.
- The lease contains no transfer of ownership provisions, no lessee purchase option, no residual value guarantees, and no renewal options.
- There are no non-lease components in the contract (e.g. maintenance services).
- LR incurs $6,000 in initial direct costs associated with executing the lease. These costs will be deferred because LR's purchase price to acquire the truck at lease commencement (i.e. its carrying amount) equals its fair value ($130,000). See discussion in section 7.3.
- LR will not retain any investment tax credit associated with the truck.

5.6.90 The rate implicit in the lease is the rate that balances the following equation, which is 5.892%:



Example 5.18
Lessee determination of incremental borrowing rate

5.6.100 Assume the same facts as Example 5.17, except that LE:

- does not have readily available information to determine LR's estimated residual value of the truck; and/or
- has readily available information to determine LR's estimated residual value, but does not know LR's deferred initial direct costs.

5.6.110 Without both pieces of information, LE cannot determine the rate implicit in the lease. Therefore, LE will use its incremental borrowing rate as the discount rate for the lease.

5.6.120 In determining the incremental borrowing rate, LE considers the rate of interest that it would have to pay on a secured borrowing in an amount equal to the lease payments ($96,000) under similar terms (e.g. over three years).[1]

5.6.130 LE also considers that it has an unsecured line of credit with a fixed rate of 7% as well as an eight-year term loan with the same national bank, secured by the assets of the company, with an original balance of $10 million and a fixed interest rate of 4%. LE determines the most efficient way for it to arrive at a reasonable incremental borrowing rate is to request its bank to quote a rate for a three-year term loan of $96,000, secured by a commercial vehicle similar to the truck in the lease. LE reviews the quote, which is 5.5%, for reasonableness based on the current risk-free rate and LE's credit history, and determines that it is reasonable. Therefore, LE uses a 5.5% discount rate to calculate the present value of the lease payments.

Note 1:

LE is paying the annual payments in advance so will have made its final payment at the beginning of Year 4 of the lease, not at the end.

KPMG observation – Lessees will likely use their incremental borrowing rate in most cases

5.6.140 It will likely be very difficult for lessees to determine the rate implicit in the lease under Topic 842. This is because of the need to know both the lessor's estimated residual value of the underlying asset (consistent with current US GAAP) and the amount of initial direct costs that the lessor will defer for the lease. Consequently, lessees will likely use their incremental borrowing rate for nearly all leases.

KPMG observation – Lessor and lessee discount rates are likely to be different

5.6.150 Consistent with many of the other estimates and judgments to be made in accordance with Topic 842, the discount rate for the lease will frequently differ between the rate implicit in the lease determined by the lessor and the lessee's incremental borrowing rate. This is because those two rates are determined in very different ways; even if that were not the case, many of the underlying estimates/judgments (e.g. lease term, assessments of lessee purchase options, etc.) may not be arrived at similarly by the lessee and the lessor, further reducing the chance that the discount rate for the lease will be the same for the lessee and the lessor in any given lease.

KPMG observation – Determining the discount rate for a portfolio of leases

5.6.160 As discussed in section 5.9, the Board concluded that the leases guidance in Topic 842 could be applied at a portfolio level by lessees and lessors in some circumstances. The basis for conclusions and Example 2 in Subtopic 842-20 highlight that the Board expects that some entities will be able to use a portfolio approach to determine the discount rate for a lessee's leases – if the effect of doing so would not materially affect the lessee's accounting for those leases to which it applies a single discount rate. In the Board's view, applying a portfolio approach to determining the discount rate would alleviate some of the concerns that entities expressed about determining (and documenting the basis for) a separate incremental borrowing rate for each and every lease. [842-20-55-18 – 55-20, ASU 2016-02.BC201]

KPMG observation – Subsidiary's use of parent (or group) incremental borrowing rate

5.6.170 In some cases, it might be reasonable for a subsidiary to use a parent entity (or group) incremental borrowing rate as the discount rate for a lease. For example, this might be appropriate when the subsidiary does not have its own treasury function (all funding for the group is managed centrally by the parent entity). Consequently, the negotiations with the lessor result in the parent entity providing a guarantee of the lease payments to the lessor. Therefore, the pricing of the lease is more significantly influenced by the credit standing of the parent than that of the subsidiary. [842-20-55-18 – 55-20, ASU 2016-02.BC201]

KPMG observation – 'Cost of money' is not an appropriate discount rate

5.6.180 The cost-of-money rate used to reimburse entities that are required to comply with the Cost Accounting Standards and the Federal Acquisition Regulation is not an appropriate proxy for the discount rate in the lease. This is because it is not necessarily linked to the lessor's implicit rate or to the lessee's incremental borrowing rate. [ASU 2016-02.BC202]

Comparison with current US GAAP

Use of lessor's implicit rate when it is higher than lessee's incremental borrowing rate

5.6.190 Topic 842 requires the lessee to discount future lease payments using the rate implicit in the lease when it is readily determinable even if it is higher than the lessee's incremental borrowing rate. Current US GAAP, like Topic 842, requires the lessee to use the rate implicit in the lease if it is practicable to do so, but only if that rate does not exceed the lessee's incremental borrowing rate. [840-10-25-31(b)]

5.6.200 This is a difference between Topic 842 and current US GAAP that, in theory, could result in a lessee recognizing smaller lease assets and lease liabilities and that could also affect lease classification – i.e. because the present value of the lease payments and any lessee residual value guarantee would be less using a higher discount rate. However, because of the infrequency with which lessees will likely be able to determine the rate implicit in the lease, the circumstances in which a lessee uses a rate implicit in the lease that is higher than its incremental borrowing rate are likely to be rare.

Required use of a secured incremental borrowing rate

5.6.210 The definition of incremental borrowing rate in Topic 842 requires that the rate reflect a secured borrowing rate – i.e. on a 'collateralized basis'. Under current US GAAP, the lessee can generally use a secured or unsecured rate as long as it is consistent with the financing that would have been used had the underlying asset been purchased, rather than leased. Therefore, current US GAAP does not require the use of a secured borrowing rate like Topic 842 does. [840 Glossary]

'Funds necessary to purchase the leased asset' versus 'an amount equal to the lease payments'

5.6.220 The current US GAAP definition of incremental borrowing rate refers to the rate that the lessee would have incurred to borrow the funds necessary to purchase the *leased asset*. Conversely, the new standard states that the incremental borrowing rate is that which the lessee would pay to borrow on a collateralized basis over a similar term an amount equal to the *lease payments*. [840 Glossary]

5.6.230 This change to the definition of incremental borrowing rate arose because under Topic 842 lessees will be capitalizing most leases, rather than just capital leases. As a result, the Board concluded that the interest rate a particular entity, with its individual credit rating and other entity-specific circumstances, might have to pay to borrow the funds necessary to purchase the underlying asset in many operating lease scenarios (e.g. a three- or five-year lease of real estate or a long-lived asset such as a ship or an airplane) may differ substantially from the interest rate that same entity would pay to borrow an amount equal to the lease payments (i.e. the rate to finance the purchase of the underlying asset would typically be higher).

5.6.240 Therefore, the current US GAAP definition of incremental borrowing rate, if used in Topic 842, would likely have resulted in discount rates unrelated to the lessor's pricing in the lease (for which the incremental borrowing rate is intended to serve as a readily determinable proxy) and in inappropriately measured lease assets and lease liabilities.

Initial direct costs and the rate implicit in the lease

5.6.250 Under current US GAAP, the rate implicit in the lease does not take into account the lessor's initial direct costs. As defined in Topic 842, the rate implicit in the lease will be lower than that determined under current US GAAP when the lessor defers initial direct costs. However, this difference is mechanical in nature; instead of separately deferring initial direct costs for sales-type and direct financing leases as under current US GAAP, the initial direct costs are automatically included in the lessor's net investment in the lease through the determination of the implicit rate. Lease income and the lessor's net investment in the lease are unaffected by this change in mechanics. [840 Glossary]

5.7 Economic life of the underlying asset

5.7.10 The economic life of an asset is either the period over which the asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from the asset by one or more users. [842 Glossary]

KPMG observation – Economic life is different from useful life

5.7.20 In contrast to the definition of economic life, the useful life of an asset is the period over which the asset is expected to contribute directly or indirectly to future cash flows. The useful life of an asset can differ depending on the asset's intended use by its current owner. [842 Glossary]

5.7.30 Consistent with current US GAAP, the Topic 842 definition of economic life will result in a period that is at least as long as, and typically longer than, the US GAAP definition of useful life.

KPMG observation – Economically usable

5.7.40 'Economically usable' is not a defined term in US GAAP. However, this phrase, when used in the existing definition of economic life, generally refers to the period over which the asset is expected to be economically viable because the benefits it can produce exceed the costs to replace it or undertake major repairs or an overhaul.

KPMG observation – By one or more users

5.7.50 The phrase 'by one or more users' is intended to convey that the economic life of an asset is an assessment that considers the perspective of the current lessee or owner *and* any future lessees or owners.

Comparison with current US GAAP – Definition of estimated economic life

5.7.60 The current US GAAP definition of estimated economic life for purposes of lease classification is "[t]he estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at lease inception, without limitation by the lease term." [840 Glossary]

5.7.70 This differs from the Topic 842 definition of economic life; for example, because the Topic 842 definition does not refer to 'normal repairs and maintenance' or to 'the purpose for which it was intended at lease inception'. However, the two definitions will likely result in similar conclusions in most cases. We believe that the Board did not intend to change current practice with respect to the application of economic life; instead, the wording changes were made to align the wording of the definition with IFRS.

5.8 Portfolio approach

5.8.10 A lessee or lessor may apply the guidance in Topic 842 to a portfolio of leases with similar characteristics (size and composition) if the entity reasonably expects that the application of the leases model to the portfolio will not differ materially from the application to the individual leases in that portfolio. [842-20-55-18 – 55-20, ASU 2016-02.BC120–BC121]

Example 5.19
Applying the portfolio approach to leases of computer servers

5.8.20 Lessee LE provides IT services, including cloud computing services, to a wide variety of customers. During March 201X, LE entered into a total of 50 individual leases of vehicles for its salesforce. The 50 leases have terms ranging from four to five years, commence on different dates (within the span of a calendar quarter), and annual lease payments of between $5,000 and $6,000 for each vehicle.

5.8.30 Because there is a narrow range of fair values and estimated remaining economic lives for the vehicles, LE reasonably expects that the effect of applying the requirements of Topic 842 to its 50 vehicle leases as a portfolio will not differ materially from applying the requirements individually to each lease. Therefore, LE decides to use a portfolio approach in determining the discount rate for each of the 50 leases. Therefore, LE will use a single discount rate in applying the measurement requirements in Topic 842 to each of the 50 leases in the portfolio.

5.8.40 Because LE is unable to determine the rate implicit in the 50 leases (see section 5.6), it uses its incremental borrowing rate. LE determines its incremental borrowing rate to be 4.25% based on the collateral represented by a representative one of the 50 vehicles and an average of the lease payments for each vehicle (i.e. an amount between $5,000 and $6,000).

KPMG observation – Portfolio approach guidance aligns with Topic 606

5.8.50 The portfolio approach permitted in applying Topic 842 is, and was intended by the Board to be, substantially similar to that included in the new revenue recognition standard, which allows entities to apply the accounting for an individual contract with a customer to a portfolio of contracts under similar circumstances. [ASU 2016-02.BC120–BC121]

KPMG observation – Cost versus benefits of applying a portfolio approach

5.8.60 The Board does not expect entities to perform quantitative evaluations to determine whether the portfolio approach differs materially from the application of Topic 842 to the individual leases in that portfolio. Instead, entities should be able to take a reasonable approach, applying judgment in selecting the size and composition of the portfolio (e.g. type of underlying asset, lease term, geographic locations, etc.). [ASU 2016-02.BC120–BC121]

5.8.70 The Board noted that the cost relief of applying the portfolio approach could be particularly high for certain aspects of Topic 842 that involve judgments and estimates, such as determining the discount rate or determining and reassessing the lease term. For example, an entity may establish a single discount rate applied to all leases in a portfolio because using that discount rate would not result in a materially different outcome than using a discount rate determined on a lease-by-lease basis. Example 2 in Subtopic 842-20 demonstrates application of the portfolio approach to determining the discount rate. [ASU 2016-02.BC120–BC121]

KPMG observation – Assessing impairment for right-of-use assets within a lease portfolio

5.8.80 During deliberations of the portfolio approach, the Board expressed a view that if some, but not all, right-of-use assets within a lease portfolio are impaired, it would be inappropriate to continue to account for those leases within a portfolio if the impairment is material to the entity. To remove the material difference at the portfolio level, an entity will need to disaggregate the portfolio into smaller portfolios or apply the leases guidance on a lease-by-lease basis. This will ensure that the portfolio is not aggregated above the level at which impairment is measured – i.e. a cash-generating unit under IFRS or an asset group under US GAAP.

US GAAP different from IFRS – Portfolio approach guidance is non-authoritative under US GAAP

5.8.90 The IASB chose to include the portfolio approach guidance for lessors and lessees in the application guidance of IFRS 16, which is authoritative under IFRS. In contrast, the FASB chose to discuss the application of a portfolio approach principally in the basis for conclusions of Topic 842, which is not authoritative under US GAAP. However, Example 2 in Subtopic 842-20, which is within the authoritative implementation guidance, illustrates the use of a portfolio approach for a group of computer server leases. [IFRS 16.B1]

6 Lessee accounting

How the standard works

- A lessee recognizes on its balance sheet a (financial) lease liability and a (nonfinancial) right-of-use asset for all leases, including operating leases, with a term greater than 12 months.
- The lease classification distinction (operating versus finance lease) continues to exist in Topic 842 and now affects how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet.

	Balance sheet	Income statement	Profile of total lease cost
Finance lease	– ROU asset – Lease liability	– **Operating expense:** Amortization of ROU asset – **Interest expense:** Interest expense on lease liability	– Front-loaded
Operating lease	– ROU asset – Lease liability	– **Operating expense:** Lease expense	– Generally straight-line

6.1 An overview

Step 1: Determine the 'lease term' (section 5.3)	The lease term is integral to determining: – Whether the lease is a short-term lease – The lease payments and the discount rate for the lease – Lease classification
Step 2: Determine the 'lease payments' (section 5.4)	The lease payments are integral to: – Determining the discount rate for the lease – Determining lease classification – Measuring the right-of-use asset and the lease liability for a lease
Step 3: Determine the discount rate for the lease (section 5.6)	The discount rate for the lease affects: – Lease classification – Measurement of the right-of-use asset and lease liability
Step 4: Lease classification (section 6.2)	Lease classification determines: – How a lessee measures and presents lease expense and cash flows – How a lessee measures the right-of-use asset after initial recognition
Step 5: Initial recognition and measurement (section 6.3)	– Lessee recognizes a right-of-use asset and a lease liability at the commencement date of the lease (unless the lease is a short-term lease) – The right-of-use asset and lease liability for finance and operating leases are initially measured in the same way
Step 6: Subsequent accounting (section 6.4)	– Subsequent measurement of the lease liability is the same for finance and operating leases – Subsequent measurement of the right-of-use asset differs for finance and operating leases
Step 7: Impairment testing (section 6.5)	– Right-of-use assets are evaluated for impairment using the long-lived assets impairment guidance (Topic 360) – Impairment of an operating lease right-of-use asset substantially changes the subsequent accounting for the lease
Steps 8A and 8B: Reassessments and modifications (sections 6.6 and 6.7)	– Lessees may be required to revise the accounting for a lease during the lease term, even if there are no lease modifications – Lessee accounting for lease modifications depends on the nature of the modification
Step 9: Presentation (section 6.8)	– Finance and operating leases are presented differently in the financial statements

6.1.10 The steps in the chart help frame the big picture of lessee accounting that is applied to separate lease components, which is the unit of account in applying Topic 842 (see section 4.1). Steps 1 to 3 deal with concepts and definitions that apply to both lessee and lessor accounting; therefore, they are included in chapter 5 as an introduction to both accounting models. Each of Steps 4 to 9 is discussed in more detail in this chapter.

KPMG observation – A more faithful financial statement representation of leases

6.1.20 Topic 842 was developed *principally* to improve financial statement users' understanding of lessees' lease obligations. In the Board's view, the recognition of right-of-use assets and lease liabilities for all leases other than short-term leases (see section 6.3.1) will:

- result in a more faithful representation of the rights and obligations arising from leases;
- improve the understanding and comparability of lessees' financial commitments regardless of how the lessee finances the assets used in its business; and
- reduce opportunities for entities to structure leases to achieve a particular accounting outcome on the balance sheet. [ASU 2016-02.BC8]

KPMG observation – Impact on key performance ratios and financial covenants

6.1.30 The requirement to recognize additional assets and liabilities arising from lease transactions may affect some key performance ratios commonly used in credit and investment-making decisions. For example, the additional lease assets and lease liabilities are likely to result in:

- lower liquidity ratios, such as the *current ratio* (current assets ÷ current liabilities) and *quick ratio* ((cash + short-term investments + receivables) ÷ current liabilities) because of increased current liabilities (current portion of the lease liabilities); and
- higher *working capital turnover* (revenue ÷ average working capital) due to reduced working capital because the lease liability is partially current, and a lower *asset turnover* (revenue ÷ average total assets) due to increased total assets.

6.1.40 Changes to a lessee's balance sheet resulting from the new requirements may impact a lessee's compliance with financial covenants. The existence and magnitude of the impacts will depend on lessee-specific facts and circumstances.

6.1.50 However, most financial statement users (e.g. investors and analysts) already adjust lessees' financial statements for operating lease obligations, often overestimating lease obligations compared to what will be recognized under Topic 842.

6.1.60 The Board believes that the effects of Topic 842 on financial covenants will not be significant, in part because many loan agreements contain provisions preventing or minimizing defaults solely due to a change in accounting standards; but also because operating lease liabilities are considered operating liabilities under Topic 842 rather than debt. [ASU 2016-02.BC14]

6.1.70 Categorizing operating lease liabilities as operating liabilities, rather than debt, may mean that Topic 842 will not have a significant effect on debt-based ratios such as:

- debt-to-capital ratio (total debt ÷ (total debt + total equity)) and debt-to-equity ratio (total debt ÷ total equity); and
- weighted-average cost of capital (WACC). [ASU 2016-02.BC14]

6.1.80 However, entities currently negotiating debt or similar arrangements that will contain financial covenants may nonetheless want to consider the adoption of Topic 842 in their negotiations of financial covenants.

6.2 Lease classification (Step 4)

6.2.10 A lessee determines lease classification for each separate lease component, which is the unit of account in applying Topic 842 (see section 4.1), at the commencement date of the lease (see section 5.1). [842-10-25-1]

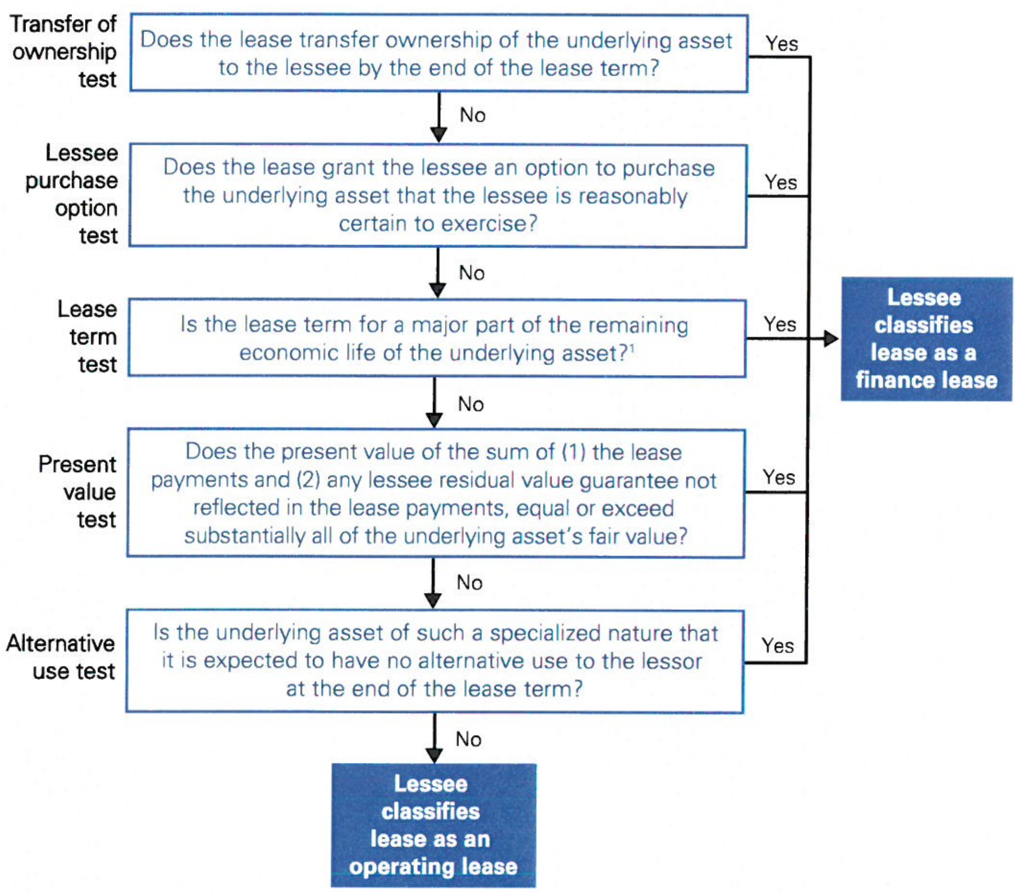
6.2.20 The lessee accounting model in Topic 842 is generally intended to classify leases as finance leases when the lease is economically similar to the purchase of a nonfinancial asset. This would be the case when the lessee effectively obtains control of the underlying asset (rather than merely obtaining control over its *use* for the lease term) by being able to direct its use and obtain substantially all of its remaining benefits as a result of the lease. [ASU 2016-02.BC56, BC70]

6.2.30 However, in determining lease classification, there is no separate or additional evaluation of this underlying principle. The Board decided that a lease is classified as a finance lease when any one (or more) of five specified tests are met, even if an entity does not believe that the lessee effectively obtains control of the underlying asset as a result of the lease. [ASU 2016-02.BC70–BC71]

6.2.40 Lease classification is not reassessed after the commencement date unless either:

- there is a change in the assessment of either (1) the lease term, or (2) whether it is reasonably certain that a lessee purchase option will be exercised (see section 6.6); or
- the contract that is or contains the separate lease component is modified and that modification is not accounted for as a separate contract (see section 6.7). [842-10-25-1]

6.2.50 The following are the lease classification tests that are applied by lessees. [842-10-25-2 – 25-3]



Note 1:

If the commencement date is at or near the end of the underlying asset's economic life, this test does not apply.

Transfer of ownership test

6.2.60 The transfer of ownership test is met in leases that require:

- the lessor to release the underlying asset from the lease and to transfer ownership to the lessee, upon lessee's performance in accordance with the terms of the lease; or
- the lessee to pay a nominal amount in connection with ownership transfer of the underlying asset (e.g. a minimum statutory fee to transfer ownership). [842-10-55-4 – 55-5]

6.2.70 When ownership of the underlying asset transfers to the lessee only if the lessee elects to pay a specified fee (whether nominal or otherwise) to complete the transfer, it is considered a purchase option that is evaluated the same way as any other lessee purchase option (see 6.2.80). [842-10-55-6]

Lessee purchase option test

6.2.80 The lessee purchase option test is met if it is reasonably certain that the lessee will exercise the option. 'Reasonably certain' is a high threshold of probability, and the Board intended the parties to account for lessee options only when the lessee has a compelling economic reason to exercise the option. For further discussion, see section 5.2. [842-10-30-1]

Lease term test

6.2.90 An entity may use the following thresholds when evaluating the lease term test.

- 75 percent or more of the remaining economic life may be considered a major part of the remaining economic life of that underlying asset.
- A lease that commences with 25 percent or less of the underlying asset's total economic life remaining may be considered to commence at or near the end of the asset's economic life. [842-10-55-2]

6.2.100 When a single lease component contains the right to use more than one underlying asset (see section 4.1), an entity considers the remaining economic life of the predominant asset in the lease component when applying the lease term test. The assessment of which underlying asset is predominant is a qualitative one that requires entities to conclude on the most important element of the lease, which the Board expects to be relatively clear in most cases. If an entity is unable to identify the predominant asset, it might be an indicator that there are additional separate lease components in the contract. [842-10-25-5, ASU 2016-02.BC74]

Present value test

6.2.110 An entity may use a threshold of 90 percent or more when determining what constitutes 'substantially all' of the fair value of the underlying asset. [842-10-55-2]

6.2.120 When evaluating lease classification, the fair value of the underlying asset excludes any related investment tax credit retained, and expected to be realized, by the lessor. [842-10-55-8]

6.2.130 In some cases, it may not be practicable for a lessee to determine the fair value of the underlying asset – i.e. a reasonable estimate of fair value cannot be made without undue cost or effort. Topic 842 notes that practicability is a dynamic concept in that:

- what is practicable for one entity may not be practicable for another;
- what is practicable in one period may not be practicable in another; and
- what is practicable for one underlying asset (or class of underlying asset) may not be practicable for another. [842-10-55-3]

6.2.140 When it is not practicable for an entity to determine the fair value of the underlying asset, lease classification is determined without consideration of the present value test. [842-10-55-3]

Alternative use test

6.2.150 In assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term, an entity considers the effect of contractual restrictions and practical limitations on the lessor's ability to readily direct the underlying asset for another use.

- Contractual restrictions on a lessor's ability to redirect an asset must be substantive (i.e. enforceable) for the asset not to have an alternative use to the lessor.
- Practical limitations exist if the lessor would incur significant economic losses to direct the underlying asset for another use. A significant economic loss could arise because the lessor either would incur significant costs to rework the asset that exceed the economic benefits it would be able to derive from that rework, or would only be able to sell or re-lease the asset at a significant loss. This might occur, for example, with assets that have unique design specifications or that are located in remote areas. [842-10-55-7]

6.2.160 The possibility of a contract with the lessee being terminated is not a relevant consideration for determining whether the lessor would be able to readily direct the underlying asset for another use. [842-10-55-7]

6.2.170 When an underlying asset has no alternative use to the lessor at the end of the lease term, the lessee consumes all (or substantially all) of the remaining benefits from the underlying asset. Absent significant rework or a change in circumstances during the lease term (e.g. the emergence of another potential customer or a new use for the underlying asset in its present, specialized form), there are no (or minimal) remaining benefits inherent in the underlying asset that revert to the lessor at the end of the lease term. Even if such a change in circumstances does occur during the lease term, classification of the lease is not reassessed. [ASU 2016-02.BC71(e)]

Lease of an acquiree

6.2.180 The acquirer retains the acquiree's lease classification, unless the lease is modified as part of the business combination and that modification is not accounted for as a separate contract – see section 6.7 (modifications). [842-10-55-11]

Related party leases

6.2.190 An entity classifies a lease between related parties on the basis of the legally enforceable terms and conditions of the lease. An entity does not classify the lease based on an evaluation of its economic substance. The classification and accounting for the leases should be the same as for leases between unrelated parties in the separate financial statements of the related parties. [842-10-55-12]

Facilities owned by a governmental unit or authority

6.2.200 Because of special provisions normally present in leases of terminal space and other airport facilities owned by a governmental unit or authority, the economic life of such facilities for lease classification purposes is in effect indeterminate. It may also not be practicable to determine the underlying asset's fair value. Accordingly, these leases are classified as operating leases if:

- they do not transfer ownership of the underlying asset to the lessee by the end of the lease term; and
- it is not reasonably certain that the lessee will exercise an option (if there is one) to purchase the underlying asset. [842-10-55-13]

6.2.210 This guidance also applies to leases of other facilities (e.g. ports and bus terminals), but only if *all* of the following conditions are met:

- the underlying asset is owned by a governmental unit or authority;
- the underlying asset is part of a larger facility (e.g. an airport), operated by or on behalf of the lessor;
- the underlying asset is a permanent structure or a part of a permanent structure (e.g. a building), that could not normally be moved to a new location;
- the lessor (or a higher governmental authority in some circumstances) has the explicit right under the lease agreement or existing statutes or regulations applicable to the underlying asset to terminate the lease at any time during the lease term (e.g. by closing or taking possession of the facility);
- the lease neither transfers ownership nor allows the lessee to purchase or otherwise acquire ownership of the underlying asset; and
- the underlying asset or equivalent asset in the same service area cannot be purchased or leased from a nongovernmental unit or authority. [842-10-55-13]

6.2.220 Leases of underlying assets that do not meet all of the above criteria are assessed using the same criteria for classifying leases that do not involve government-owned property. [842-10-55-14]

Indemnification for environmental contamination

6.2.230 Lessee indemnification for environmental contamination, whether for environmental contamination caused by the lessee during its use of the underlying asset over the lease term or for pre-existing environmental contamination, does not affect lease classification. [842-10-55-15]

Example 6.1

Lease classification – Lease term test

6.2.240 Lessee LE and Lessor LR enter into a lease of a piece of used, non-specialized production equipment. The following facts are relevant at the lease commencement date.

– Transfer of ownership:	No
– Renewal/purchase options:	None
– Total economic life of equipment:	20 years
– Residual value guarantee:	None
– LE's incremental borrowing rate:	5% (implicit rate cannot be readily determined)
– Initial direct costs:	None

6.2.250 In addition, LE evaluates lease classification using the bright-line thresholds – i.e. the 75%, 25%, and 90% thresholds for the lease term and present value tests (see 6.2.90 and 6.2.110).

Scenario 1: Lease does not begin near the end of the asset's economic life	Scenario 2: Lease begins near the end of the asset's economic life
6.2.260 **Additional facts** – Non-cancellable 5-year lease term. – Equipment has a remaining economic life of 6 years at lease commencement. – Equipment has a fair value of $30,000 at lease commencement. – Present value of lease payments discounted at 5% is $24,245 (fixed lease payments of $5,600 per year in arrears).	6.2.280 **Additional facts** – Non-cancellable 4-year lease term. – Equipment has a remaining economic life of 4.5 years at lease commencement. – Equipment has a fair value of $25,000 at lease commencement. – Present value of lease payments discounted at 5% is $21,276 (fixed lease payments of $6,000 per year in arrears).
6.2.270 **Lease classification** LE classifies the lease as a **finance lease** based on the following. – Transfer of ownership test – No – Lessee purchase option test – N/A – Lease term test – Yes (83%) – Present value test – No (81%) – Alternative use test – No	6.2.290 **Lease classification** LE classifies the lease as an **operating lease** based on the following. – Transfer of ownership test – No – Lessee purchase option test – N/A – Lease term test – N/A (lease commencement falls at or near the end of the equipment's economic life) – Present value test – No (85%) – Alternative use test – No

Example 6.2
Lease classification – Present value test

6.2.300 Lessee LE and Lessor LR enter into a lease of a truck. The following facts are relevant at the lease commencement date.

– Non-cancellable lease term:	7 years
– Lease payments:	Fixed payments of $2,710 per year in arrears
– Transfer of ownership:	No
– Renewal/purchase options:	None
– Fair value of truck:	$28,272
– Total economic life of truck:	20 years
– Remaining economic life of truck:	10 years
– LE's incremental borrowing rate:	4.5% (implicit rate cannot be readily determined)
– Initial direct costs:	None
– Residual value guarantee (lessee):	Guarantees residual value of $14,545
– Amount probable of being owed under residual value guarantee:	$1,818
– Present value of the lease payments + residual value guarantee:	$26,657 = PV of the 'lease payments' of $17,305 ([$2,710 x 7] + $1,818 at end of Year 7, discounted at 4.5%) + PV of the amount of the RVG not already included in the lease payments of $9,352 ($12,727 [$14,545 - $1,818] at end of Year 7, discounted at 4.5%)

6.2.310 In addition, LE evaluates lease classification using the bright-line thresholds – i.e. the 75%, 25%, and 90% thresholds for the lease term and present value tests (see 6.2.90 and 6.2.110).

6.2.320 **Lease classification**

LE classifies the lease as a **finance lease** based on the following.

- Transfer of ownership test – No
- Lessee purchase option test – N/A
- Lease term test – No (70%)
- Present value test – Yes (94%, or $26,657 ÷ $28,272)
- Alternative use test – No

Example 6.3
Lease classification – Alternative use test

6.2.330 Lessor LR enters into a contract to customize a piece of production equipment for Lessee LE's specific needs and then to lease LE that equipment for five years. At the end of five years, LR would incur significant costs to rework the design and functionality of the equipment to be able to lease or sell that equipment to another customer that it is unlikely to be able to recover.

6.2.340 The lease is classified as a finance lease by LE (and a sales-type lease by LR). This is regardless of both the other terms and conditions of the lease, and other facts – i.e. regardless of the lease term, the lease payments, whether the lease includes a purchase option, etc.

KPMG observation – Judgment in applying lease term and present value classification tests

6.2.350 The Board decided to *permit*, rather than *require*, the use of bright-line thresholds when evaluating the lease term and present value classification tests. In deciding to permit use of these thresholds, the Board observed that entities need to operationalize the guidance in a scalable manner, which requires the establishment of internal accounting policies and controls. However, because these thresholds are characterized as only one reasonable approach to interpreting what 'major part', 'substantially all', and 'at or near the end' mean, entities are permitted to exercise judgment. That means, for example, that amounts below 90 percent could be considered substantially all in the context of the present value test or that a lease term that is less than 75 percent of the remaining economic life of the underlying asset could be considered a major part of the asset's remaining economic life in the lease term test. [ASU 2016-02.BC73]

6.2.360 Determining reasonable thresholds will require the exercise of judgment. However, in general, we believe that straying from these bright-lines by any significant amount will raise the risk of being questioned about the judgment reached.

Lease term test

6.2.370 Consideration of the control classification principle may be useful in determining an appropriate threshold for applying the lease term test. That is, when considering what might be an acceptable threshold (i.e. other than 75%), an entity should consider that the classification test is intended to capture, as finance (sales-type) leases, those leases that give the lessee the ability to both (1) direct the use of the underlying asset and (2) obtain substantially all of the remaining benefits of the underlying asset. [ASU 2016-02.BC70]

6.2.380 This is because, in determining the qualitative threshold for the lease term test (i.e. 'major part' rather than 'substantially all'), the Board considered that most assets, particularly equipment, decline in value in a front-loaded manner; this means that the earlier years of an asset's economic life provide a disproportionate percentage of the remaining benefits from the underlying asset. Consequently, an entity that controls the use of an asset for only a *major part* of its remaining economic life may still have the ability to direct its use to obtain substantially all of its remaining benefits. [ASU 2016-02.BC71(c)]

6.2.390 That major part was intended to be a substantively lower threshold than substantially all, also evidenced by the fact that the 75 percent bright-line threshold for a major part is significantly lower than the 90 percent bright-line threshold for substantially all. This means that, potentially, a qualitative evaluation of what constitutes a major part of the asset's economic life should consider the pattern in which the asset is expected to experience a diminution in economic utility or value. This evaluation may differ for different classes of underlying assets; for example, it might be less than 75 percent for an asset with a more front-loaded dimunition in economic utility or value, but more than 75 percent for an asset that holds its economic utility or value more steadily over time.

At or near the end of the economic life

6.2.400 In general, because there is no guidance provided about what *at or near the end* means other than the 25 percent bright-line threshold provided in the implementation guidance, we believe that entities generally should adhere to the bright-line threshold provided of 25 percent. Unlike for the lease term test, the classification principle provides no insight into how to interpret this threshold because the 'at or near the end of the economic life' exception is *contrary* to the classification principle, rather than an application of that principle, and was adopted for cost-benefit reasons. [ASU 2016-02.BC71(c)]

Present value test

6.2.410 In general, we believe that there is little leeway from the 90 percent bright-line threshold in evaluating the present value test. This is because, unlike 'major part' or 'at or near the end', 'substantially all' is used elsewhere in US GAAP and is interpreted on a mostly consistent basis to mean approximately 90 percent; this includes when thinking about whether a customer is obtaining substantially all of the remaining benefits from an asset in other Topics.

KPMG observation – Alternative use test

6.2.420 The alternative use test is new in Topic 842; current US GAAP has no equivalent. As such, it has not previously been applied in practice. The following are observations based on the basis for conclusions, as well as the guidance in Topic 606, which includes a similar alternative use notion from which the one in Topic 842 is derived. [ASU 2016-02.BC71(e)]

Alternative use test infrequently met on its own

6.2.430 The basis for conclusions states, "In general, it is expected that lessors would lease specialized assets that have no alternative use to them at the end of the lease term only under terms that would transfer substantially all the benefits (and risks) of the asset to the lessee (thus, one of the other criteria for a finance lease also likely will be met)." [ASU 2016-02.BC71(e)]

6.2.440 We believe that this statement is instructive to applying this new test for two reasons.

- It suggests that a conclusion that this test is met without meeting or nearly meeting any of the other accompanying tests may be worthy of further consideration; for example, when the lease term is *almost* a major part of the remaining economic life of the underlying asset, or the present value of lease payments is *almost* substantially all of the fair value of the underlying asset. That is not, however, to say it cannot be met in isolation.
- It emphasizes that this test is focused on capturing scenarios in which the lessor would have to perform significant rework on the underlying asset, or there would have to be a change in circumstances to redirect it for another use. This means that the underlying asset being of a highly specialized nature or subject to highly specialized circumstances (e.g. being located in a remote area) is, in fact, key to meeting this test. This test is not intended to be a second lease term test whereby it is met solely because the asset will have no alternative use at the end of the lease term because of its age.

Contractual restrictions

6.2.450 Enforceable contractual restrictions on the lessor after the end of the lease term can also affect whether this test is met. However, because the alternative use test explicitly applies only when the underlying asset is highly specialized or subject to highly specialized circumstances, we believe that contractual restrictions (e.g. preventing the lessor from re-leasing or selling the asset to another customer) *alone*, without the asset being of a highly specialized nature or subject to highly specialized circumstances, would not meet this test.

6.2.460 Rather, contractual restrictions can affect the evaluation of this test because even a highly specialized asset may have an alternative use to the lessor at the end of the lease term; for example, there may be other customers, even if only a few, that could lease or purchase the asset. A contractual restriction may be placed on the lessor if the lessee designed some of the specifications or paid the lessor a premium to develop or include those specifications in the asset; in that case, the lessee may require the restriction to prevent a competitor from benefitting from its investment in the asset. If that contractual restriction is enforceable, even though the asset could be redirected for an alternative use, then this test would be met.

Completed asset

6.2.470 Under Topic 606, when considering whether a good or service that will be transferred to the customer has an alternative use to the seller, the seller considers the characteristics of the asset that will ultimately be transferred to the customer. Therefore, this test can be met for an asset that only becomes customer-specific at or near the end of the production, modification, or customization process.

6.2.480 The equivalent notion under Topic 842 is to consider the characteristics of the underlying asset that will ultimately be returned to the lessor at the end of the lease term. While lease classification is assessed at lease commencement, we believe that the assessment considers all relevant expectations about customizations or modifications that will be made during the lease term, and that will affect the characteristics of the underlying asset at the point in time it is returned to the lessor. For example, if there is an agreement for the lessor to make significant customizations after the commencement date that will result in the underlying asset not having an alternative use to the lessor at the end of the lease term, those should be considered at lease commencement when performing the alternative use test. We believe that consideration of the asset that will ultimately be returned to the lessor should not take into account customizations or modifications that are not already agreed or committed to at lease commencement. However, if significant customizations or modifications are made after lease commencement, that *may* result in a reassessment of the lease classification, among other things; this is because significant customizations or modifications to an underlying asset will generally trigger a reassessment of any lessee options in the contract (see section 6.6). [606-10-25-28, ASU 2014-09.BC136]

US GAAP different from IFRS – Single lessee accounting model under IFRS 16

6.2.490 Under IFRS 16, a lessee accounts for a lease under a single lessee accounting model. The IASB determined that a single lessee accounting model, under which all leases are finance leases, provides the most useful information to the widest range of financial statement users and results in greater coherency between the primary financial statements. [IFRS 16.BC41–BC56]

6.2.500 IASB members expressed concerns with an operating lease accounting model similar to that in Topic 842 because of the lack of consistency between the items recognized in the balance sheet and those recognized in the income statement (which could have distorted ratio analyses based on the primary financial statements).

- A lessee would recognize a financial liability (lease liability) in the balance sheet but would not present corresponding interest expense in the income statement.
- A lessee would recognize a nonfinancial asset, but would not recognize any amortization or depreciation.
- Either the right-of-use asset or the lease liability would need to be measured as a balancing figure.

6.2.510 Unlike the IASB, the FASB determined that a dual lessee accounting model better depicts economic differences between various leases that should be reflected in the lessee's financial statements. [ASU 2016-02.BC50–BC51]

Comparison with current US GAAP – Similar but not the same

6.2.520 While the lease classification tests in Topic 842 are similar to current US GAAP, there may be differences in lease classification even when a lessee uses the bright-line thresholds – i.e. the 75%, 25%, and 90% thresholds for the lease term and present value tests, respectively (see 6.2.90 and 6.2.110). This is because:

- The alternative use test in Topic 842 does not exist under current US GAAP.
- The exception that applies to the lease term test for leases that commence at or near the end of the underlying asset's economic life applies to both the lease term *and* the present value tests in current US GAAP. Therefore, some leases that would have met the present value test under current US GAAP if it were not for the exception may meet that test, and be classified as a finance lease (or sales-type lease for lessors), under Topic 842.
- Most of the specific asset rules in current US GAAP (e.g. for the classification of a lease involving real estate) have not been carried forward to Topic 842. The only specific rule in current US GAAP carried forward is the exception to the lease term test when the lease commences at or near the end of the asset's economic life.
- There are other differences that are relevant for lessors that are discussed in section 7.2. [840-10-10-1, 25-1 – 25-69]

6.2.530 There are also other changes reflected in Topic 842 that potentially could result in different lease classification compared with current US GAAP, even if the lease classification tests were identical. This is because:

- 'Lease payments' under Topic 842 are not the same as 'minimum lease payments' under current US GAAP. For example, executory costs such as property taxes and insurance are specifically excluded from minimum lease payments under current US GAAP, while some (or all) of the payments made by a lessee to reimburse the lessor's costs of ownership of an underlying asset will be reflected in lease payments under Topic 842 if payment for those costs is fixed (see section 4.6).
- Lease payments under Topic 842 may be an allocated amount when there is more than one component of a contract (see section 4.4).

6.2.540 Finally, lease classification under current US GAAP is determined at lease inception, as opposed to lease commencement. [840-10-25-1]

6.3 Initial recognition and measurement (Step 5)

6.3.10 A lessee recognizes a right-of-use asset and a lease liability at lease commencement. [842-20-25-1]

6.3.20 At lease commencement, the lease liability for both finance and operating leases equals the present value of the unpaid lease payments, discounted at the rate implicit in the lease (if readily determinable), or otherwise at the lessee's incremental borrowing rate. The discount rate for the lease is calculated on the basis of information available at lease commencement. For a discussion on determining the 'lease payments', see section 5.4; and on determining the 'discount rate for the lease', see section 5.6. [842-20-30-1 – 30-3]

Lease liability = **PV of *unpaid* lease payments**

6.3.30 A lessee that is not a public business entity may use a risk-free discount rate for the lease determined based on a comparable period as the 'lease term' (see 5.6.30). This accounting policy, if elected, is applied to all leases. [842-20-30-3]

6.3.40 The right-of-use asset for finance and operating leases is initially measured at the sum of: [842-20-30-5]

Initial measurement of the lease liability + **IDCs** (section 5.5) + **Prepaid lease payments** − **Lease incentives received** (section 5.4.3)

Example 6.4

Initial measurement of the lease liability and right-of-use asset

6.3.50 Lessee LE enters into a contract with Lessor LR for the right to use office space for a 10-year term. The right to use the office space is a lease and there are no other components of the contract. The following facts are relevant at the lease commencement date.

– Lease payments:	Fixed payments of $14,527 per year in arrears, with a 3% increase every year after Year 1
– Renewal options:	5-year extension; payments during that period are $19,523 per year in arrears, with a 3% increase every year after Year 1 of the extended period
– Termination/purchase options:	None
– Transfer of ownership:	No
– Residual value guarantee:	None
– LE's incremental borrowing rate:	10% (the rate implicit in the lease cannot be readily determined)
– Initial direct costs (LE):	$5,000

Contractual payments

6.3.60 For ease of reference in this and subsequent examples, the contractual payments for the right to use the office space are presented here.

Non-cancellable lease period

Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
$14,527	$14,963	$15,412	$15,874	$16,350	$16,841	$17,346	$17,866	$18,402	$18,954

Extension period

Yr 11	Yr 12	Yr 13	Yr 14	Yr 15
$19,523	$20,109	$20,712	$21,333	$21,973

Lease payments

6.3.70 LE concludes, based on all relevant economic factors at the lease commencement date, that it does not have a compelling economic reason to exercise the extension option, and therefore is not reasonably certain to do so. Therefore, the lease term is 10 years and the lease payments are the $166,535 in payments (see table in 6.3.60) that will be made during the 10-year lease term.

Lease liability

6.3.80 At the lease commencement date, LE recognizes a lease liability of $100,000. This is the present value of the 10 lease payments (starting at $14,527 and escalating at 3% per year), discounted at LE's incremental borrowing rate of 10%.

Lease liability	=	PV of *unpaid* lease payments (section 5.4)
$100,000		

Right-of-use asset

6.3.90 LE recognizes a corresponding right-of-use asset of $105,000, which is calculated as follows.

Initial measurement of the lease liability	+	Initial direct costs	+	Prepaid lease payments	−	Lease incentives received
$100,000		**$5,000**		**Nil**		**Nil**

KPMG observation – Recognition date for right-of-use assets and lease liabilities

6.3.100 The recognition of right-of-use assets and lease liabilities at the lease commencement date is consistent with the overall lease accounting model for lessees. A lessee recognizes a lease asset and a lease liability when it obtains control over the use of the underlying asset, which is at the lease commencement date (see section 5.1). [ASU 2016-02.BC182]

6.3.110 A lease may be an onerous contract (e.g. the lease payments exceed the expected benefits to be derived from the use of the asset by the lessee) between inception and commencement date. In that case, the lessee accounts for the contract in accordance with Topic 450 (contingencies), which may require recognition of a liability before the lease commencement date. [ASU 2016-02.BC117, BC182]

6.3.120 In addition, as discussed in chapter 12 (Disclosures), Topic 842 requires a lessee to disclose qualitative information about significant leases that have been entered into as of the reporting date, but that have not yet commenced. [842-20-50-3]

Comparison with current US GAAP – Initial measurement

6.3.130 Under current US GAAP, an entity initially *measures* a lease at lease inception – i.e. the date on which an agreement is reached.

6.3.140 In addition, current US GAAP precludes a lessee in a capital lease from measuring the asset recognized at an amount that is greater than the fair value of the underlying asset at lease inception. That requirement is not included in Topic 842. Consequently, the initial measurement of a right-of-use asset at the commencement date could potentially exceed the fair value of the underlying asset, although this outcome is unlikely. [840-30-30-1, 30-3]

6.3.150 Other differences could arise because 'lease payments' under Topic 842 are not the same as 'minimum lease payments' under current US GAAP (see section 5.4).

6.3.1 Short-term lease recognition exemption

6.3.160 A short-term lease is a "lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise." [842 Glossary]

6.3.170 Although short-term leases are within the scope of Topic 842, a simplified form of accounting is permitted. A lessee can elect, by class of underlying asset, not to apply the recognition requirements of Topic 842 and instead to recognize the lease payments as lease cost on a straight-line basis over the lease term. This is consistent with current US GAAP operating lease accounting. [842-20-25-2]

6.3.180 The lease term and the lease payments are determined in a manner consistent with all other leases (see sections 5.3–5.4). Consequently, the short-term lease exemption may be applied to cancellable leases (e.g. month-to-month, evergreen, and at-will leases) if the lessee is not reasonably certain to renew (or to continue, in the case of a termination option) the lease beyond 12 months. [842-20-25-2]

6.3.190 When the assessment of the lease term or a lessee purchase option changes such that the remaining lease term extends more than 12 months from the end of the previously determined lease term, or it becomes is reasonably certain that the lessee will exercise a purchase option, the lease no longer qualifies for the recognition exemption. In that case, the lessee applies the requirements of Topic 842, including the recognition and measurement requirements, as if the date of the change were the commencement date of the lease. [842-20-25-3]

6.3.200 A lessee is required to disclose each period its lease cost for short-term leases for which it elects the recognition exemption, excluding expenses relating to leases with a lease term of one month or less. [842-20-50-4(c)]

6.3.210 A lessee applying the short-term lease exemption to a class of underlying assets for which it has short-term leases discloses that fact. In addition, if the short-term lease cost for the period is not representative of the lessee's short-term lease commitments, the lessee discloses that fact, and the amount of its short-term lease commitments (see section 12.2). [842-20-50-8]

Example 6.5
Is it a short-term lease?

Scenario 1: Lease meets the definition of a short-term lease

6.3.220 Lessee LE enters into a contract with Lessor LR to lease a piece of non-specialized equipment for 12 months for construction work at one of its factories. The following facts are relevant at lease commencement.

– Lease payments:	Fixed payments of $500 per month in arrears, with a 3% increase every month after Month 1
– Renewal options:	Two 12-month extensions, with no change in payment structure
– Termination options:	None
– Purchase option:	Option to purchase at then-prevailing fair value at any time during the lease.

6.3.230 At lease commencement, LE determines it is not reasonably certain to exercise the renewal options or the purchase option considering all relevant economic factors – i.e. based on the renewal lease payments or the purchase option exercise price, and the nature of the underlying asset as a non-specialized asset with readily available equivalents in the marketplace.

6.3.240 Therefore, the lease is a short-term lease because the lease term is not more than 12 months and LE is not reasonably certain to exercise the purchase option in the contract.

6.3.250 LE has not already elected an accounting policy for short-term leases. On entering into this lease, LE elects to apply the short-term lease exemption to all short-term leases of assets within the same class of underlying asset. Going forward, LE will be required to apply the exemption for all other short-term leases of that class of underlying asset.

6.3.260 In applying the short-term lease exemption, LE recognizes the lease payments as lease cost on a straight-line basis over the lease term.

Scenario 2: Short-term lease that still meets the definition after a reassessment

6.3.270 Continuing from Scenario 1, three months after entering into the lease, Lessee LE expands the scope and duration of construction at its factory so that it is now reasonably certain to exercise the first renewal option for the equipment. The equipment is installed at the factory such that it would be cost-prohibitive to remove and install a replacement piece of equipment to complete the construction work.

6.3.280 The lease continues to qualify as a short-term lease, because the remaining lease term after the reassessment does not extend more than 12 months from the end of the previously determined lease term.

6.3.290 However, if the renewal period had been for 13 months instead of 12, the lease would no longer have qualified as a short-term lease and LE would have been required to apply the requirements of Topic 842 as if the date of the change in assessment of the renewal option were the commencement date. In that case, LE would have recognized and measured at the end of Month 3 a lease liability and a right-of-use asset for the equipment lease (reflecting a lease term of 22 months).

Scenario 3: Lease does not meet the definition of a short-term lease

6.3.300 Lessee LE enters into a contract with Lessor LR to lease a car. The lease term is nine months and LE has the option to renew the lease for another six months. At lease commencement, LE is reasonably certain to exercise the renewal option.

6.3.310 The lease does not meet the definition of a short-term lease because the lease term is 15 months.

Example 6.6
Leases with termination options

Scenario 1: Termination option controlled by lessor

6.3.320 Lessee LE enters into a contract with Lessor LR to lease a jackhammer. The lease is for 10 months and is automatically renewed for a further six months unless the lease is terminated by LR.

6.3.330 Periods covered by an option to extend (or not to terminate) the lease where exercise of the option is controlled by the lessor are included in the lease term (see section 5.3). Accordingly, the lease term is 16 months. Therefore, the lease does not meet the definition of a short-term lease because the lease term is more than 12 months.

Scenario 2: Termination option controlled by lessee

6.3.340 Assume the same facts as in Scenario 1, except that the decision about whether to terminate the lease after 10 months is Lessee LE's (rather than Lessor LR's). At lease commencement, LE is not reasonably certain to continue the lease beyond the 10-month non-cancellable term based on all relevant economic factors – i.e. LE is not reasonably certain to not exercise the termination option.

6.3.350 The lease term is 10 months. Therefore, the lease meets the definition of a short-term lease because the lease term is not more than 12 months.

KPMG observation – Exemption may not create significant structuring opportunities

6.3.360 The Board considered the possibility of leases being structured to meet the definition of a short-term lease. However, there are economic considerations that are likely to affect the appetite that both the lessee and the lessor have to structure short-term leases. For example, lessors who enter into short-term leases will take on more residual asset risk, and therefore may require increased lease payments to mitigate that risk. Other lessors may refuse to take on that additional risk entirely or be unable to do so based on the terms of their financing arrangements to acquire the leased assets. [ASU 2016-02.BC381]

KPMG observation – Short-term lease exemption does not necessarily mean 'business as usual' for those leases

6.3.370 For leases with a non-cancellable period of 12 months or less that include renewal options (including options not to terminate the lease) and/or purchase options, the 'reasonably certain' assessment (see section 5.2) will, in effect, become the on-/off-balance sheet test for these leases if the lessee elects the short-term lease exemption. Therefore, lessees with leases of that nature that elect the exemption will need to have processes and internal controls in place to ensure that the exemption is applied appropriately and, because the exemption is an accounting policy election, is applied consistently to all similar leases.

6.3.380 In addition, the specific disclosure requirements applicable to short-term leases mean that lessees will need processes and controls in place to accumulate and maintain the information necessary to comply with those disclosure requirements. This includes processes to differentiate short-term leases (i.e. those with a lease term of 12 months or less) from very short-term leases (i.e. those with a lease term of one month or less), the costs of which are not disclosed in the short-term lease cost disclosure. The disclosures are discussed in section 12.2.

US GAAP different from IFRS – Exemptions

Lessee purchase options

6.3.390 The definition of a short-term lease in IFRS 16 states that a lease that contains a lessee option to purchase the underlying asset is not a short-term lease. This is different from the definition of a short-term lease in Topic 842, which only precludes short-term lease categorization if the lessee is reasonably certain to exercise its option to purchase the underlying asset. [IFRS 16.A]

Changes in short-term lease categorization

6.3.400 Both IFRS 16 and Topic 842 require lessees to re-evaluate whether a lease qualifies as a short-term lease in the event that the lease is modified or there is a change in the lease term. However, Topic 842 also states that a lease is no longer a short-term lease if it becomes reasonably certain that the lessee will exercise an option to purchase the underlying asset. This additional provision is unnecessary under IFRS 16 because any lessee purchase option precludes short-term lease categorization. [IFRS 16.7]

6.3.410 Under Topic 842, a short-term lease only loses that categorization if the change in the lease term results in the remaining lease term being more than 12 months beyond *the end of the previously determined lease term*. The FASB decided on this approach because it was concerned that a lessee might exercise a renewal option prior to the end of the existing lease term and the FASB did not want that action alone to trigger the recognition and measurement requirements of Topic 842 for that lease. Therefore, if a lessee has a 12-month lease and exercises a 12-month renewal option 30 days before the end of the initial 12-month lease term, the remaining lease term at the date of the option exercise would be 13 months. However, the lease would still qualify as a short-term lease.

6.3.420 In contrast, a short-term lease is assessed as a new lease under IFRS 16 if the lease is modified or there is any change in the lease term (e.g. the lessee exercises an option not previously included in its determination of the lease term). It is presently unclear, under IFRS 16, in the example in 6.3.410, whether the lease would continue to qualify as a short-term lease. [IFRS 16.7]

Exemption for leases of low-value assets under IFRS 16

6.3.430 Under IFRS 16, a lessee is permitted not to apply the recognition and measurement requirements to leases of assets that are of low value when new. This exemption, unlike the short-term lease exemption, can be made on a lease-by-lease basis. The exemption permits a lessee applying IFRS 16 to account for qualifying leases in the same manner as existing operating leases. However, if an underlying asset of low value is highly dependent on, or highly interrelated with, other underlying assets, a lessee should not apply the recognition exemption to the lease of that individual asset on the basis that it is not a separate lease component. [IFRS 16.5(b), B3–B8]

6.3.440 In applying IFRS 16, a lessee will not provide the disclosures applicable to other leases (e.g. a maturity analysis of the remaining lease payments) for leases of low-value assets. However, it will disclose low-value asset lease expense (for those leases to which it applies the exemption) for each reporting period presented in the financial statements.

6.3.450 The IASB included the low-value assets lease exemption on the basis that it would provide substantial cost relief for many lessees (and, in particular, smaller entities). The exemption is intended to apply to assets with a value of $5,000 or less when new, such as those of small IT equipment (e.g. laptops, desktops, tablets, mobile phones, individual printers) and office furniture. The exemption is not intended to capture underlying assets such as automobiles and most photocopiers. The exemption applies without regard to materiality (individually or in aggregate) of the leases to the reporting entity. This exemption could have a significant effect on certain industries – e.g. a telemarketing firm that leases a large number of phones and low-value IT equipment. In turn, this may complicate the comparison of financial statements of entities in such industries reporting under US GAAP and IFRS, given the FASB's decision not to provide a similar exemption. [IFRS 16.BC98–BC105]

6.3.460 The FASB decided against a low-value asset exemption because current guidance on materiality permits a lessee to exclude leases that are immaterial to its financial statements. The FASB observed that a lessee may be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, consistent with capitalization thresholds currently used by some entities in other areas of US GAAP (e.g. for capitalizing purchases of property, plant, or equipment).

6.3.470 If a lessee uses capitalization thresholds to account for its leases, it should have processes and controls in place to monitor that the capitalization thresholds used continue to result in an immaterial effect, individually and in the aggregate, on the lessee's financial statements in the current and future periods. While use of capitalization thresholds may be acceptable, we believe that the considerations about how to determine an appropriate capitalization threshold are different for leases from those that apply in determining appropriate capitalization thresholds for purchases of property, plant, or equipment. Specifically, we believe that an entity should independently evaluate the effect on the financial statements of the right-of-use assets and the lease liabilities that would not be recognized. Because non-recognition of liabilities generally has a greater quantitative and qualitative effect on the financial statements than non-recognition of assets, we believe that lease capitalization thresholds would typically need to be lower than those established for the capitalization of property, plant, and equipment.

Comparison with current US GAAP – Short-term leases

Short-term lease exemption not relevant under current GAAP

6.3.480 There is a possibility (albeit remote) that some leases that are classified as capital leases under current US GAAP may qualify for the short-term lease exemption, and therefore be derecognized as a result of the short-term lease exemption. However, the exemption is most likely to apply to current operating leases, which are not required to be recognized on-balance sheet currently.

Similar disclosure requirements

6.3.490 Current US GAAP requires lessees to disclose rental expense for all leases with a lease term of more than one month. Therefore, the requirement to disclose short-term lease cost for all such leases with a term greater than one month is not incremental to the current disclosure requirements. However, the requirement to disclose short-term lease cost each period separately from other lease costs (e.g. operating lease cost and variable lease cost) may involve some incremental effort. [840-20-50-1]

6.4 Subsequent accounting (Step 6)

6.4.1 Finance leases

6.4.10 After lease commencement, a lessee measures the lease liability on an amortized cost basis. The lease liability is increased to reflect interest on the lease liability and decreased to reflect the lease payments made during the period. [842-20-35-1(a)]

6.4.20 Interest on the lease liability is determined each period during the lease term as the amount that results in a constant periodic discount rate on the remaining balance of the lease liability. [842-20-35-1(a)]

6.4.30 After lease commencement, a lessee measures the right-of-use asset at cost, less accumulated amortization and any accumulated impairment losses (see section 6.5). [842-20-35-1(b)]

ROU asset = **Beginning balance** − **Accumulated amortization** − **Accumulated impairment losses**

6.4.40 A lessee amortizes the right-of-use asset on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the future economic benefits of the right-of-use asset. After an impairment, amortization is generally on a straight-line basis based on the carrying amount of the right-of-use asset following the impairment. [842-20-35-7]

6.4.50 In general, amortization of the right-of-use asset is recognized over the period from the commencement date to the earlier of (1) the end of the useful life of the right-of-use asset, or (2) the end of the lease term. However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise a purchase option to acquire the underlying asset, the lessee amortizes the right-of-use asset to the end of the underlying asset's useful life. [842-20-35-8]

6.4.60 A lessee recognizes the following amounts in the income statement each period of the lease term (unless the costs are included in the carrying amount of another asset in accordance with other US GAAP):

- amortization of the right-of-use asset;
- interest on the lease liability;
- variable lease payments in the period in which the obligation is incurred (see 6.4.70); and
- any impairment of the right-of-use-asset (see section 6.5). [842-20-25-5]

6.4.70 For variable lease payments based on the achievement of a specified target, a lessee recognizes the costs in annual periods and in interim periods before the achievement of the specified target that triggers the variable lease payments, to the extent the achievement of that target is considered probable. Variable lease costs recognized are reversed if it becomes probable that the specified target will not be met. [842-20-55-1 – 55-2]

Example 6.7
Subsequent measurement of a finance lease

6.4.80 In Example 6.4, Lessee LE recognized a lease liability of $100,000 and a right-of-use asset of $105,000 for its lease of office space with Lessor LR. Assume that the lease is actually of a piece of equipment (rather than office space), and the following facts are changed from Example 6.4.

– Remaining economic life of equipment:	12 years
– Renewal options:	None

6.4.90 LE classifies the lease as a finance lease. This is based on the lease term test: 10/12 years equals 83% of the remaining economic life of the equipment (see 6.2.50).

6.4.100 LE expects to consume the right-of-use asset's future economic benefits evenly over the lease term. Accordingly, LE amortizes the right-of-use asset on a straight-line basis over 10 years.

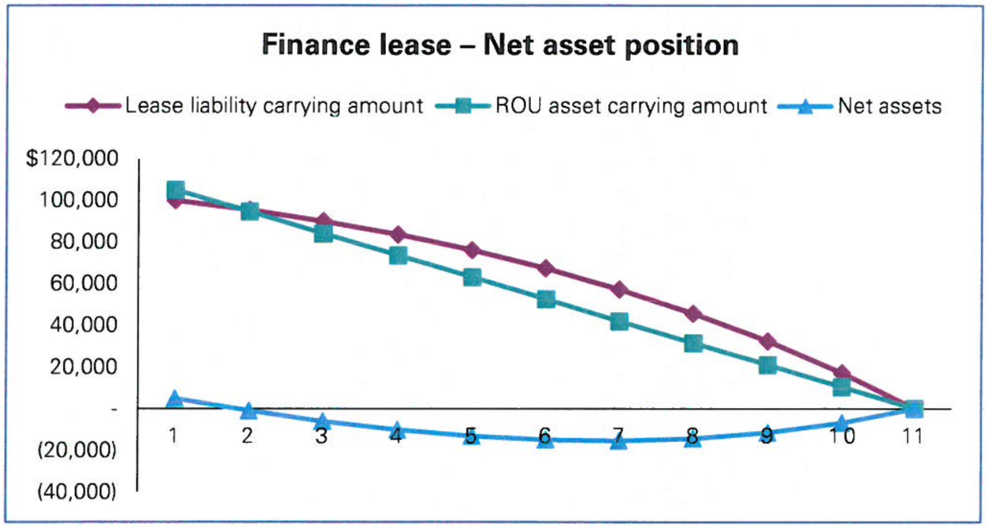
6.4.110 During the lease term, LE will account for the lease liability and the right-of-use asset as follows (assuming no remeasurements, modifications, or impairments).

Year	Lease liability				ROU asset		
	Beg. balance	Interest	Pmts	End. balance	Beg. balance	Amort.	End. balance
1	$100,000	$10,000	$(14,527)	$95,473	$105,000	$(10,500)	$94,500
2	95,473	9,547	(14,963)	90,057	94,500	(10,500)	84,000
3	90,057	9,006	(15,412)	83,651	84,000	(10,500)	73,500
4	83,651	8,365	(15,874)	76,142	73,500	(10,500)	63,000
5	76,142	7,614	(16,350)	67,406	63,000	(10,500)	52,500
6	67,406	6,741	(16,841)	57,306	52,500	(10,500)	42,000
7	57,306	5,731	(17,346)	45,691	42,000	(10,500)	31,500
8	45,691	4,569	(17,866)	32,394	31,500	(10,500)	21,000
9	32,394	3,239	(18,402)	17,231	21,000	(10,500)	10,500
10	17,231	1,723	(18,954)	–	10,500	(10,500)	–

KPMG observation – Negative net asset position for most finance leases

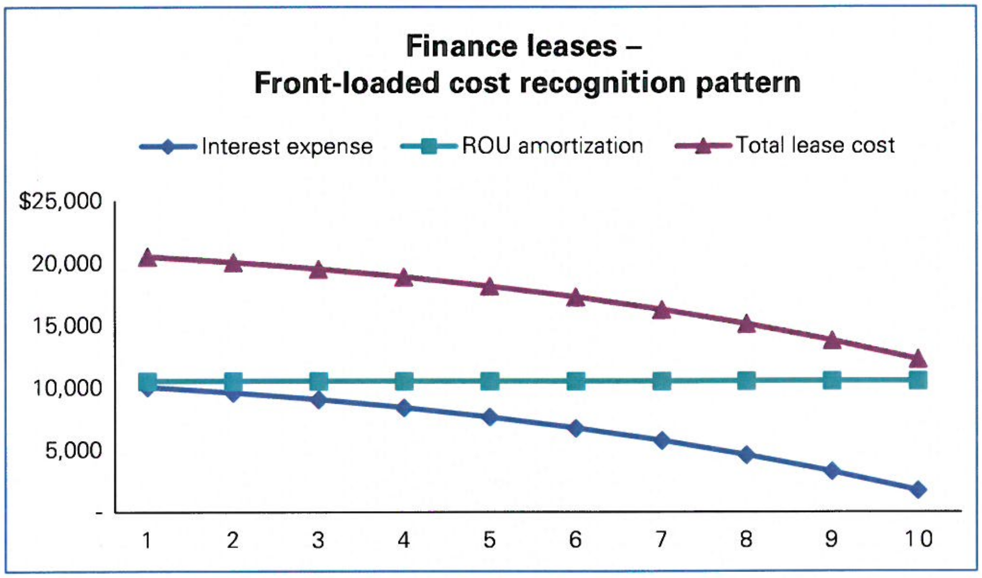
6.4.120 The subsequent measurement guidance in Topic 842 for finance leases will generally result in a negative net asset position for the lessee (in leases with no prepaid rent) throughout the lease term other than at lease commencement and at the end of the lease term (assuming a straight-line basis of amortization for finance lease right of use assets). The finance lease amortization model results in a balance sheet impact that is generally consistent with the effect that assets entirely acquired with debt financing have on the balance sheet.

6.4.130 The following chart illustrates these effects for lessees using the fact pattern in Example 6.7.



KPMG observation – Front-loaded pattern of expense recognition for finance leases

6.4.140 Because the right-of-use asset is generally amortized on a straight-line basis while interest is calculated on the lease liability using the effective interest method, finance leases will generally result in a front-loaded pattern of total expense recognition. This is illustrated in the following chart using the fact pattern in total Example 6.7.



KPMG observation – Lease cost may be capitalized as part of the cost of another asset

6.4.150 The guidance in Topic 842 refers to lease costs (for finance and operating leases) potentially being included in the carrying amount of another asset in accordance with other US GAAP. Consistent with current US GAAP, some or all of the cost of a lease may be capitalized as part of the cost of another asset (e.g. an item of property, plant, or equipment or an item of inventory). [842-10-25-5, 25-6]

6.4.160 This focus on lease cost, rather than lease expense, has been carried forward to the lessee disclosure requirements (see section 12.2) to ensure that financial statement users have a more complete picture of a lessee's leasing activity. The Board concluded that the adjustments made by many financial statement users would be based on incomplete information if the quantitative disclosures were based on amounts recognized as lease expense in the income statement rather than total lease cost.

US GAAP different from IFRS – Subsequent measurement

6.4.170 Unlike Topic 842, after the commencement date, a lessee applying IFRS is:

- required to measure right-of-use assets that meet the definition of investment property at fair value if the lessee has an accounting policy to measure investment property at fair value; and
- permitted to apply the revaluation model to all of its right-of-use assets that relate to a class of property, plant, and equipment to which the lessee applies the revaluation model. [IFRS 16.29, 34–35]

Comparison with current US GAAP – Important differences between finance lease accounting and capital lease accounting

6.4.180 As outlined in chapters 4 and 5, there are important separation/allocation model differences (e.g. allocation of certain executory costs) and definitional differences (e.g. 'lease payments' in Topic 842 versus 'minimum lease payments' in current US GAAP) that mean that the accounting for a finance lease under Topic 842 will often differ from the accounting for a capital lease under current US GAAP.

6.4.190 In addition, while the guidance about how to amortize the right-of-use asset and accrete the lease liability in a finance lease is substantially the same as that applicable to capital leases in current US GAAP, the subsequent accounting for a finance lease will differ substantially from a capital lease in the following ways.

- Having to monitor for reassessment events; for example, a significant event requiring a reassessment of the lease term or a change in the amount probable of being owed under a residual value guarantee (see section 6.6.1).
- Having to remeasure the lease liability (and right-of-use asset) if a reassessment event occurs (see section 6.6.2).
- The accounting for modifications to a finance lease (see section 6.7).

6.4.2 Operating leases

6.4.200 After lease commencement, a lessee measures the lease liability at the present value of the unpaid lease payments discounted at the discount rate for the lease established at the commencement date. An exception to this general principle occurs when the rate is updated as a result of a lease remeasurement (see section 6.6) or lease modification (see section 6.7). [842-20-35-3(a)]

6.4.210 Although Topic 842 describes the subsequent measurement of an operating lease liability differently from a finance lease liability, the carrying amount of the lease liability throughout the lease term is not affected by the classification of the lease. The carrying amount will equal the present value of the remaining, unpaid lease payments throughout the lease term.

6.4.220 After lease commencement, a lessee measures the right-of-use asset as follows, unless the right-of-use asset has been impaired (see section 6.5). [842-20-35-3(b)]

Lease liability carrying amount + **Unamortized initial direct costs** +/(−) **Prepaid/(accrued) lease payments** − **Unamortized balance of lease incentives received**

6.4.230 Alternatively, the carrying amount of an operating lease right-of-use asset can be determined using a second method, which produces the same carrying amount throughout the lease term. This alternative method also only applies if the right-of-use asset has *not* been impaired (see section 6.5).

ROU asset = **Beginning balance** − **Accumulated amortization[1]**

Note 1:

The amortization of the right-of-use asset each period is calculated as the difference between the straight-line lease cost for the period (including amortization of initial direct costs) – see 6.4.250 – and the periodic accretion of the lease liability using the effective interest method.

6.4.240 Regardless of lease classification as finance or operating, the right-of-use asset is a non-monetary asset while the lease liability is a monetary liability. Therefore, for a lease denominated in a foreign currency, remeasurement into the lessee's functional currency is required using the following rates. [842-20-55-10, 830-10]

	Current exchange rate	Commencement date exchange rate
Lease liability	✓	✗
Right-of-use asset	✗	✓

6.4.250 After the lease commencement date, a lessee recognizes the following amounts in the income statement (unless the costs are included in the carrying amount of another asset in accordance with other US GAAP).

- **A single lease cost**, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (if another systematic and rational basis is not more representative of the benefit expected to be derived from the right to use the underlying asset), unless the right-of-use asset has been impaired (see section 6.5).

Remaining lease cost = **Total lease payments for the lease term[1]** + **Total IDCs incurred[2]** − **Periodic lease cost previously recognized[3]**

Notes:

1. Paid and unpaid, reflecting any adjustments resulting from a remeasurement (see section 6.6) or a modification (see section 6.7).
2. Those attributable to that lease.
3. The total amount of lease cost recognized (including capitalized as part of the cost of another asset) for the lease in prior periods.

- **Variable lease payments** in the period in which the obligation is incurred, or achievement of the target that triggers the variable payments becomes probable (see 6.4.260).
- Any **impairment** of the right-of-use-asset (see section 6.5). [842-20-25-6, 25-8]

6.4.260 For variable lease payments based on the achievement of a specified target, a lessee recognizes the costs in annual periods and in interim periods before the achievement of the specified target that triggers the variable lease payments, to the extent the achievement of that target is considered probable. Variable lease costs recognized are reversed if it is probable that the specified target will not be met. This means that the cumulative amount recognized at any point in time will be the amount of variable lease payments either paid or probable of being paid. [842-20-55-1 – 55-2]

KPMG observation – Choice of subsequent measurement methods for operating lease right-of-use assets

6.4.270 As discussed in 6.4.220–230 and illustrated in Example 6.8, the subsequent measurement of the right-of-use asset in an operating lease can be determined in either of two ways, which yield the same carrying amount. An exception arises if the right-of-use asset is impaired (see section 6.5).

Method 1: Derive the right-of-use asset from the lease liability

6.4.280 The carrying amount of the ROU asset is derived from the carrying amount of the lease liability at the end of each reporting period as illustrated below. [842-20-35-3]

Lease liability + **Unamortized IDCs** +/(–) **Prepaid/(accrued) lease payments** – **Unamortized balance of lease incentives received**

6.4.290 Method 1 is what a lessee would use if it does not want to recognize right-of-use assets and lease liabilities for operating leases until it closes its books during the financial reporting process; sometimes referred to as a 'display approach'. Under this method, at each reporting date, the lessee creates a journal entry to (1) credit a lease liability for the present value of the remaining unpaid lease payments, (2) reverse other accrual-based operating lease accounting balances reflected in the balance sheet (i.e. prepaid or accrued rent, unamortized initial direct costs, and unamortized lease incentives), and (3) debit a right-of-use asset for the balancing amount.

Method 2: Amortize the right-of-use asset

ROU asset = **Beginning balance** – **Accumulated amortization**[1]

Note 1:

The amortization of the right-of-use asset each period is calculated as the difference between the straight-line lease cost for the period (including amortization of initial direct costs) – see 6.4.250 – and the periodic accretion of the lease liability using the effective interest method.

Method 1 or Method 2?

6.4.300 Method 1 is the only method described in Topic 842. The basis for conclusions indicates that this method will permit many entities to perform the new accounting for operating leases without significant changes to systems or processes. However, we believe that Method 1 will generally not be practicable to apply for entities other than those with a smaller volume of leases that are relatively straightforward. Method 1 is inherently a manual process that likely will be unwieldy when applied to a large portfolio of leases, especially in the context of the more complex circumstances that will arise under the guidance in Topic 842 (e.g. modifications, remeasurements, impairments, and foreign currency translation adjustments).

6.4.310 We believe that Method 2 will more readily enable a lessee to implement systems, processes, and internal controls where lease liabilities and right-of-use assets are tracked separately in a manner more consistent with other assets and liabilities. It is more likely to be effective for addressing the more complex circumstances outlined above that are likely to arise for many lessees. For leases denominated in a foreign currency, where different exchange rate requirements apply to the lease liability and the right-of-use asset, maintaining and amortizing the right-of-use asset (Method 2) may be significantly easier than attempting to establish the carrying amount of the right-of-use asset anew at each reporting date (Method 1).

Example 6.8

Subsequent accounting for an operating lease – Assuming no impairments, remeasurements, or lease modifications

Scenario 1: Subsequent measurement using method described in Topic 842

6.4.320 In Example 6.4, Lessee LE recognized a lease liability of $100,000 and a right-of-use asset of $105,000 for its lease of office space with Lessor LR.

6.4.330 The following facts in addition to those in Example 6.4 are relevant.

– Remaining economic life of office space:	35 years
– Fair value of office space:	$400,000

6.4.340 LE classifies the lease as an operating lease, because none of the tests for classification as a finance lease are met (see 6.2.50). There are no impairments (see section 6.5), no remeasurements (see section 6.6) or modifications (see section 6.7) during the lease term.

6.4.350 LE recognizes a single lease cost of $17,154 each year of the 10-year lease, which is calculated as follows.

Remaining lease cost $171,535 = **Total lease payments for the lease term $166,535** + **Total IDCs recognized $5,000**

Lease term 10 years

6.4.360 Whether a lease is classified as an operating or a finance lease, the carrying amount of the lease liability is the same throughout the lease term. Therefore, the carrying amount of the lease liability in this example is the same throughout the lease term as it is in Example 6.7, which at all times equals the present value of the unpaid lease payments (discounted at 10%, which is the discount rate for the lease determined at lease commencement in Example 6.4).

6.4.370 Following the subsequent measurement method described (and illustrated) in Topic 842, LE subsequently accounts for the operating lease right-of-use asset as follows.

Year	Lease liab. carry. amt.	Unamort. IDCs[1]	Prepaid (accrued) lease pmts[2]	ROU asset carry. amt.
1	$95,473	$4,500	$(2,127)	$97,846
2	90,057	4,000	(3,818)	90,239
3	83,651	3,500	(5,060)	82,091
4	76,142	3,000	(5,840)	73,302
5	67,406	2,500	(6,144)	63,762
6	57,306	2,000	(5,956)	53,350
7	45,691	1,500	(5,263)	41,928
8	32,394	1,000	(4,050)	29,344
9	17,231	500	(2,301)	15,430
10	–	–	–	–

Notes:

1. Initial direct costs are amortized on a straight-line basis over the 10-year lease term.
2. Represents the cumulative difference between the annual straight-line lease cost (excluding initial direct costs) of $16,654 and the amount of the lease payments.

Scenario 2: Alternative subsequent measurement method

6.4.380 As described in paragraph 6.4.230, the carrying amount of the right-of-use asset can be determined using a second method, which produces the same carrying amount as the method used in Scenario 1 throughout the lease term.

ROU asset = **Beginning balance** – **Accumulated amortization**[1]

Note 1:

The amortization of the right-of-use asset each period is calculated as the difference between the straight-line lease cost for the period (including initial direct costs) and the periodic accretion of the lease liability using the effective interest method.

6.4.390 LE calculates the annual single lease cost for the 10-year lease term of $17,154 in the same manner as illustrated above in Scenario 1.

6.4.400 However, the amortization of the right-of-use asset, and carrying amount of the right-of-use asset at the end of each period, are determined as follows.

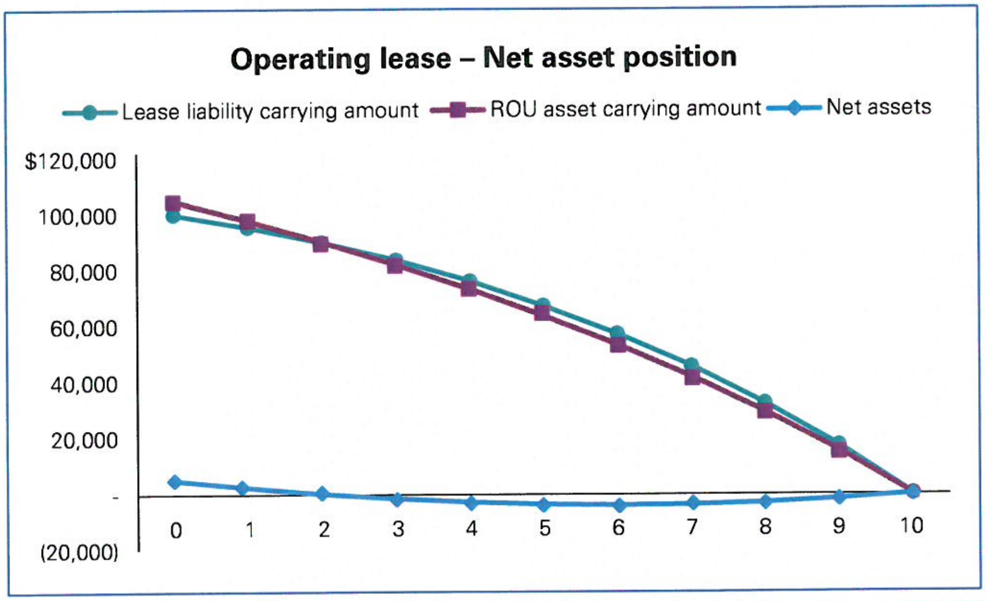
	ROU asset amortization			ROU asset carrying amount		
Year	Straight-line lease cost	Lease liab. accret.	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance
1	$17,154	$(10,000)	$ 7,154	$105,000	$ (7,154)	$97,846
2	17,154	(9,547)	7,607	97,846	(7,607)	90,239
3	17,154	(9,006)	8,148	90,239	(8,148)	82,091
4	17,154	(8,365)	8,789	82,091	(8,789)	73,302
5	17,154	(7,614)	9,540	73,302	(9,540)	63,762
6	17,153	(6,741)	10,412	63,762	(10,412)	53,350
7	17,153	(5,731)	11,422	53,350	(11,422)	41,928
8	17,153	(4,569)	12,584	41,928	(12,584)	29,344
9	17,153	(3,239)	13,914	29,344	(13,914)	15,430
10	17,153	(1,723)	15,430	15,430	(15,430)	–

6.4.410 As illustrated in this example, the ending balance of the right-of-use asset is the same throughout the lease term for the two scenarios. In addition, the single lease cost recognized by LE each period of the lease and the carrying amount of the lease liability at the end of each period of the lease is unaffected by which subsequent measurement method LE chooses for the right-of-use asset.

KPMG observation – Operating lease right-of-use assets likely to track more closely to lease liability

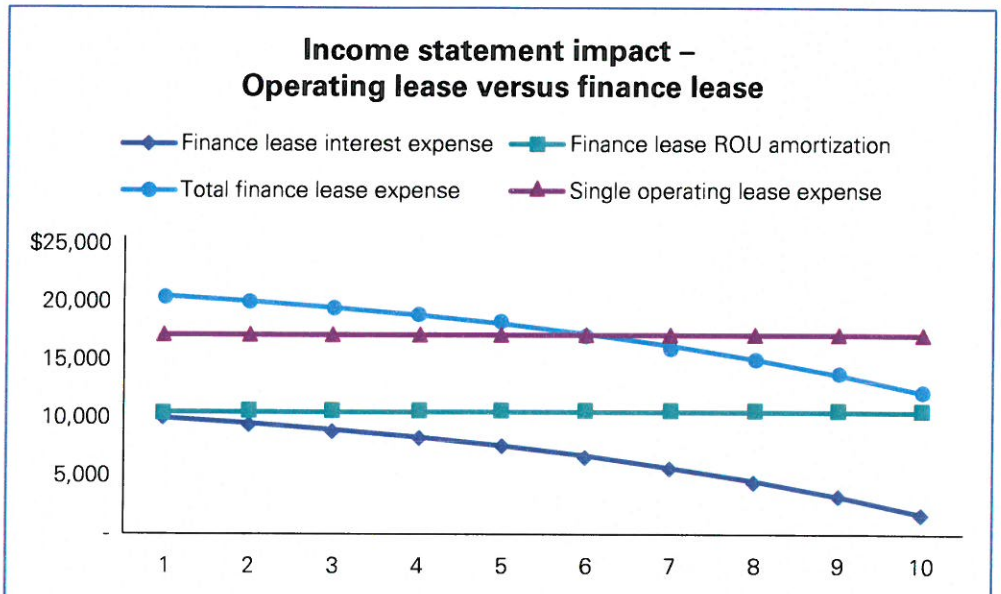
6.4.420 The carrying amount of an operating lease right-of-use asset is likely to track more closely to the carrying amount of the lease liability throughout the lease term than a finance lease right-of-use asset. As noted in the KPMG observation at 6.4.120–130, a finance lease right-of-use asset will generally result in a negative net asset position for a particular lease. The balance sheet impact between an operating lease and a finance lease may be an important consideration relating to the impact on balance sheet ratios based on assets and liabilities.

6.4.430 The following chart illustrates how the right-of-use asset tracks with the lease liability for Example 6.8.



KPMG observation – Operating lease and finance expense recognition patterns differ

6.4.440 The following chart depicts the differences in lease expense recognition patterns between a finance lease and an operating lease under Topic 842 using the fact pattern in Examples 6.7 and 6.8. The difference in expense recognition pattern may be less dramatic in a portfolio of leases; for example, for a lessee with a large revolving portfolio of leases that have varying maturities.



US GAAP different from IFRS – Single model under IFRS

6.4.450 There is no equivalent IFRS 16 guidance to that included in this section, because all leases that are recognized on the balance sheet under IFRS 16 are accounted for in a manner similar to finance leases under Topic 842.

6.5 Impairment testing (Step 7)

6.5.10 A lessee uses the long-lived assets impairment guidance (Topic 360) to determine whether a right-of-use asset is impaired, and if so, the amount of the impairment loss to recognize. The impairment loss related to a right-of-use asset is presented in the same manner in the income statement as an impairment loss recognized for any other long-lived asset. [842-20-35-9]

6.5.20 After the impairment of a right-of-use asset, the asset is measured at its carrying amount immediately after the impairment less any accumulated amortization subsequent to the impairment. *Regardless of the lease classification*, a lessee amortizes the right-of-use asset after impairment on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the future economic benefits) from the date of impairment to the earlier of the end of the right-of-use asset's useful life or the end of the lease term. [842-20-35-10]

ROU asset balance = **Carrying amount of ROU asset after impairment** − **Accumulated amortization after impairment**

6.5.30 If an operating lease right-of-use asset has been impaired, for each period from the date of impairment through the end of the lease term, the *single lease cost* for the operating lease (which is still presented in a single income statement line item as before the impairment) is calculated as the sum of the following. [842-20-25-7]

Single lease cost = **Accretion of the lease liability[1]** + **Amortization of the ROU asset**

Note 1:

Determined for each remaining period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability – i.e. the effective interest method.

6.5.40 Topic 842 characterizes operating lease liabilities as operating liabilities, rather than as debt. [ASU 2016-02.BC14(c)]

KPMG observation – Long-lived assets impairment model for right-of-use asset impairment

6.5.50 The Board concluded that a lessee should not continue to recognize a right-of-use asset from which it does not expect to obtain future economic benefits or to measure that asset at an inflated amount above what the lessee expects to recover. The Topic 360 impairment model is the appropriate one to apply to right-of-use assets because the right-of-use asset in a finance lease or an operating lease is a long-lived, nonfinancial asset. [ASU 2016-02.BC255]

KPMG observation – Including lease liabilities in the carrying amount of the asset group

6.5.60 The recoverability test for a held-and-used asset group excludes (1) financial and nonoperating liabilities from the carrying amount of the asset group, and (2) the cash flows attributable to the financial and nonoperating liabilities in determining the undiscounted future expected cash flows of the asset group (e.g. both interest and principal components of the financial and nonoperating liabilities should be excluded). However, consistent with Example 1 to Topic 360, an entity should include operating liabilities (e.g. accrued liabilities and accounts payable) in the carrying amount and the cash flows used in the recoverability test. Any terminal value of the asset group included in the recoverability test should reflect the value inclusive of normal operating working capital assets and liabilities and not how the asset group is financed (e.g. through debt or equity). [ASU 2016-02.BC14, 360-10-55-20 – 55-22]

6.5.70 We believe that the conclusion as to whether a lease liability should be included in the carrying amount of the asset group to which the right-of-use asset relates depends on the classification of the lease or its qualification as a short-term lease.

Finance leases

6.5.80 For finance leases, we believe that the lease liability should be *excluded* in determining the carrying amount of the asset group, and the interest and principal components of the lease liability *excluded* in determining the undiscounted future expected cash flows of the asset group in the recoverability test.

6.5.90 This is consistent with the accounting related to capital leases under current US GAAP; capital lease obligations are not included in the carrying amount of the asset group that includes the related capital lease assets. Capital lease obligations are a financial liability that is equivalent to debt and the impairment guidance in Topic 360 has long been premised on the view that debt, as simply a form of capitalization other than equity, should not be included in the asset group.

Operating leases

6.5.100 For operating leases, we believe that either of the following approaches could be consistent with US GAAP, although Approach A appears more consistent with how similar financial, but also operating, obligations (e.g. asset retirement obligations) are considered in the long-lived asset impairment guidance. However, as demonstrated in Example 6.9, we believe that entities should not come to different impairment conclusions regardless of the approach taken.

Approach A

6.5.110 *Exclude* the carrying amount of the lease liability in determining the carrying amount of the asset group, and therefore also *exclude* the operating lease payments in determining the undiscounted future expected cash flows of the asset group.

6.5.120 An operating lease liability is a financial liability even though the Board decided it should be characterized as an operating liability for presentation purposes. We have observed that, in discussions about operating lease liabilities and their characterization as operating liabilities for presentation purposes, the Board frequently compared those lease liabilities to other discounted, financial liabilities that are not characterized as debt, including those related to asset retirement obligations (AROs).

6.5.130 An analogy to AROs would suggest that Approach A is appropriate because, in accordance with Topic 360, the carrying amount of an ARO is *excluded* from the carrying amount of the asset group to which it relates, as are the estimated cash flows related to the liability. In addition, the introduction to ASU 2016-02 acknowledges leasing as a form of financing. Because the impairment guidance in Topic 360 is *not* intended to create different impairment results solely based on how an entity capitalizes (or finances its operations), this further supports our belief that Approach A is an acceptable application of the impairment guidance in Topic 360. [360-10-35-18]

Approach B

6.5.140 *Include* the carrying amount of the lease liability in determining the carrying amount of the asset group, and *include* the operating lease payments (net of the portion that relates to accretion of the operating lease liability) in determining the undiscounted future expected cash flows of the asset group.

6.5.150 The Board explicitly stated that operating lease liabilities are operating in nature. Therefore, consistent with the view that an entity should include operating liabilities (e.g. accrued liabilities and accounts payable) in the carrying amount of the asset group and in the undiscounted cash flows of the asset group, we believe that Approach B is an acceptable application of the impairment guidance in Topic 360.

Short-term lease payments

6.5.160 If a short-term lease is not recognized on the balance sheet (see section 6.3.1), the short-term lease payments should be *included* in determining the undiscounted future expected cash flows of the asset group to which the lease relates.

Variable lease payments

6.5.170 For finance and operating leases (and short-term leases recognized on the balance sheet), *include* variable lease payments in determining the undiscounted future expected cash flows of the asset group.

Example 6.9

Recoverability test for a held-and-used asset group that includes a right-of-use asset

6.5.180 This example is a continuation of Examples 6.4 and 6.8, in which Lessee LE leases office space from Lessor LR for 10 years.

6.5.190 LE tests one of its asset groups for impairment because of a triggering event. The asset group being tested includes the right-of-use asset related to the office space that LE leases from LR. The impairment test coincides with the end of Year 2 of LE's lease.

6.5.200 The following additional facts are relevant.

– Carrying amount of asset group:	$770,000 (includes the right-of-use asset but not the operating lease liability)
– Undiscounted future expected cash flows:	$100,000 annually (before considering the lease payments associated with the lease)
– Period over which recoverability test performed (for illustrative purposes):	8 years
– Terminal value at the end of Year 8:	Nil

6.5.210 As outlined in the KPMG observation at 6.5.100, we believe that it may be reasonable for an entity to apply either one of the following two approaches (A or B) as to inclusion of the operating lease liability in the asset group that includes the operating lease right-of-use asset.

Scenario 1: Approach A – Do not include operating lease liability in the asset group

6.5.220 LE *excludes* the operating lease liability in determining the carrying amount of the asset group, and *excludes* the cash outflows from the lease payments in determining the undiscounted future expected cash flows of the asset group. Accordingly, LE's recoverability test is as follows.

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Total
Undiscounted future expected cash flows before lease pmts.	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$800,000
Effect of lease pmts.	–	–	–	–	–	–	–	–	–
Total	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$800,000

Carry. amt. of asset group, excl. operating lease liab.	$770,000	
Less carry. amt. of operating lease liab.	N/A	
Carry. amt. of asset group	770,000	
Total undiscounted future expected cash flows	800,000	
Excess	**$ 30,000**	**Asset group does not fail the recoverability test**

Scenario 2: Approach B – Include operating lease liability in the asset group

6.5.230 LE *includes* the lease liability in determining the carrying amount of the asset group, and *includes* the operating lease payments (net of the portion that relates to accretion of the operating lease liability) in determining the undiscounted future expected cash flows of the asset group. Accordingly, LE's recoverability test is as follows, the result of which is the same as under Approach A.

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Total
Undiscounted future expected cash flows before lease pmts.	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$800,000
Effect of lease pmts.	(15,412)	(15,874)	(16,350)	(16,841)	(17,346)	(17,866)	(18,402)	(18,954)	(137,045)
Add back portion related to lease liab. accret.	9,006	8,365	7,614	6,741	5,731	4,569	3,239	1,723	46,988
Total	$ 93,594	$ 92,491	$ 91,264	$ 89,900	$ 88,385	$ 86,703	$ 84,837	$ 82,769	$709,943

Carry. amt. of asset group, excl. operating lease liab.	$770,000	
Less carry. amt. of operating lease liab.	(90,057)	
Carry. amt. of asset group	679,943	
Total undiscounted future expected cash flows	709,943	
Excess	**$ 30,000**	**Asset group does not fail the recoverability test**

Example 6.10
Operating lease accounting before and after impairment

6.5.240 Assume that instead of passing the recoverability test in Example 6.9, the asset group is impaired and the amount of the impairment allocated to the right-of-use asset is $10,000. The following table illustrates the accounting for the right-of-use asset before and after impairment.

	ROU asset carrying amount				Lease liability	Income statement[2]		
Year	Beg. balance	ROU asset amort.	Impair. charge	End. balance	Carry. amt. (end. balance)[1]	Accret.	ROU asset amort.	Single lease cost
1	$105,000	$ (7,154)		$97,846	$95,473	$10,000	$ 7,154	$ 17,154
2	97,846	(7,607)	$(10,000)	80,239	90,057	9,547	7,607	17,154
3	80,239	(10,030)		70,209	83,651	9,006	10,030	19,036
4	70,209	(10,030)		60,179	76,142	8,365	10,030	18,395
5	60,179	(10,030)		50,149	67,406	7,614	10,030	17,644
6	50,149	(10,030)		40,119	57,306	6,741	10,030	16,771
7	40,119	(10,030)		30,089	45,691	5,731	10,030	15,761
8	30,089	(10,030)		20,059	32,394	4,569	10,030	14,599
9	20,059	(10,030)		10,029	17,231	3,239	10,030	13,269
10	10,029	(10,029)		–	–	1,723	10,029	11,752

Lease expense recognized during the lease term:	161,535
Impairment of ROU asset recognized in Year 2:	10,000
Total lease cost	$171,535

Notes:

1. The lease liability carrying amount at the end of each year is unaffected by the impairment of the right-of-use asset – i.e. it is the same as in Example 6.8 where the right-of-use asset is not impaired.
2. The accretion of the lease liability and the right-of-use asset amortization are shown separately for illustrative purposes only. For an operating lease, a lessee presents a single lease expense in the income statement, whether or not the right-of-use asset is impaired (and will not calculate these amounts separately before an impairment if the lessee applies Method 1 in subsequently measuring the right-of-use asset). However, the impairment loss allocated to the right-of-use asset will be presented in the same manner in the income statement as the remainder of the impairment loss allocated to other assets in the asset group.

6.5.250 As illustrated in 6.5.240:

- The amortization of the right-of-use asset is determined as follows.
  - **Before impairment**. Amortization equals the difference between the straight-line lease cost for the period ($17,154) and the periodic accretion of the lease liability using the effective interest method. LE uses Method 2 for the subsequent measurement of its operating lease right-of-use asset (see KPMG observation at 6.4.270–310).
  - **After impairment**. Like a finance lease, it is amortized on a straight-line basis over the remaining lease term (right-of-use asset carrying amount post-impairment of $80,239 ÷ 8 remaining annual periods).
- The single lease cost is determined as follows.
  - **Before impairment**. So that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (total lease cost at lease commencement of $171,535 ÷ 10 annual periods).
  - **After impairment**. Front-loaded pattern of lease cost recognition due to the accretion of the lease liability, and amortization of the right-of-use asset, which is now on a straight-line basis over the remaining lease term (rather than as a balancing amount that increases each period throughout the lease term).

KPMG observation – Proportional allocation of impairment losses to an asset group

6.5.260 An impairment loss of an asset group generally is allocated on a pro rata basis to all of the long-lived assets in the group on a relative carrying amount basis. However, no portion of the impairment loss is allocated to an individual long-lived asset within the asset group if doing so would reduce the carrying amount of that asset below its fair value *and* that fair value is determinable without undue cost or effort. [360-10-35-28]

6.5.270 Based on these requirements, right-of-use assets will often be written down because of an allocated impairment loss, rather than because of an event or occurrence specific to that right-of-use asset. When an asset group includes multiple operating lease right-of-use assets, all of those right-of-use assets will generally receive an allocation of the impairment loss; therefore, all of those leases will be subject to the post-impairment operating lease accounting model illustrated in Example 6.10.

KPMG observation – Operating lease cost post-impairment similar to current US GAAP

6.5.280 The front-loaded single lease cost recognition pattern post-impairment for an operating lease under Topic 842 has some similarities with the lease cost recognition that results for an operating lease under current US GAAP after the recognition of a termination cost liability under Topic 420 (exit or disposal cost obligations). [ASU 2016-02.BC257–BC259]

6.5.290 Under Topic 842, the post-impairment single lease cost for the remainder of the lease term will be front-loaded – i.e. the combination of the straight-line amortization of the remaining right-of-use asset and the accretion of the remaining lease liability. Similarly, under current US GAAP, the remaining lease cost after recognition of a Topic 420 liability is front-loaded – i.e. the combination of the generally straight-line remaining lease expense, if any, and accretion of the contract termination liability. [ASU 2016-02.BC258]

6.5.300 In some cases, the net effect of those leases on the balance sheet under Topic 842 and current US GAAP will be similar. The generally net liability position of the lease under Topic 842 (i.e. carrying amount of the right-of-use asset less the carrying amount of the lease liability) may not differ substantially from the balance of the Topic 420 liability that would be recognized under current US GAAP.

US GAAP different from IFRS – Impairment of right-of-use assets

Guidance specific to the impairment of an operating lease right-of-use asset

6.5.310 IFRS 16 does not have any guidance about the impairment of operating lease right-of-use assets because IFRS 16 does not have a lease classification test for lessees. All leases that are recognized on the balance sheet (i.e. all leases other than short-term leases or leases of low-value assets) are accounted for in a manner substantially consistent with finance lease accounting for lessees under Topic 842.

Existing US GAAP/IFRS differences in assessing and accounting for impairment of long-lived assets

6.5.320 There are existing differences between the long-lived assets impairment guidance in US GAAP and the equivalent guidance in IFRS. None of those differences were affected by the issuance of ASU 2016-02 and IFRS 16, respectively. Therefore, there will be differences in how lessees assess and account for impairments of right-of-use assets between US GAAP and IFRS.

Comparison with current US GAAP – Impairment testing

6.5.330 Under current US GAAP, consistent with the requirements in Topic 842 applicable to finance lease right-of-use assets, capital lease assets are assessed for impairment in accordance with the long-lived assets impairment guidance in Topic 360. However, finance lease assets may frequently have different carrying amounts than their capital lease asset counterparts. For example:

- A finance lease right-of-use asset may have a *lower* carrying amount because it includes only amounts probable of being owed under a residual value guarantee rather than the full amount of the guarantee.
- A finance lease right-of-use asset may have a *greater* carrying amount because it may include amounts related to certain executory costs (e.g. payment of the lessor's costs for property taxes or insurance) that are excluded from a capital lease asset. [840-30-35]

6.5.340 The differences in carrying amounts will affect the carrying amount of the asset group, and therefore could affect the results of the impairment analysis.

6.5.350 There are no operating lease right-of-use assets under current US GAAP; therefore, assessing such assets for impairment is a new concept resulting from the issuance of Topic 842.

6.5.360 Charges are recognized for operating leases under current US GAAP based on the contract termination and other associated costs guidance in Topic 420. That guidance differs substantially from how operating lease right-of-use assets will be assessed for impairment under the long-lived assets impairment guidance. Charges recognized in accordance with Topic 420 are generally only recognized at the earlier of:

- when the lessee formally terminates the lease agreement – i.e. a contractual commitment is made through formal notice of intent to exercise a termination option or agreement is reached mutually with the lessor – the termination charge is measured at fair value; or [420-10-25-12]
- when the lessee ceases use of the underlying asset (e.g. when the lessee vacates the building) – the charge (and related liability) represents costs that will be incurred without economic benefit to the lessee, and is measured at fair value. [420-10-25-13]

6.5.370 In addition to the differences above, another important difference is that a lessee recognizes charges in accordance with Topic 420 on a specific lease basis – i.e. a charge relates to a specific lease only. Under the long-lived assets impairment guidance, if a right-of-use asset is part of a larger asset group, it may receive an *allocated* impairment charge – i.e. an allocation of a larger impairment charge taken on all, or substantially all, of the asset in the asset group – even if there is no specific indication that the right-of-use asset was impaired.

6.6 Lease reassessments (Step 8A)

6.6.10 A lease reassessment or modification (that is not accounted for as a separate contract) will often result in the remeasurement of the lease liability and the right-of-use asset. The following diagram provides an overview of the reassessment and modification requirements applicable to lessees, which are explained in this section (reassessments) and in section 6.7 (modifications). [842-10-35-4]

	Remeasurement of the lease liability and the right-of-use asset occurs when:				
	Lease modification not accounted for as a separate contract (section 6.7)	Change in lease term	Change in assessment of lessee purchase option being exercised	Change in amount probable of being owed by lessee under residual value guarantee	Variable lease payments become lease payments following resolution of contingency
When do I reassess?	N/A	Only when there is a triggering event (as defined)		Whenever relevant facts and circumstances change	
In remeasuring, what do I update:					
Lease payments?[1]	✓	✓	✓	✓	✓
Consideration in the contract?	✓	✓	✓	✓	✓
Allocation of consideration in the contract?	✓	✓	✓	✓	✓
Discount rate?	✓	✓	✓	✗	✗
Lease classification?	✓	✓	✓	✗	✗

Note 1:

This includes updating variable lease payments that depend on an index or rate using the index or rate as of the remeasurement date.

6.6.1 When to reassess

6.6.20 The discussion that follows is based on the diagram in 6.6.10, and deals with lease reassessments. Lease modifications are discussed in section 6.7.

Reassessment of the lease term or a lessee purchase option

6.6.30 The lease term and the likelihood of a lessee exercising a purchase option are only reassessed when one of the following occurs.

- An event written into the contract obliges the lessee to exercise (or not exercise) an option.
- The lessee elects to exercise an option that it had previously determined that it was not reasonably certain to exercise.
- The lessee elects not to exercise an option that it had previously determined that it was reasonably certain to exercise.
- A 'triggering event'. [842-10-35-1, ASU 2016-02.BC232]

6.6.40 A triggering event is a significant event or significant change in circumstances that both:

- is within the lessee's control; and
- directly affects the assessment of whether the lessee is reasonably certain to exercise an option. [842-10-35-1, ASU 2016-02.BC232]

6.6.50 The following are examples of triggering events. [842-10-55-28, ASU 2016-02.BC232]

Constructing significant leasehold improvements[1]	Subleasing the asset for a period beyond the end of the lease term[2]
Significantly modifying or customizing the asset	Making a business decision directly relevant to option exercise[3]

Notes:

1. The lessee constructs leasehold improvements that are expected to have significant economic value beyond the end of the previously assessed lease term. For example, assume that in Year 6 of the 10-year office space lease in Example 6.4, the lessee constructs leasehold improvements that will have significant economic value for 10 years. The construction of those leasehold improvements might make it reasonably certain that the lessee will extend the lease to obtain the remaining economic benefits from those leasehold improvements.
2. For example, subleasing an asset for which the lease term was initially assessed as 15 years (15-year non-cancellable period with two 5-year renewal options), to a sublessee for a non-cancellable period of 25 years or subleasing it for the remainder of the head lease term with renewal options that the sublessee is reasonably certain to exercise. In those cases, fulfilling the sublease makes it reasonably certain that the entity will exercise its renewal options on the head lease.
3. For example, extending the lease of a complementary asset or disposing of an alternative asset.

6.6.60 Changes in *market-based* factors (e.g. changes in the real estate market) do not, in isolation, trigger the reassessment of a lessee option – i.e. to extend or terminate the lease or purchase the underlying asset – because they are generally not within the lessee's control. [842-10-55-29, ASU 2016-02.BC232]

Resolution of a contingency

6.6.70 The resolution of a contingency on which some or all variable lease payments to be paid over the remainder of the lease are based may be resolved, and result in those payments prospectively meeting the definition of lease payments. For example, if the payments for Years 2-10 of a retail store lease will be based on 10 percent of Year 1 retail store sales, at the end of Year 1 the lease payments for Years 2-10 become fixed payments. In this scenario, a remeasurement of the lease payments is required. [842-10-35-4(b), ASU 2016-02.BC238]

Example 6.11
Is reassessment required?

6.6.80 Lessee LE leases a building, to be used as a retail store, from Lessor LR for a non-cancellable period of five years. The following facts are relevant at the lease commencement date.

– Renewal options:	Two options for 5 years each (at market rentals)
– Purchase option:	$250,000 (estimated fair value) at the end of Year 5, increasing by 1% a year if LE exercises one or both of the renewal options
– Transfer of ownership:	No

6.6.90 At lease commencement, LE concludes that it is not reasonably certain to exercise either of the five-year renewal options or the purchase option. Therefore, the lease term at commencement is five years.

Scenario 1: Change in market value of underlying asset

6.6.100 In addition to the basic facts for this example, assume that at the end of Year 2 of the five-year lease term, the city announces a major renovation of the downtown neighborhood in which the building is located. The renovation is expected to significantly increase both (1) the fair value of the building, and (2) consumer traffic in the area.

6.6.110 As a result, the exercise price of the purchase option is expected to be significantly lower than the fair value of the building, and the rental payments during the two renewal periods are expected to be at a bargain compared to market rentals. The increased consumer traffic is also expected to substantially affect the revenues that will be generated by the retail store once the renovation is completed.

6.6.120 In this scenario, LE does not reassess either the lease term (i.e. consider whether it is now reasonably certain to exercise one or both of the renewal options) or the purchase option. This is because the significant event and significant change in circumstances related to the building were not within the control of LE. The city, not LE, undertook the action that is significantly changing the circumstances surrounding this lease. In addition, market-based factors (e.g. a change in the real estate market) not within the control of the lessee do not, in isolation, trigger a reassessment of a lessee option.

Scenario 2: Change in business climate

6.6.130 In addition to the basic facts for this example, assume the following.

- LE is operating a retail store that is unproven in the marketplace where the leased building is located (e.g. it has not been tested in this part of the country).
- By the end of Year 3 of the lease term, the store is far exceeding initial expectations and has developed a devoted customer base in the neighborhood for a variety of reasons that were validly not anticipated at lease commencement. It is not expected that LE could relocate to another location within the city and replicate its results at the present location. Therefore, LE concludes that it is reasonably certain to exercise at least the first five-year renewal option.

6.6.140 Despite the fact that LE now views itself as reasonably certain to exercise the first five-year renewal option, unless LE actually exercises that renewal at the end of Year 3, LE does not reassess the lease term based on the facts presented. The success of the retail store is not a significant event or significant change in circumstances undertaken by LE – LE is merely operating the retail store in this new location successfully.

Scenario 3: Business decision that affects lessee's economic reasons to exercise (or not to exercise) an option

6.6.150 In addition to the basic facts for this example, assume the following.

- LE has been fulfilling all of its online sales orders from this retail location and one other retail location. None of its other retail locations engage in online fulfillment or are equipped, without significant expense, to do so.
- At the end of Year 4 of the lease term, LE terminates its lease of the other retail location engaged in online fulfillment activities and vacates that building. Between the end of Year 4 and the end of the lease term for this retail store, LE will be unable to relocate and recreate its fulfillment activities absent significant cost (either to move to an outsourcing model or pay a premium to acquire the proper space needed and have it customized).

6.6.160 The decision to terminate the lease of the other retail location was within the control of LE and affects LE's economic reasons to exercise (or not exercise) the renewal options related to the building lease in this example. Therefore, LE reassesses the lease term of the building lease in this example.

6.6.170 Upon reassessment, as a result of making the business decision to terminate the lease of the other location, based on the facts presented, LE concludes that it is now (at the end of Year 4) reasonably certain to exercise the first five-year renewal option. LE will remeasure the lease payments based on a revised remaining lease term of six years from the reassessment date.

KPMG observation – Reassessment of a lessee option will not always result in remeasurement

6.6.180 A reassessment will result in a remeasurement of the lease payments when the event leading to the reassessment is one of the following.

- An event written into the contract obliges the lessee to exercise (or not to exercise) an option.
- The lessee elects to exercise an option even though it had previously determined that it was not reasonably certain to do so.
- The lessee elects not to exercise an option even though it had previously determined that it was reasonably certain to do so. [842-10-35-1]

6.6.190 In each of those cases, the event *will* change the lease term or the reasonably certain assessment of a purchase option.

6.6.200 However, because reasonably certain is a high threshold of assurance (see section 5.2), a significant event or significant change in circumstances (within the control of the lessee and directly related to the assessment of the lessee option) – i.e. a 'triggering event' – may not result in a change to the previous assessment of whether the lessee is reasonably certain to exercise an option (or not exercise a termination option). Although reassessments will not always result in a formal change to the assessment of lessee option exercise, we believe that they usually will, particularly if the triggering event is one of the examples in Topic 842 (see 6.6.50).

KPMG observation – Impacts to processes and controls of option reassessment guidance

6.6.210 The reassessment requirements should not require lessees to continually reassess the lease term and lessee purchase options. However, given the pervasive, and potentially material, effect that lease reassessments could have on a lessee's financial statements, lessees will need to implement new processes and controls to address the new risk points. [ASU 2016-02.BC232]

6.6.220 These include processes and controls to monitor and, where relevant, account for (1) significant events or changes in circumstances (i.e. triggering events) within their control; (2) the exercise of options or a decision taken not to exercise an option; and (3) events specified explicitly in the contract that require the lessee to exercise (or not to exercise) an option. This effort likely will need to involve cross-functional coordination to ensure timely identification of events requiring revisions to lease accounting.

KPMG observation – Changes to amounts probable of being owed under a residual value guarantee

6.6.230 Unlike for reassessments of the lease term or lessee purchase options, Topic 842 does not provide specific guidance about when a lessee must reassess amounts probable of being owed under a residual value guarantee. However, the basis for conclusions suggests that it is the Board's intent for lessees to remeasure the lease payments whenever facts and circumstances change, suggesting that the amount previously estimated is no longer accurate (subject to materiality considerations). [ASU 2016-02.BC239]

6.6.240 Therefore, the lease payments may be required to be remeasured, which results in a number of additional accounting steps (see section 6.6.2), whenever there is a change in the estimated residual value of the underlying asset at the end of the lease term that affects the amount payable under a residual value guarantee – typically a decrease in the estimated residual value.

KPMG observation – Resolution of a contingency upon which future lease payments are based

6.6.250 The Board decided to specify that a lessee should remeasure its lease liability if a contingency on which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments (on a prospective basis) meet the definition of 'lease payments'. This is illustrated in Example 6.13. [ASU 2016-02.BC238]

6.6.260 The Board considered scenarios in which entities might attempt to circumvent the lessee right-of-use asset and lease liability recognition and measurement requirements by initially structuring the lease payments at a nominal amount. For example, lease payments could be set at $10 for Year 1 of a 10-year lease and then become fixed (or partially fixed) after Year 1 for the remainder of the lease term based on a percentage of Year 1 sales using a leased building, or based on Year 1 production using a piece of leased equipment. [ASU 2016-02.BC238]

6.6.270 Absent this requirement, some stakeholders suggested that the guidance would not require the lessee to reassess the lease payments and update its lease liability and right-of-use asset in those scenarios. If so, the lessee might not recognize a meaningful right-of-use asset or lease liability throughout the lease term even though the terms of the lease would require fixed payments after resolution of the contingency. Therefore, the Board decided to specify that if variability in some or all of the remaining lease payments is resolved, those amounts prospectively meet the definition of lease payments and should be reflected, from that point forward, in the right-of-use asset and the lease liability. [ASU 2016-02.BC238]

6.6.280 This general provision on the resolution of contingencies does not apply to variable lease payments that depend on an index or rate. For example, if the periodic lease payments increase based on the change in CPI, and under the terms of the lease the periodic lease payments will never decrease after they have increased (i.e. even if CPI were to decrease), the payment increase linked to the change in CPI is not captured by this general contingency guidance. Instead, the guidance appears to be intended to capture only situations related to all other types of variable lease payments (e.g. those related to usage or performance of the underlying asset).

6.6.2 Accounting for a change arising from a reassessment

6.6.290 The discussion, diagram, and table that follows complement the overview diagram in 6.6.10, and deal with remeasurements resulting from lease reassessments. Lease modifications are discussed in section 6.7.

6.6.300 The accounting steps a lessee must undertake depend on which of the following circumstances (see section 6.6.1) requires the lessee to undertake the remeasurement. [842-10-25-1, 842-10-35-4, 842-20-35-4 – 35-5]

1 Change in lease term

2 Change in assessment of lessee purchase option exercise

3 Change in amount probable of being owed under RVG

4 Resolution of a contingency

6.6.310 The following table summarizes the accounting steps a lessee must undertake in each of the above circumstances.

Accounting steps	Circumstance			
	1	2	3	4
Remeasure and reallocate the 'consideration in the contract' to the remaining lease and non-lease components of the contract (see chapter 4).	✓	✓	✓	✓
Remeasure the lease liability to reflect the revised lease payments, using a 'discount rate for the lease' (see section 5.6) *determined at the remeasurement date.*[1,2]	✓	✓	✗	✗
Remeasure the lease liability to reflect the revised lease payments, *using the original discount rate for the lease.*[1]	✗	✗	✓	✓
Adjust the amount of the right-of-use asset by the amount of the remeasurement of the lease liability. However, once the right-of-use asset is reduced to zero, then the remaining amount of the lease liability remeasurement is recognized in the income statement.	✓	✓	✓	✓
Reassess lease classification (see section 6.2) at the remeasurement date based on the circumstances at that date (e.g. fair value and remaining economic life of the underlying asset at the remeasurement date).	✓	✓	✗	✗
If there is a change in lease classification (see section 6.2), adjust the remaining lease cost recognition pattern and presentation in the income statement and statement of cash flows prospectively.	✓	✓	✗	✗

Notes:

1. When a lessee remeasures the lease payments, variable lease payments that depend on an index or rate are measured using the index or rate as of the remeasurement date.
2. The discount rate is not updated for circumstances #1 or #2 if the discount rate for the lease already reflects that the lessee has an option to extend or terminate the lease or to purchase the underlying asset. [842-10-35-5, ASU 2016-02.BC237]

6.6.320 After the commencement date, a lessee remeasures the lease liability to reflect the changes to the lease payments. [842-20-35-4]

6.6.330 A lessee recognizes as an adjustment to the right-of-use asset the amount of remeasurement of the lease liability, unless the carrying amount of the right-of-use asset is reduced to zero (in which case any remaining amount of the remeasurement is recognized in net income). [842-20-35-4]

Example 6.12
Change in assessment of the lease term

6.6.340 Assume the same facts as in Examples 6.4 and 6.8, in which Lessee LE leases office space from Lessor LR.

6.6.350 At the end of Year 6, LE constructs leasehold improvements that are expected to have significant economic value at the end of the 10-year lease term, such that it becomes reasonably certain that LE will exercise the five-year extension option. Lease payments during the original and the revised lease term are as follows.

Non-cancellable lease period

Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
$14,527	$14,963	$15,412	$15,874	$16,350	$16,841	$17,346	$17,866	$18,402	$18,954

Extension period

Yr 11	Yr 12	Yr 13	Yr 14	Yr 15
$19,523	$20,109	$20,712	$21,333	$21,973

Remeasuring the lease liability and right-of-use asset

6.6.360 Because the remeasurement of the lease payments results from a change in the assessment of the lease term, LE is required to use a discount rate for the lease determined at the remeasurement date (i.e. at the end of Year 6). The rate implicit in the lease is not readily determinable. Accordingly, LE uses its incremental borrowing rate at the end of Year 6 (12%) as the discount rate for the modified lease, taking into account:

- a remaining lease term of nine years (four years remaining from the original lease term plus the five-year extension period); and
- the remeasured lease payments for the revised lease term of nine years.

6.6.370 At the end of Year 6, the carrying amounts of the lease liability and right-of-use asset immediately prior to remeasurement are $57,306 and $53,350, respectively (see Example 6.8).

6.6.380 LE remeasures the lease liability at the present value of the remaining lease payments for the revised lease term (i.e. Years 7 though 15), discounted at 12%, which is $102,048 (or an increase of $44,742). LE records the following journal entry.

	Debit	Credit
Right-of-use asset	44,742	
Lease liability		44,742
To remeasure the ROU asset and lease liability following reassessment of lease term		

6.6.390 After this journal entry, the carrying amount of LE's right-of-use asset is $98,092 ($53,350 + $44,742).

Lease classification reassessment

6.6.400 LE is required to reassess the original classification of the lease as an operating lease (see Example 6.8). The fair value of the office space has increased from lease commencement to $420,000, while the remaining economic life of the building in which the office space resides is 29 years. Therefore, the reassessed lease is an operating lease.

Accounting subsequent to remeasurement

6.6.410 LE calculates the remaining lease cost for the lease as follows. [842-20-25-8]

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the lease term reassessment (i.e. all lease payments from Year 1 through Year 15)	$ 270,185
Plus: Total initial direct costs	5,000
Less: Periodic lease cost recognized in prior periods calculated as (straight-line lease cost of $17,154 x 6 years prior to remeasurement)	(102,923)
Remaining cost of the lease	**$ 172,262**

6.6.420 LE recognizes a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (i.e. $19,140 per year the remaining nine years).

6.6.430 LE accounts for the lease liability and the right-of-use asset after the remeasurement using the guidance in Topic 842 for an operating lease, as illustrated below (using Method 2 to subsequently measure the right-of-use asset).

	ROU asset amortization			ROU asset carrying amount			
Year	Straight-line lease cost	Lease liab. accret.	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance	Lease liab. balance
7	$19,140	$(12,246)	$ 6,894	$98,092	$ (6,894)	$91,198	$96,948
8	19,140	(11,634)	7,506	91,198	(7,506)	83,692	90,716
9	19,140	(10,886)	8,254	83,692	(8,254)	75,438	83,200
10	19,140	(9,984)	9,156	75,438	(9,156)	66,282	74,230
11	19,140	(8,908)	10,232	66,282	(10,232)	56,050	63,615
12	19,140	(7,634)	11,506	56,050	(11,506)	44,544	51,140
13	19,140	(6,137)	13,003	44,544	(13,003)	31,541	36,565
14	19,141	(4,388)	14,753	31,541	(14,753)	16,788	19,620
15	19,141	(2,353)	16,788	16,788	(16,788)	–	–

Example 6.13
A contingency on which payments are based is resolved

6.6.440 Lessee LE leases long-lived equipment (operating lease) to be used in its production process for a lease term of five years. The following facts are relevant at lease commencement.

– Lease payments:	Fixed payments of $1,000 per year (in arrears) plus $2 each hour that the equipment is used
– Renewal/termination/purchase options:	None
– Transfer of ownership:	No
– LE's incremental borrowing rate:	5% (implicit rate cannot be readily determined)
– Initial direct costs:	None
– Lease incentives:	None

6.6.450 In addition, the lease contains a clause specifying that the payments will become fixed at $2,500 per year for the remainder of the contract if the equipment is utilized more than 600 hours in Year 1.

6.6.460 At lease commencement, LE determines that the total cost for the lease is $5,000 ($1,000 x 5 payments). The variable payments that will be made by LE are variable lease payments. LE measures the lease liability based on the present value of the lease payments, discounted at 5%, which is $4,329. Because there are no initial direct costs or lease incentives, the initial measurement of the right-of-use asset is equal to the initial measurement of the lease liability, $4,329.

6.6.470 LE utilizes the equipment for 675 hours during Year 1. Accordingly, LE's straight-line operating lease cost is $1,000, but LE also incurs variable lease cost of $1,350. The carrying amount of the lease liability and the right-of-use asset at the end of Year 1 is $3,545.

6.6.480 Because Year 1 utilization of the equipment exceeded 600 hours, the payments contingent on use of the equipment become fixed at $1,500 for the remaining lease term. Accordingly, LE remeasures the lease liability, considering four remaining lease payments of $2,500 ($1,000 original fixed annual payment + $1,500 additional amount that becomes fixed for the remaining four years of the lease upon resolution of the contingency), discounted at 5%, which results in a revised lease liability balance of $8,865 (an increase of $5,320).

6.6.490 LE does not update the discount rate for the lease in remeasuring the lease liability because the remeasurement relates to the resolution of a contingency on which payments for use of the equipment were based.

6.6.500 LE records the following entry at the end of Year 1.

	Debit	Credit
Right-of-use asset	5,320	
Lease liability		5,320
To remeasure the ROU asset and lease liability following resolution of contingency		

6.6.510 LE does not reassess lease classification because the remeasurement is not the result of a change in the assessment of the lease term, a change in the assessment of a lessee purchase option, or a lease modification.

6.6.520 LE calculates the remaining cost of the lease as follows. [842-20-25-8]

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from resolution of the contingency (i.e. $1,000 for Year 1 and $2,500 thereafter)	$11,000
Plus: Total initial direct costs attributable to the lease	–
Less: Periodic lease cost recognized in prior periods	(1,000)
Remaining lease cost	**$10,000**

6.6.530 LE will recognize a single lease cost, calculated so that the remaining lease cost is allocated over the remaining lease term on a straight-line basis (i.e. $2,500 per year for each of the remaining four years).

6.6.540 LE will account for the lease liability and right-of-use asset from the effective date of the remeasurement using the guidance in Topic 842 for an operating lease, as illustrated below.

	ROU asset amortization			ROU asset carrying amount			
Year	Straight-line lease cost	Lease liab. accret.	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance	Lease liab. balance
2	$2,500	$(443)	$2,057	$8,865	$(2,057)	$6,808	$6,808
3	2,500	(340)	2,160	6,808	(2,160)	4,648	4,648
4	2,500	(232)	2,268	4,648	(2,268)	2,380	2,380
5	2,500	(120)	2,380	2,380	(2,380)	–	–

Example 6.14
Variable lease payments indexed to CPI

6.6.550 Lessee LE enters into a lease of a building for a five-year term with a two-year extension option. At lease commencement, LE does not consider exercise of the extension option to be reasonably certain.

6.6.560 LE's base payment under the lease is $100,000 per year (paid in arrears). The base payment will be adjusted each year by the change in CPI after the lease commencement date. The CPI index value at lease commencement is 196.800. LE incurs no initial direct costs to enter into the lease, does not prepay any lease payments, and does not receive any lease incentives.

6.6.570 LE cannot readily determine the rate implicit in the lease. Therefore, LE's incremental borrowing rate, which is 6% at lease commencement, is the discount rate for the lease.

6.6.580 The lease is classified as an operating lease. LE initially measures the lease liability as the present value of $100,000 per year for five years, discounted at 6%. The $100,000 initial payment already reflects the CPI index at the lease commencement date.

Scenario 1: Lease is not modified and lease liability is not remeasured

6.6.590 The following table summarizes LE's accounting for the lease assuming that there is no remeasurement of the lease liability and no lease modification. The table assumes that the actual outcomes during the lease term (CPI index) are known by LE at lease commencement.

						Single lease cost				
Year	Base pmts.	CPI index	Actual pmts.	End. ROU asset	End. lease liab.	ROU asset amort.	Lease liab. accret.	Single lease Cost	Variable lease cost	Total lease cost
0		196.800		$421,236	$421,236					
1	$100,000	201.800	$102,541	346,510	346,510	$ 74,726	$25,274	$100,000	$ 2,541	$102,541
2	100,000	210.036	106,726	267,301	267,301	79,209	20,791	100,000	6,726	106,726
3	100,000	210.228	106,823	183,339	183,339	83,962	16,038	100,000	6,823	106,823
4	100,000	215.949	109,730	94,339	94,339	89,000	11,000	100,000	9,730	109,730
5	100,000	219.179	111,371	–	–	94,339	5,661	100,000	11,371	111,371
	$500,000		**$537,191**			**$421,236**	**$78,764**	**$500,000**	**$37,191**	**$537,191**

Scenario 2: Lease liability is remeasured at the end of Year 3

6.6.600 Assume the same facts as in Scenario 1, except that at the end of Year 3, LE constructs leasehold improvements that will have significant economic value to LE at the end of the original five-year lease term. Because of this triggering event, LE reassesses the lease term, determining it is now reasonably certain to exercise the two-year extension option. That is, at the end of Year 3, LE reassesses the remaining lease term to be four years (two years remaining from the original lease term plus the two-year extension period).

6.6.610 Accordingly, LE remeasures the lease liability based on a revised discount rate for the lease at the remeasurement date and updated lease payments for the revised lease term (and because the lease payments are remeasured for a change in the lease term, LE also remeasures the variable lease payments based on CPI using the CPI index at the remeasurement date, which is 210.228). LE's incremental borrowing rate at the end of Year 3 is 7%, taking into consideration the remaining, revised lease term and the updated lease payments.

6.6.620 The remeasured lease liability is $361,832 (four payments of $106,823 discounted at 7%).

6.6.630 LE reassesses the lease classification, based on the facts and circumstances as of the reassessment date, and determines that the lease is still an operating lease.

6.6.640 LE calculates the remaining cost for the lease as follows. [842-20-25-8]

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the remeasurement (i.e. $100,000 for the first 3 years and $106,823 for the 4 remaining years)	$ 727,292
Plus: Total initial direct costs attributable to the lease	–
Less: Periodic lease cost recognized in prior periods	(300,000)
Remaining lease cost for the lease	**$ 427,292**

6.6.650 LE will recognize a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (i.e. $106,823 per year for each of the remaining four years).

6.6.660 The following table summarizes LE's accounting for the lease before and after the remeasurement. The table assumes that the actual outcomes during the lease term (CPI index) are known by LE at lease commencement.

						Single lease cost				
Year	Base pmts.	CPI index	Actual pmts.	End. ROU asset	End. lease liab.	ROU asset amort.	Lease liab. accret.	Single Lease Cost	Variable lease cost	Total lease cost
0		196.800		$421,236	$421,236					
1	$100,000	201.800	$102,541	346,510	346,510	$ 74,726	$ 25,274	$100,000	$ 2,541	$102,541
2	100,000	210.036	106,726	267,301	267,301	79,209	20,791	100,000	6,726	106,726
3	100,000	210.228	106,823	183,339	183,339	83,962	16,038	100,000	6,823	106,823
Remeasurement lease liability and ROU asset				361,832	361,832					
4	106,823	215.949	109,730	280,337	280,337	81,495	25,328	106,823	2,907	109,730
5	106,823	219.179	111,371	193,138	193,138	87,199	19,624	106,823	4,548	111,371
6	106,823	222.454	113,036	99,835	99,835	93,303	13,520	106,823	6,213	113,036
7	106,823	224.765	114,210	–	–	99,835	6,988	106,823	7,387	114,210
	$727,292		**$764,437**			**$599,729**	**$127,563**	**$727,292**	**$37,145**	**$764,437**

Example 6.15
Remeasurement and reallocation of the consideration in the contract

Original lease

6.6.670 Lessee LE leases a machine from Lessor LR for three years. As part of the contract, LR will maintain the machine for LE. The following facts about the underlying lease (an operating lease, properly classified) are relevant at the lease commencement date:

– Fixed payments:	Fixed payments of $120,000 per year (paid in arrears)
– Transfer of ownership:	No
– Options:	A single two-year extension option, not reasonably certain of exercise at lease commencement
– Fair value of machine:	$600,000
– Remaining economic life of machine:	8 years
– Residual value guarantee (lessee):	The first $50,000 that the residual value is below $350,000 If the extension option is exercised, then the first $50,000 that the residual value is below $220,000
– Amount probable of being owed under the residual value guarantee:	$18,000
– LE's incremental borrowing rate:	7% (implicit rate cannot be readily determined)

6.6.680 Based on the information above, the consideration in the contract is $378,000.

– Fixed payments:	$360,000 ($120,000 × 3 years)
– Amount probable of being owed under the residual value guarantee:	$18,000

6.6.690 LE concludes that the contract has two components, the machine lease and the (non-lease) machine maintenance, and allocates the consideration in the contract to those components as follows.

Component	Stand-alone price	Allocation	Calculation
Machine lease	$330,000	$315,000	(330,000/396,000) × 378,000
Maintenance	66,000	63,000	(66,000/396,000) x 378,000
	$396,000	**$378,000**	

6.6.700 At lease commencement, LE recognizes a lease liability and a right-of-use asset based on rental payments of $100,000[1] per year and a residual value guarantee payment of $15,000[2] at the end of Year 3.

– Lease liability:	$274,676[3]
– Right-of-use asset:	$274,676[4]

Notes:

1. ($330,000 ÷ $396,000) × $120,000 annual rental payment = $100,000
2. ($330,000 ÷ $396,000) × $18,000 end of lease RVG payment = $15,000
3. The present value of the unpaid lease payments (3 annual payments of $100,000 and one residual value guarantee payment of $15,000 probable of being owed at the end of the lease term), discounted at 7%.
4. Equal to the lease liability because there are no initial direct costs, no lease incentives, or rent prepayments.

Lease reassessment

6.6.710 At the end of Year 2, LE decides to exercise its two-year renewal option, triggering a reassessment of the lease term. At that date, the following facts are relevant.

– Remaining, reassessed lease term:	3 years
– Lease payments:	Fixed payments of $120,000 per year (paid in arrears)
– Remaining options:	None
– Residual value guarantee:	The first $50,000 that the residual value is below $220,000
– Amount probable of being owed under the residual value guarantee:	$6,000
– LE's incremental borrowing rate:	6%

6.6.720 Based on the information above, the remaining consideration in the contract is $366,000:

– Fixed payments:	$360,000 ($120,000 × 3 years)
– Amount probable of being owed under the residual value guarantee:	$6,000

6.6.730 LE reallocates the remaining consideration in the contract to the machine lease and the machine maintenance based on relative stand-alone prices.

Component	Stand-alone price	Allocation	Calculation
Machine lease	$335,000	$306,525	(335,000/400,000) × 366,000
Maintenance	65,000	59,475	(65,000/400,000) x 366,000
	$400,000	**$366,000**	

6.6.740 At the end of Year 2, before the reassessment of the lease term, the balance of the right-of-use asset and the lease liability is:

Lease liability:	$107,476
Right-of-use asset:	$97,476

6.6.750 Due to the change in the lease term, and based on the allocation of the remaining consideration in the contract, LE remeasures the lease payments at $306,525, which is based on:

- allocated rental payments of $100,500[1] per year; and
- An allocation of the residual value guarantee payment at the end of the revised lease term, equal to 5,025[2].

6.6.760 This results in a lease liability and a right-of-use asset immediately after the remeasurement of:

Lease liability:	$272,857[3]
Right-of-use asset:	$262,857[4]

6.6.770 LE recognizes the adjustment from the remeasurement with the following journal entry; there is no profit or loss effect of the remeasurement.

	Debit	Credit
Right-of-use asset	165,381[5]	
Lease liability		165,381[5]
To remeasure the ROU asset and lease liability following reassessment of lease term		

Notes:

1. ($335,000 ÷ $400,000) × $120,000 annual payment = $100,500.
2. ($335,000 ÷ $400,000) × $6,000 end of lease RVG payment = $5,025.
3. The present value of the unpaid lease payments (3 annual payments of $100,500 paid in arrears, and one probable residual value guarantee payment of $5,025 at the end of the lease term), discounted at 6%.
4. $97,476 + ($272,857 - $107,476) = $262,857.
5. $272,857 - $107,476 = $165,381.

KPMG observation – Lease liability remeasured with an equal adjustment to the right-of-use asset

6.6.780 The Board determined that changes in the lease term or lease payments related to a purchase option represent a lessee's expectation that it has acquired more or less of the right to use the underlying asset; and the adjustment to the right-of-use asset should be made to appropriately measure the total cost of the asset. Meanwhile, changes in estimates of the amount probable of being owed under a residual value guarantee and changes to the lease payments resulting from the resolution of a contingency reflect changes to the cost of the right-of-use asset. [ASU 2016-02.BC232, BC238–BC239]

6.6.790 Consequently, changes to the lease liability are recognized as an adjustment to the right-of-use asset unless the adjustment will result in a negative right-of-use asset carrying amount. This means that the effect of the remeasurement in the income statement is *prospective*.

6.6.800 Changes to the carrying amount of the right-of-use asset as a result of revised assessments of the lease term or lessee purchase options also require the lessee to revise useful life estimates for the right-of-use asset (and related assets, such as leasehold improvements) and amortization expense on a prospective basis.

KPMG observation – Remeasurement of a non-lease component

6.6.810 Topic 842 does not address the accounting for non-lease components (e.g. how to recognize the cost of a non-lease component). In Example 6.15, Lessee LE initially allocates $63,000 to the three-year non-lease maintenance component of the contract. Assuming that the maintenance is effectively a stand-ready obligation on the part of Lessor LR, absent the remeasurement outlined above, LE would likely recognize that allocated amount as expense ratably over the three-year lease term (which is also the maintenance services period). However, after the remeasurement, LE allocates $59,475 of the remaining consideration in the contract to the remaining three years of maintenance services.

6.6.820 Consequently, LE might account for the remeasurement as a true-up to a five-year maintenance service, with a total price of $101,475.[1] In that case, LE would recognize contra-expense of $1,410[2] at the time of remeasurement, with an offsetting accrual for that amount. However, because the remeasurement results from a change in estimate, we believe that it would be more appropriate for LE to simply account for the remaining maintenance services to be provided over the final three years of the revised lease term prospectively; this is consistent with how LE will account for the remainder of the lease. Therefore, LE would recognize the $59,475 allocated to the maintenance services ratably over the remaining three-year lease term after the remeasurement; no contra-expense amount would be recognized at the remeasurement date.

Notes:

1. ([$63,000 initial allocation to the 3-year maintenance service ÷ 3 years] × 2 years) + $59,475 allocation after the remeasurement at the end of Year 2 = $101,475.
2. $40,590 (which equals [$101,475 ÷ 5 years] × 2 years) - $42,000 ([$63,000 ÷ 3 years] × 2 years) = $(1,410).

KPMG observation – Reassessment of the discount rate for the lease

6.6.830 The Board decided that, in general, an entity should not reassess the discount rate used to measure the lease liability during the lease term, which is generally consistent with the amortized cost accounting for other, similar financial liabilities. However, the Board concluded that a change in the lease term or in the assessment of a lessee purchase option represent a significant change in the economics of the arrangement, and therefore the discount rate for the lease should be adjusted in those cases. [ASU 2016-02.BC240–BC242]

US GAAP different from IFRS – Remeasurements more frequent under IFRS 16

6.6.840 Under IFRS 16, lessees remeasure the lease liability for changes in variable lease payments based on an index or rate on the date when:

- like Topic 842, lease payments are remeasured for other reasons (e.g. a reassessment due to a change in the lease term); and
- unlike Topic 842, there is a change in the cash flows – i.e. when an adjustment to the lease payments based on an index or rate takes effect under the lease's terms. [IFRS 16.42(b)]

6.6.850 Under IFRS 16, lessees remeasure the lease liability using a revised discount rate when:

- like Topic 842, there is a change in the lease term or the assessment of whether the lessee is, or is not, reasonably certain to exercise a purchase option;
- like Topic 842, there is a lease modification that is not accounted for as a separate contract; and
- unlike Topic 842, there is a change in future lease payments as a result of a change in floating interest rates. [IFRS 16.43]

Comparison with current US GAAP – Reassessments

Requirement to revise lease liability represents a significant change from capital (finance) lease accounting

6.6.860 A requirement to potentially revise the lease liability during the lease term is a significant change from current US GAAP requirements for capital leases where the liability is not remeasured during the lease term unless the lease is modified. [840-30-35-17]

Residual value guarantees

6.6.870 Under current US GAAP, any amounts expected to be payable under a residual value guarantee within an operating lease are accrued separately. For a capital lease, the full amount of the residual value guarantee is included in the determination of the capital lease obligation and the capital lease asset and is not separately accounted for. [840-10-25-6(b)]

Updating the discount rate for the lease

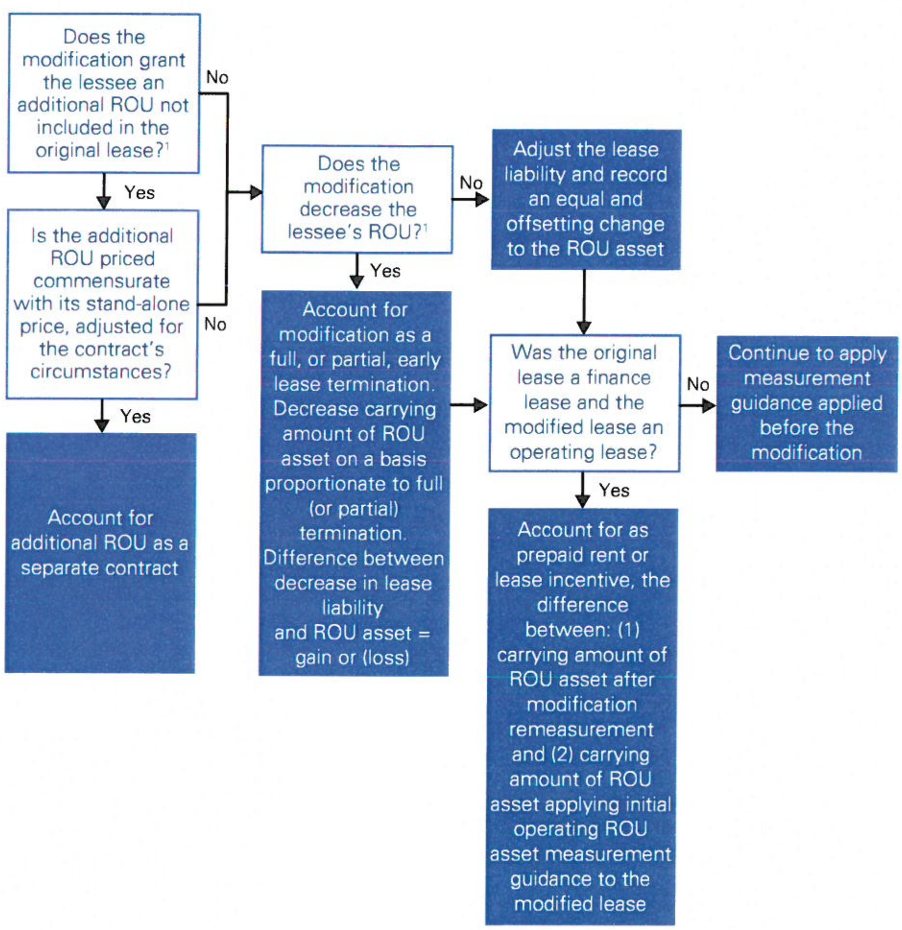
6.6.880 Topic 842's requirement to reassess the discount rate for the lease represents a shift from current US GAAP for capital leases where a lessee, subject to certain requirements, uses the initial discount rate that was determined at lease inception to calculate the change in the lease liability as a result of a change in the amount of remaining minimum lease payments due to a lease modification. [840-30-35-8]

6.7 Lease modifications (Step 8B)

6.7.10 A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term) is a lease modification. [842 Glossary]

6.7.20 The effective date of a lease modification is the date the modification is approved by both the lessee and the lessor. [842 Glossary]

6.7.30 The following flowchart summarizes the lease modification requirements applicable to a lessee. [842-10-25-8 – 25-14]



Note 1:

Lease term is an attribute of the lessee's right to use the underlying asset (i.e. an extension does not grant the lessee an additional right of use).

6.7.40 An entity accounts for a modification as a separate contract when the following conditions are met:

- the modification grants the lessee an additional right-of-use that was not included in the original lease (e.g. a right to use an additional asset); and
- the lease payments increase commensurate with the stand-alone price of the additional right-of-use, adjusted for the circumstances of the contract. For example, the stand-alone price for the lease of one floor in an office building in which the lessee already leases other floors may be different than the stand-alone price of a similar floor in a similar office building because the lessor did not have to incur costs it would have incurred for a new lessee. [842-10-25-8]

6.7.50 The accounting steps an entity performs for a lease modification that is not accounted for as a separate contract are similar to the steps a lessee performs when remeasuring lease liabilities for changes in the lease term or in the assessment of a lessee purchase option, with some differences for Steps 3 and 4 described below. [842-10-25-9 – 25-13]

Accounting steps for a lease modification not accounted for as a separate contract
1. Remeasure and reallocate the consideration in the contract to the remaining lease and non-lease components of the contract at the effective date of the modification (see chapter 4).
2. Remeasure the lease liability to reflect the revised lease payments, using a discount rate for the lease (see section 5.6) determined at the effective date of the modification.[1]
3. Either: a. If the modification decreases the lessee's right-of-use (e.g. reduces the number of assets leased or reduces the space leased in a building), then the carrying amount of the right-of-use asset is reduced on a proportionate basis to the full (or partial) termination of the existing lease; and any difference between the reduction in the lease liability and the reduction in the right-of-use asset is recognized as a gain (loss) at the effective date of the modification. b. Otherwise,[2] adjust the amount of the right-of-use asset by the amount of the remeasurement of the lease liability.
4. Account for initial direct costs (see section 5.5), lease incentives (see section 5.4.3), and other payments in connection with the modification in the same manner as for a new lease.
5. Reassess lease classification as of the effective date of the modification based on the circumstances at that date (e.g. fair value and remaining economic life of the underlying asset at that date).
6. If there is a change in lease classification, adjust the remaining lease cost recognition pattern and presentation in the income statement and statement of cash flows prospectively.

Notes:

1. When a lessee remeasures the lease liability, variable lease payments that depend on an index or rate are measured using the index or rate as of the remeasurement date. The Board decided that a lessee should remeasure variable lease payments that depend on an index or a rate when the lessee remeasures the lease liability for another reason since it would not be logical to use an outdated index or rate in remeasuring the lease payments [842-10-35-5, ASU 2016-02.BC237]

2. Including modifications that:
   - grant the lessee an additional right-of-use not included in the original contract (and that modification is not accounted for as a separate contract)
   - change the term of an existing lease (e.g. extend or reduce the lease term), other than through the exercise of an extension or termination option included in the original contract
   - change the consideration in the contract only

6.7.60 If a finance lease is modified and the modified lease is classified as an operating lease, the lessee accounts for (in the manner of a rent prepayment or a lease incentive) the difference between:

- the carrying amount of the right-of-use asset immediately after remeasurement as a result of the modification; and
- the carrying amount of the right-of-use asset that would result from applying the initial measurement guidance for an operating lease right-of-use asset to the modified lease. [842-10-25-14]

Lease modifications in connection with the refunding of tax-exempt debt

6.7.70 In a tax-exempt debt financing structure in which the facility transfers to the user of such facility by lease (e.g. tax exempt debt financing of construction of a plant or hospital), the lease may serve as collateral to the tax-exempt debt and the lease payments are essentially the same, as to both amount and timing, as those required by the tax-exempt debt. A lease modification resulting from a refunding by the lessor of tax-exempt debt (including an advance refunding) should be accounted for in the same manner as any other lease modification. For example, if the perceived economic advantages of the refunding are passed through to the lessee in the form of reduced lease payments, the lessee should recognize the amount of remeasurement of the lease liability for the modified lease as an adjustment to the corresponding right-of-use asset. [842-10-55-16]

Master lease agreements

6.7.80 Under a master lease agreement, the lessee may gain control over the use of additional underlying assets during the term of the agreement. If the agreement specifies a minimum number of units or dollar value of equipment, a lessee does not apply the lease modification guidance when it gains control over the use of those additional underlying assets. Rather the lessee will identify the separate lease components and allocate the consideration in the contract to those components (see chapter 4). [842-10-55-17]

6.7.90 When the master lease agreement permits the lessee to gain control over the use of additional underlying assets but does not require the lessee to do so, the lessee's taking control over the use of additional underlying assets is accounted for as a lease modification. [842-10-55-18]

Example 6.16
Modification that adds an additional right of use

Scenario 1: Modification is accounted for as a separate contract

6.7.100 Assume the same facts as in Examples 6.4 and 6.8, in which Lessee LE leases office space from Lessor LR. At the beginning of Year 7, LE and LR modify their contract to grant LE the right to use an additional floor of office space in the same building as the current office space LE leases from LR for four years (making the non-cancellable period coterminous with that of the original office space lease), with an option to renew the new space lease for five years (consistent with the option LE has to renew the original office space lease). The new office space is the same size as the original office space and is similar in all significant respects.

6.7.110 The lease payments for the new office space are 5 percent lower each year than the lease payments for the original office space – the lease payments for the original office space continue to be considered market rentals for office space of that size and characteristics.

6.7.120 Because of its existing relationship with LE, LR was able to obtain this lease without incurring any marketing or commission costs and was able to forego costs such as those for a credit check since LE is already a tenant in good standing.

6.7.130 LE (and LR) conclude that this modification should be accounted for as a separate contract (i.e. separate from the original contract that granted LE the right to use the original office space). This conclusion is based on the following.

- The modification grants LE an additional right of use – i.e. the right to use an additional floor of office space.
- The increase in the lease payments for the additional office space is commensurate with the stand-alone price for the right to use that office space *based on the circumstances of this contract*. That is, even though the lease payments for the new office space are 5 percent below market rentals, the lower lease payments are reflective of sharing with LE the benefit of LR not having to incur origination costs to obtain this lease – i.e. as noted in 6.7.120, LR did not have to market the property or pay a broker's commission to obtain the new office space lease and did not have to incur other common origination costs.

6.7.140 Therefore, in accounting for the new office space lease, LE does not undertake any accounting for the original office space lease. LE accounts for the new office space lease just as it would any other new lease.

Scenario 2: Modification is not accounted for as a separate contract

6.7.150 Assume the same facts as in Scenario 1, except that the lease payments are discounted 20 percent from those in the original office space lease, the payments for which are still considered to be market rentals.

6.7.160 LE (and LR) conclude that this modification should *not* be accounted for as a separate contract. Even though, consistent with Scenario 1, the modification grants LE an additional right of use, the increase in the lease payments resulting from the additional right of use is not commensurate with the stand-alone price for that additional right of use, even after considering the factors outlined in Scenario 1 as to the particular circumstances of obtaining this additional lease. The discount from market rentals cannot be considered entirely attributable to the origination costs LR will not have to incur to obtain the new office space lease.

6.7.170 In this scenario, because the new office space lease is commencing immediately, and both leases have the same lease term, it does not matter whether LE accounts for the original office space lease and the new office space lease as separate lease components. However, if the new office space lease commenced at the beginning of Year 8, rather than at the beginning of Year 7, LE would separately account for the two lease components (original office space and new office space), remeasuring the original lease component for the modification (i.e. for the change in the lease payments that will result from allocating a portion of those lease payments to the new office space lease) as of the effective date of the modification. LE would recognize and measure the new office space lease at the commencement date for that lease.

Scenario 3: Blend and extend

6.7.180 Assume the same basic facts as in Scenario 2, except that the right to use the new office space is for a non-cancellable period of nine years from the effective date of the modification and, as part of the modification, the right to use the original office space is made coterminous with the new office space – i.e. LE also commits to lease the original office space for nine years from the effective date of the modification. In addition, the lease payments for the original office space are reduced to match those for the additional office space.

6.7.190 At the beginning of Year 7 of the original lease (which is the effective date of the modification in this example), the carrying amount of the right-of-use asset and the lease liability were (see Example 6.8):

– Lease liability:	$57,306
– Right-of use asset:	$53,350

6.7.200 At the effective date of the modification, the following facts are relevant.

– Rate implicit in the lease:	Not readily determinable
– LE's incremental borrowing rate:	9%
– Residual value guarantee:	None
– Options:	There are no lessee or lessor options in the contract
– Transfer of ownership:	No
– Fair value of the combined office space:	$840,000
– Remaining economic life of the office space:	29 years
– Additional initial direct costs incurred:	$1,000

6.7.210 Because LE's right to use the new office space commences on the effective date of the modification, LE is not required to account for the original office space and the new office space as separate lease components. LE concludes that the single, modified lease component in the contract (for two floors of office space for nine years) is an operating lease.

6.7.220 The lease liability for the modified lease is $184,674 (the present value of the nine annual lease payments, discounted at 9%). Therefore, LE increases its existing lease liability by $127,368 ($184,674 - $57,306). The offset to that adjustment is to the existing right-of-use asset. LE accounts for the initial direct costs incurred in connection with the modification in the same manner as it would for a new lease. Therefore, LE recognizes the additional $1,000 in initial direct costs that it incurs as an addition to its remeasured right-of-use asset.

6.7.230 Consequently, LE records the following journal entry at the effective date of the modification.

	Debit	Credit
Right-of-use asset	128,368	
Lease liability		127,368
Cash (initial direct costs)		1,000
To recognize the lease modification		

6.7.240 From the effective date of the modification, LE accounts for the modified lease in the same manner as for any other lease; see Example 6.8 for an example of subsequent accounting for an operating lease.

Example 6.17
Modification that extends the lease term only

6.7.250 Assume all of the same facts as in Example 6.12 (remeasurement resulting from a change in the lease term), *except that*, instead of there being a remeasurement event at the end of Year 6, assume the lease did not contain a renewal option and the lease is *modified* at the end of Year 6 to extend the total lease term from 10 years to 15 years.

6.7.260 Assume the terms for the extension agreed through the modification and the terms of the renewal option in Example 6.12 are the same. That is, Lessee LE and Lessor LR modify the lease to add an additional period of five years to the lease. Lease payments during the extension period start at $19,523 and increase 3% annually, all payable in arrears. There are no initial direct costs, lease incentives, or other payments between LE and LR as a result of the modification.

Separate contract analysis

6.7.270 Because the modification increases the lease term only (i.e. it does not grant LE an additional right-of-use), the modification cannot be accounted for as a separate contract.

Accounting for the modification and accounting for the lease post-modification

6.7.280 The accounting for the modification and the accounting for the modified lease after the modification in this example is the same as the accounting for the remeasurement and the accounting for the lease after the remeasurement in Example 6.12. Therefore, see that example for the journal entries recorded to remeasure the lease liability and the right-of-use asset, as well as the accounting that results post-modification.

Example 6.18
Partial lease termination

6.7.290 This example continues Examples 6.4 and 6.8, in which Lessee LE entered into a lease with Lessor LR to lease office space for a 10-year term. The terms and conditions are the same. Accordingly the subsequent accounting for the lease in this example is the same as that illustrated in Example 6.8, absent lease reassessments or modifications. Also assume that the lease was for 10,000 square feet of space.

6.7.300 At the end of Year 6, LE and LR modify the lease for the remaining four years to reduce the lease to only 7,500 square feet of the original space and to reduce the remaining annual lease payments by $3,500 for each of the remaining four years. In conjunction with the partial termination, LE also agrees to pay LR a termination fee of $1,000.

6.7.310 Lease classification for the lease does not change as a result of the modification (i.e. it remains an operating lease since the modification reduces both the lease term and the lease payments).

6.7.320 LE remeasures the lease liability at the effective date of the modification based on a remaining lease term of four years, the remeasured lease payments (which decreased by $3,500 per year as compared to the original terms of the lease), and LE's incremental borrowing rate at the modification date, which is 11%. The remeasured lease liability is $45,210 (a $12,096 or 21.11% decrease from the pre-modification liability).

Scenario 1: Remeasuring the right-of-use asset based on the change in lease liability

6.7.330 The decrease of 21.11% in the lease liability reflects the early termination of the right to use 2,500 square feet of space (or 25% of the original space), the change in the lease payments, and the change in the discount rate for the lease.

6.7.340 LE decreases the carrying amount of the right-of-use asset immediately prior to the modification (which equaled $53,350) by 21.11% to reflect the partial termination of the lease. This results in a reduction in the right-of-use asset of $11,261. LE records the following entry related to the partial lease termination at the end of Year 6.

	Debit	Credit
Lease liability	12,096	
Loss on partial lease termination	165	
Right-of-use asset		11,261
Cash		1,000
To recognize lease modification		

Scenario 2: Remeasuring the right-of-use asset based on the remaining right of use

6.7.350 LE determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset (7,500 square feet representing 75% of the original right-of-use asset).

6.7.360 Accordingly, LE decreases the carrying amount of the right-of-use asset by $13,338 (25% x premodification right-of-use asset of $53,350) and the carrying amount of the lease liability by $14,327 (25% x premodification lease liability of $57,306), which results in an adjusted lease liability balance of $42,979. The following journal entry is recorded.

	Debit	Credit
Lease liability	14,327	
Loss on partial lease termination	11	
Right-of-use asset		13,338
Cash		1,000
To recognize lease modification		

6.7.370 LE then recognizes the difference between the remaining lease liability of $42,979 and the remeasured lease liability of $45,210 (determined in the introduction to this example), or $2,231, as an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate.

	Debit	Credit
Right-of-use asset	2,231	
Lease liability		2,231
To recognize lease modification		

KPMG observation – Lease modifications versus lease remeasurements resulting from reassessments

6.7.380 The decisions by the Board to consider the lease term an attribute of the lease and to require a reassessment of lease classification for lease modifications that are not accounted for as a separate contract substantially aligns the lease modification guidance with the lease reassessment guidance. This minimizes accounting differences between the two models that could have created structuring opportunities. [ASU 2016-02.BC177]

Comparison with current US GAAP

Modification guidance is substantially changed from current US GAAP

6.7.390 The lease modification guidance in Topic 842 is substantially different from, and more extensive than, the guidance on lease modifications in current US GAAP. There is virtually no parallel between the two sets of guidance such that entities should take careful note of the new modifications guidance and not assume that anything done with respect to modifications under current US GAAP applies under Topic 842.

6.8 Financial statement presentation (Step 9)

6.8.10 The following table summarizes the financial statement presentation requirements applicable to lessees, which are specified in detail in 6.8.20–110. [842-20-45-1 – 45-5]

	Balance sheet	Income statement	Statement of cash flows
Finance leases	**ROU assets** – separate line item; or – within another line item, separate from where operating lease ROU assets are presented **Lease liabilities** – separate line item; or – within another line item, separate from where operating lease liabilities are presented	**ROU asset amortization** – consistent with presentation of depreciation or amortization of similar assets **Interest expense on lease liability** – consistent with presentation of other interest expense	**Principal repayments** – Financing activities **Interest payments** – In accordance with Topic 230 (typically, in operating activities) **Variable lease payments** – Operating activities
Operating leases	**ROU assets** – separate line item; or – within another line item, separate from where finance lease ROU assets are presented **Lease liabilities** – separate line item; or – within another line item, separate from where finance lease liabilities are presented	**Lease expense** – included in lessee's income from continuing operations (operating expense)	**Lease payments** – Operating activities, unless payments are for costs to put another asset in service **Variable lease payments** – Operating activities

Balance sheet

6.8.20 A lessee presents in the balance sheet (or discloses in the notes) the following.

- Finance lease right-of-use assets and operating lease right-of-use assets separately from each other and from other assets.
- Finance lease liabilities and operating lease liabilities separately from each other and from other liabilities. [842-20-45-1]

6.8.30 Right-of-use assets and lease liabilities are classified as current or noncurrent in a classified balance sheet in the same manner as any other nonfinancial assets and financial liabilities. [842-20-45-1]

6.8.40 If a lessee does not present finance lease and operating lease right-of-use assets and lease liabilities separately in the balance sheet, it discloses the line items in which the right-of-use assets and lease liabilities are included. [842-20-45-2]

6.8.50 A lessee is prohibited from presenting:

- finance lease right-of-use assets in the same line as operating lease right-of-use assets; and
- finance lease liabilities in the same line item as operating lease liabilities. [842-20-45-3]

6.8.60 Operating lease liabilities are presented as operating liabilities, rather than debt. [ASU 2016-02.BC14, BC264]

Income statement

6.8.70 For finance leases, a lessee presents the interest expense on the lease liability and the amortization of the right-of-use asset in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets, respectively. They are not required to be presented as separate line items. [842-20-45-4(a)]

6.8.80 For operating leases, a lessee presents lease expense in income from continuing operations. [842-20-45-4(b)]

6.8.90 Topic 842 does not indicate in which line item in the income statement a lessee should present variable lease payments not included in the lease liability. However, the Basis for Conclusions states that variable lease payments not included in lease liabilities should be classified within operating activities in the statement of cash flows *because the corresponding lease cost will be presented in income from continuing operations*, rather than something else (e.g. interest expense for finance leases). [ASU 2016-02.BC271]

Statement of cash flows

6.8.100 A lessee classifies cash flows from leasing transactions as follows.

- Repayments of the principal portion of the lease liability arising from finance leases within financing activities.
- Interest on the lease liability arising from finance leases in accordance with Topic 230 (statement of cash flows).

- Payments arising from operating leases within operating activities unless the lease payments represent costs to bring another asset to the condition and location necessary for its intended use (i.e. investing activities).
- Variable lease payments and short-term lease payments not included in the lease liability within operating cash flows. [842-20-45-5]

6.8.110 The initial recognition of a lease liability and right-of-use asset is a non-cash transaction that is not included in the statement of cash flows but separately disclosed with other non-cash transactions. [842-20-50-4(g)(2)]

KPMG observation – Basis for the presentation requirements in the balance sheet

6.8.120 The Board decided that finance lease right-of-use assets, operating lease right-of-use assets, finance lease liabilities, and operating lease liabilities should either be presented as separate line items in the balance sheet or disclosed in the notes to the financial statements. Lessees will also disclose the line items in which those amounts are included if they do not separately present them in the balance sheet. [ASU 2016-02.BC262–BC264]

6.8.130 These requirements are about ensuring that financial statement users get the benefit of what the Board believes is the primary improvement to US GAAP resulting from Topic 842: the recognition of right-of-use assets and lease liabilities for all leases other than short-term leases. The Board wanted users to be able to identify the amounts and where they are included in the balance sheet. [ASU 2016-02.BC262]

6.8.140 The requirement not to include finance lease right-of-use assets and lease liabilities in the same line items as their operating lease counterparts is primarily a function of Board members' understanding that some view finance leases and operating leases as two different types of transactions – one being more similar to a purchase of the underlying asset; the other being simply a rental of another entity's owned asset. [ASU 2016-02.BC263]

KPMG observation – Presentation of operating lease liabilities

6.8.150 The Board chose to characterize operating lease liabilities as operating in nature, rather than debt. Therefore, when considering how to present these liabilities in the balance sheet, entities might consider a presentation similar to what they do for other discounted financial liabilities that are considered operating in nature, such as restructuring liabilities and asset retirement obligations. [ASU 2016-02.BC264]

7 Lessor accounting

How the standard works

Topic 842 does not make extensive changes to lessor accounting. A lessor will classify leases using criteria similar to current US GAAP, as (1) sales-type, (2) direct financing, or (3) operating leases. Once classified, the accounting model applied to each type of lease is also substantially similar to the lessor accounting model under current US GAAP.

	Balance sheet	Income statement	Cash flow statement
Sales-type and direct financing leases	– Recognize net investment in lease – Derecognize underlying asset	– Selling profit (loss) at lease commencement[1] – Interest income over lease term	– Cash received from leases as operating cash flows
Operating leases	– Continue to recognize underlying asset	– Lease income generally on straight-line basis over lease term	– Cash received from leases as operating cash flows

Note 1:

Selling profit is recognized over the lease term for direct financing leases.

7.1 An overview

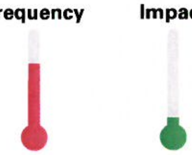
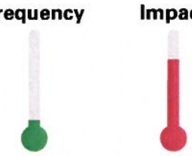
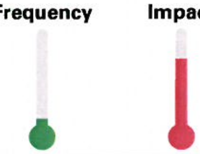
7.1.10 As the following table shows, many of the key concepts and definitions underlying the lessor accounting model are substantially similar to current US GAAP.

Key concept or definition	Meaning in Topic 842
Net investment in the lease	Lease receivable **+** unguaranteed residual asset
Lease receivable	PV of the lease payments **+** PV of guaranteed portion of estimated residual value
Unguaranteed residual asset	PV of unguaranteed portion of estimated residual value
Commencement date (section 5.1)	Date on which the lessor makes the underlying asset available for use by the lessee; date of initial recognition and measurement of a lease
Lease term (section 5.3)	Non-cancellable period of the lease **+** periods covered by lessee option to extend that lessee is reasonably certain to exercise **+** periods subsequent to lessee termination option that lessee is reasonably certain *not* to exercise **+** periods covered by a lessor-controlled option to extend or not to terminate
Lease payments (section 5.4)	Undiscounted fixed (including in-substance fixed) payments **+** optional payments that are reasonably certain to be paid
Discount rate for the lease (section 5.6)	Rate implicit in the lease
Rate implicit in the lease (section 5.6)	Discount rate that balances the following equation. PV of lease payments **+** PV of estimated residual value **=** Fair value of the underlying asset **+** capitalizable initial direct costs

7.1.20 Despite the overall similarities between the lessor accounting guidance in current US GAAP and the lessor accounting guidance in Topic 842, there are some important changes that lessors should be aware of as they implement Topic 842. Despite not wanting to fundamentally change lessor accounting, the Board made a number of changes for one or more the following reasons:

- to align the new lessor accounting guidance with the new lessee accounting guidance;
- to align the new lessor accounting guidance with certain aspects of Topic 606; and/or
- to improve and/or simplify lessor accounting for a long-standing complexity or absence of guidance in current US GAAP.

7.1.30 The following table summarizes the key changes to the lessor accounting model from current US GAAP. The frequency with which a specific change will arise and the impact of each change when it does arise is not necessarily the same for each of the changes in the table. We have provided our current expectation about the frequency with which each change will arise and the impact we expect the change to have when it does. These are general expectations; the frequency with which each of these changes will arise, and the impact they have when they do, will vary by lessor. For some of the changes below, the frequency of occurrence and/or impact of the change will be so specific to the facts and circumstances that no general expectation is provided.

Key change	Summary
Changes in lease classification between sales-type and direct financing (section 7.2)	Sales-type leases and direct financing leases are no longer differentiated by whether there is manufacturer/dealer profit or loss. Instead, they will be differentiated by whether the lessor transfers substantially all of the risks and benefits of ownership of the underlying asset to only the lessee or to the lessee *and* an unrelated third party.
Frequency **Impact** 	– The changes will result in many current direct financing leases being classified as sales-type leases under Topic 842.
Frequency **Impact** 	– A smaller number of current sales-type leases will be classified as direct financing leases under Topic 842.
Recognition of selling profit (section 7.3.1) **Frequency** **Impact** 	If selling profit arises from a direct financing lease, it will be deferred and recognized over the lease term.
Narrowed definition of initial direct costs (section 5.5) **Frequency** **Impact** 	Initial direct costs include only those incremental costs of a lease that would not have been incurred if the lease had not been executed. Some costs (e.g. legal fees and allocated internal costs) that an entity capitalizes as initial direct costs under current US GAAP will be expensed when incurred under Topic 842. For some lessors, this may result in recognizing more expenses before the lease commences and higher margins on lease income earned over the lease term.

Key change	Summary
Allocation of consideration in the contract to lease and non-lease (e.g. service) components (section 4.4) **Frequency** **Impact** **Lessor specific** **Lessor specific**	Lessors will apply the transaction price allocation guidance in Topic 606, which includes specific guidance on allocating bundled discounts and variable consideration that will be new to lessors.
Executory costs (4.2.20–30) **Frequency** **Impact**	Executory costs that do not represent payments for a good or service (e.g. payments to reimburse the lessor for property taxes or insurance) will be allocated to the lease and non-lease components in the same manner as all other payments in the contract; they will not be excluded from lease accounting as they are under current US GAAP.
Collectibility (section 7.6) **Frequency** **Impact**	Leases with collectibility uncertainties will no longer be precluded from sales-type lease classification; and Topic 842 includes specific guidance about lease income recognition when collectibility of the lease payments, plus any amounts necessary to satisfy residual value guarantees, is not probable.
Leases with significant variable payments (section 7.2) **Frequency** **Impact**	Leases with predominantly variable payments may be classified as sales-type or direct financing leases, which will result in significantly different accounting compared to current US GAAP.
Lease modifications (section 7.7) **Frequency** **Impact** **Depends on facts and circumstances**	Topic 842 includes guidance on lease modifications that is substantially different from current US GAAP; it was developed to more closely align lessor modification accounting with the contract modification accounting applicable to sellers of goods or services under Topic 606. Lease classification is reassessed on a lease modification that is not accounted for as a separate contract. The lessor accounting for a lease modification depends on the classification of the original *and* the modified lease.

Key change	Summary
Leveraged leases (section 7.5) Frequency Impact	Leveraged lease classification and accounting is eliminated by Topic 842 for all leases that commence on or after the effective date of Topic 842. Lessors will continue to account for leveraged leases that commence prior to the effective date in accordance with current US GAAP, unless the lease is modified on or after the effective date.

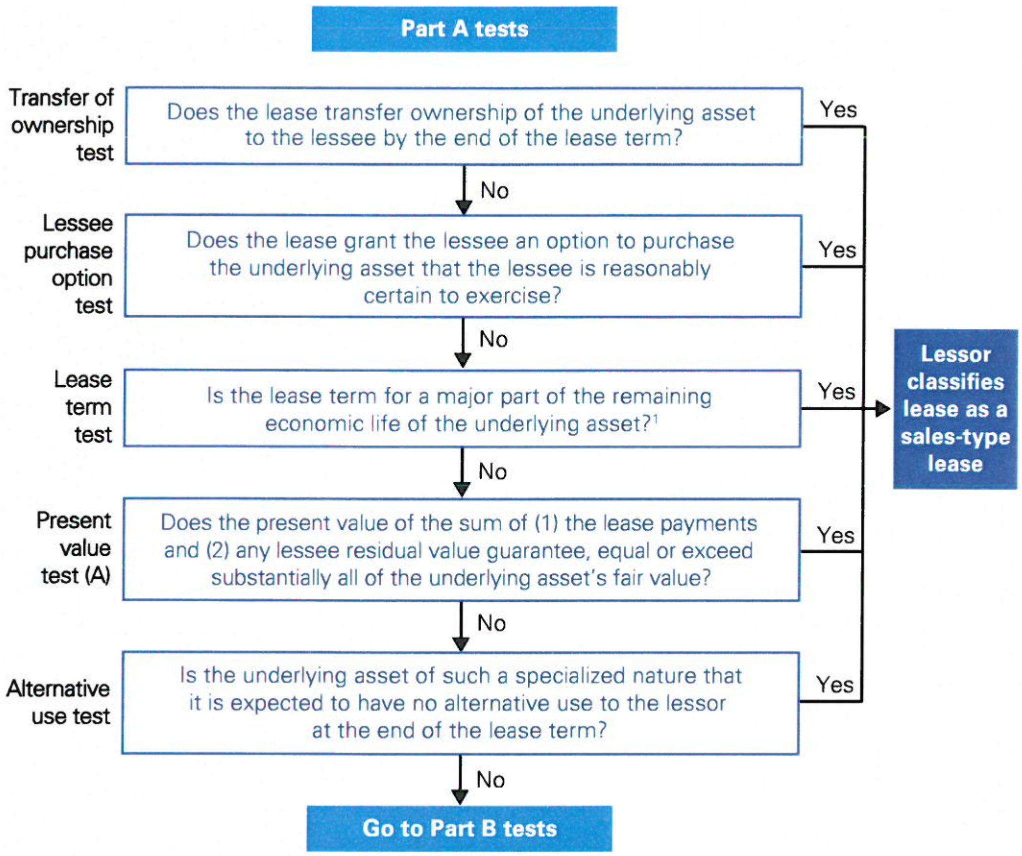
7.2 Lease classification

7.2.10 A lessor determines lease classification for each separate lease component, which is the unit of account in applying Topic 842 (see section 4.1), at the lease commencement date. [842-10-25-1]

7.2.20 Lease classification is only reassessed if the lease is modified and the modification is not accounted for as a separate contract (see section 7.7) [842-10-25-1]

7.2.30 The lease classification tests can be grouped into two parts.

- **Part A.** These tests determine whether a lease is a sales-type lease and are the same as the classification tests for lessees. The outcome of these tests is either (1) the lease is a sales-type lease, or (2) further testing is required (Part B) to classify the lease.
- **Part B.** These tests determine whether the lease is an operating lease or a direct financing lease. [842-10-25-2 – 25-3]



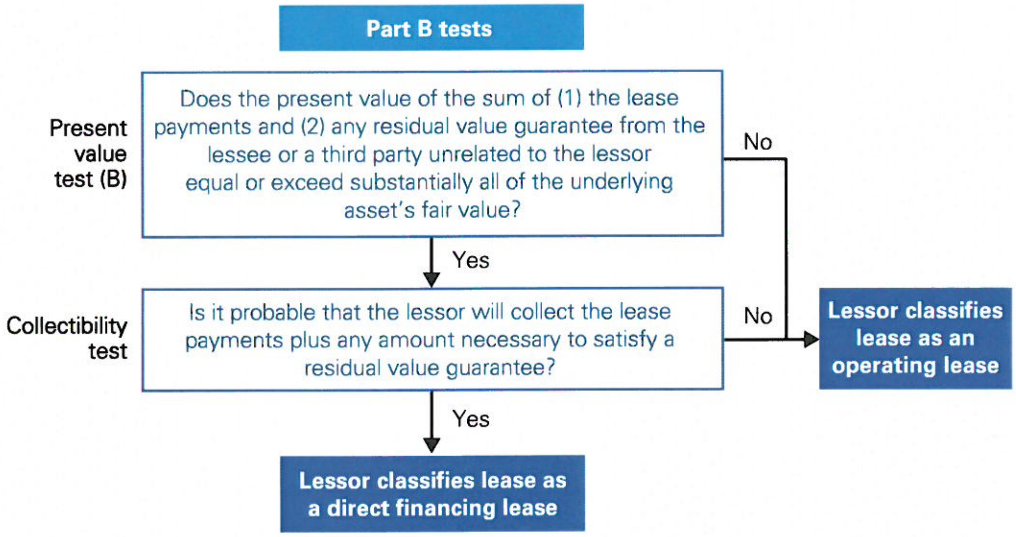
Note 1:

If the commencement date is at or near the end of the underlying asset's economic life, this test does not apply.

7.2.40 Because the Part A lease classification tests are the same for lessors as they are for lessees, our discussion of the application of those tests is mostly in section 6.2 (in the chapter dealing with lessees).

7.2.50 However, there are two additional points relevant to lessors in applying the Part A classification tests.

- The lessor determines the present value of the lease payments and residual value guarantees using the rate implicit in the lease (see section 5.6) – i.e. unlike lessees, a lessor always uses the rate implicit in the lease.
- In determining the rate implicit in the lease for lease classification purposes, a lessor assumes that no initial direct costs will be deferred if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. [842-10-25-4]



7.2.60 The difference between the present value test in Part A, and the present value test in Part B, is the inclusion in Part B of a residual value guarantee provided by a third party unrelated to the lessee or the lessor (in addition to any residual value guarantee provided by the lessee in the Part A present value test). Consistent with the present value test in Part A, a lessor may use a threshold of 90 percent or more when determining whether the sum of the present value of (1) the lease payments and (2) any residual value guarantees amount to 'substantially all' of the fair value of the underlying asset. Section 6.2 provides additional discussion about 'substantially all'.

7.2.70 The Part B tests focus on whether substantially all of the lessor's risk in the lease is credit risk. When the lessor effectively converts its risk in the nonfinancial residual asset to credit risk (e.g. through a residual value guarantee provided by an unrelated third party or through a combination of residual value guarantees provided by the lessee and an unrelated third party) and collectibility of the lease payments (plus any amount necessary to satisfy the residual value guarantee(s) provided to the lessor) is probable, the lease is a direct financing lease. Otherwise, it is an operating lease.

7.2.80 Under a portfolio residual value guarantee, the lessor is economically assured of receiving a minimum residual value for a portfolio of underlying assets that are subject to separate leases, but not for each individual asset. Any excess of an asset's residual value over the guaranteed amount is offset against shortfalls in residual value that exist in other assets in the portfolio. [842-10-55-9]

7.2.90 Residual value guarantees of a portfolio of underlying assets preclude a lessor from determining the amount of the guaranteed residual value of any individual underlying asset within the portfolio. Consequently, such amounts are ignored when evaluating the present value test for lease classification purposes.[1] [842-10-55-10]

Note 1:

It is unclear presently whether the Board intended for this provision related to lease classification to also apply to lessees.

US GAAP different from IFRS – IFRS 16 does not distinguish between sales-type and direct financing leases

7.2.100 Consistent with current IFRS, IFRS 16 does not distinguish between sales-type and direct financing leases. Lessors will account for their leases as either finance or operating leases, like they do today. In most respects, the two classification system (finance or operating) for lessors under current IFRS and the four classification system (sales-type, direct financing, leveraged, or operating) for lessors under current US GAAP does not result in substantial lessor accounting differences. Similarly, it is not expected that the two classification system for lessors under IFRS 16 and the three classification system for lessors under Topic 842 will result in substantial lessor accounting differences going forward. [IFRS 16.61–66]

Comparison with current US GAAP

7.2.110 In general, the lease classification guidance in Topic 842 is likely to result in operating lease classification for most leases classified as operating leases under current US GAAP.

7.2.120 The following table summarizes the key differences in lease classification between current US GAAP and Topic 842 applicable to lessors. [842-10-25]

Current US GAAP	Topic 842
Sales-type lease	
Results when the lease meets: – any one of the criteria in paragraph 840-10-25-1; – both of the criteria in paragraph 840-10-25-42; and – the fair value of the underlying asset does not equal its carrying amount.	Results when the lease passes any one of the five tests in 7.2.30, regardless of whether the fair value of the underlying asset equals the carrying amount of the underlying asset.
Effect	
Many leases classified as direct financing leases under current US GAAP will be classified as sales-type leases under Topic 842; however, the accounting effect of that difference in classification will typically be insignificant. In contrast, relatively few leases classified as sales-type leases under current US GAAP will be classified as direct financing leases under Topic 842; but the accounting effect will be significant for those leases, because the selling profit, which is recognized at lease commencement under current US GAAP, will be deferred and recognized over the lease term instead (see section 7.3.1).	

Current US GAAP	Topic 842
Direct financing lease	
Results when the lease meets: – any one of the criteria in paragraph 840-10-25-1; – both of the criteria in paragraph 840-10-25-42; and – the fair value of the underlying asset equals its carrying amount.	Results when the lease is not a sales-type lease, but the Part B tests are both passed (see diagram in 7.2.50).
Effect The same as discussed for sales-type leases.	

Current US GAAP	Topic 842
Leveraged leases	
Results when the lease meets: – the criteria to be classified as a direct financing lease; and – three additional specified criteria in paragraph 840-10-25-43(c).	Leveraged lease classification and accounting no longer exists prospectively from the effective date of Topic 842 (see section 13.6).
Effect Leases that commence on or after the effective date of Topic 842 that would be classified as leveraged leases under current US GAAP will be accounted for differently. In addition, any grandfathered leveraged leases that are modified on or after the effective date are no longer accounted for as leveraged leases after the modification date.	

Current US GAAP	Topic 842
Real estate leases	
Real estate leases are subject to classification requirements different from other leases. For example, a real estate lease can only be a sales-type lease if ownership is transferred to the lessee.	Real estate leases no longer have special rules; they are subject to the same guidance as all other leases.
Effect Lease classification for real estate leases under Topic 842 will differ more significantly from current US GAAP than for other leases. More real estate leases will likely be classified as sales-type or direct financing leases under Topic 842.	

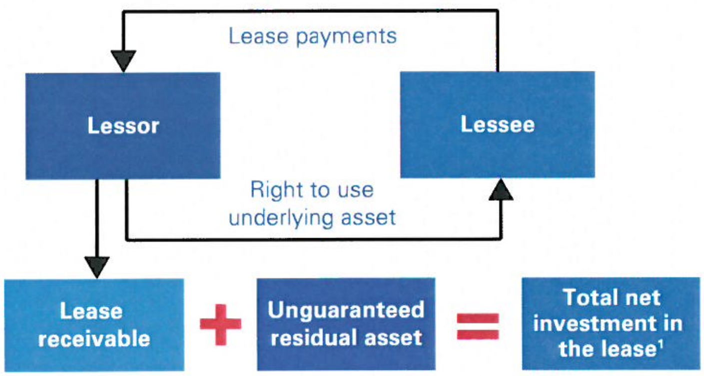
Current US GAAP	Topic 842
Collectibility uncertainties	
If collectibility of the minimum lease payments is not reasonably predictable, the lease is classified as an operating lease. An exception is when the underlying asset is real estate and ownership transfers to the lessee.	Collectibility uncertainties do not preclude a lease from being classified as a sales-type lease. However, a lease cannot be classified as a direct financing lease if the collectibility test is failed (see diagram in 7.2.50).
Effect Some leases currently classified as operating leases because of collectibility uncertainties will be classified as sales-type leases under Topic 842. For a discussion of collectibility considerations for lessors, see section 7.6.	

Current US GAAP	Topic 842
Unreimburseable costs	
If there are important uncertainties as to the amount of unreimburseable costs that the lessor will incur under the lease, the lease is classified as an operating lease. An exception is a lease of real estate that transfers ownership to the lessee.	There is no similar lease classification test in Topic 842.
Effect Some leases currently classified as operating leases because of failing to meet this criterion will be classified as sales-type or direct financing leases under Topic 842. This includes some leases that are currently classified as operating leases under this criterion because a significant portion of the payments for the lease are variable.	

7.3 Sales-type and direct financing leases

7.3.1 An overview

7.3.10 For sales-type and direct financing leases, a lessor recognizes a net investment in the lease in its balance sheet and derecognizes the underlying asset. [842-30-25-1, 25-7,40-1]



Note 1:

If the lease is a direct financing lease, any selling profit is deferred and the deferred selling profit reduces the net investment in the lease.

7.3.20 For a **sales-type lease**, the lessor's net investment in the lease comprises:

- a lease receivable (see 7.3.50); and
- an unguaranteed residual asset for the lessor's interest in the underlying asset's estimated future value at the end of the lease term that is not guaranteed by either:
  - the lessee; or
  - another third party unrelated to the lessor. [842-30-30-1]

7.3.30 For a **direct financing lease**, the lessor's net investment in the lease comprises (is):

- a lease receivable and an unguaranteed residual asset (calculated in the same way as for a sales-type lease);
- reduced by any selling profit on the lease, which is deferred and recognized over the lease term; it is not recognized at lease commencement as it is for a sales-type lease. [842-30-25-8, 30-2]

7.3.40 The selling profit or selling loss on the lease is:

- the lower of: (1) the fair value of the underlying asset or (2) the sum of the lease receivable + any prepaid lease payments;
- minus the carrying amount of the underlying asset, net of any unguaranteed residual asset;
- minus any initial direct costs (see section 5.5) of the lessor that are deferred (i.e. capitalized) – see 7.3.60. [842 Glossary]

7.3.2 Initial recognition and measurement

7.3.50 For a sales-type lease or a direct financing lease, the lessor initially measures the lease receivable at the present value of the following, discounted at the rate implicit in the lease (see section 5.6):

- future lease payments receivable over the lease term; and
- any portion of the estimated residual value at the end of the lease term that is guaranteed (either by the lessee or by a third party unrelated to the lessor). [842-30-30-1(a), 30-2]

Lease receivable = **PV of future lease payments** + **PV of RVGs**

7.3.60 At lease commencement, a lessor recognizes any selling profit (loss) and initial direct costs as follows. [842-30-25-1, 25-7 – 25-8, 30-1 – 30-2]

Sales-type lease	Direct financing lease
Selling profit	
Recognize at lease commencement	Defer as a reduction of the net investment in the lease
Selling loss	
Recognize at lease commencement	
Initial direct costs	
– If the fair value of the underlying asset does not equal its carrying amount: » Expense at lease commencement. » Exclude from determination of the rate implicit in the lease (see Example 7.2, Scenario 1) – If the fair value of the underlying asset equals its carrying amount: » Defer and include in the net investment in the lease[1] » Include in determination of the rate implicit in the lease (see Example 7.2, Scenario 2)	– Defer and include in the net investment in the lease[1] – Include in determination of the rate implicit in the lease

Note 1:

The rate implicit in the lease is defined in such a way that the initial direct costs eligible for deferral are included automatically in the net investment in the lease; there is no need to add them separately.

7.3.70 A lessor initially measures the unguaranteed residual asset as the present value of the amount that the lessor expects to derive from the underlying asset following the end of the lease term that is *not* guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease. [842-30-30-1(b), 30-2]

7.3.80 Notwithstanding the above general guidance on the initial recognition and measurement of a sales-type lease, an exception arises if collectibility of the lease payments and any lessee residual value guarantee is not probable. For a discussion of the accounting that applies under the exception, see section 7.6. [842-30-25-3 – 25-6]

7.3.3 Subsequent accounting

7.3.90 After the lease commencement date, the lessor measures the net investment in the lease by:

- increasing the carrying amount to reflect interest income resulting from amortization of the lease receivable and accretion of the unguaranteed residual asset (and recognition of deferred selling profit, if any, for direct financing leases); and
- reducing the carrying amount to reflect lease payments received. [842-30-35-1]

7.3.100 The lessor uses the effective interest method to both (1) amortize the lease receivable and (2) accrete the unguaranteed residual asset to its estimated future value at the end of the lease term.

7.3.110 A lessor only remeasures its net investment in the lease after initial measurement if the lease is modified and that modification is not accounted for as a separate contract (see section 7.7). [842-30-35-2]

7.3.120 After the lease commencement date, the lessor recognizes:

- interest income on the net investment in the lease, as described in 7.3.90;
- variable lease payments as income in profit or loss in the period in which the changes in facts and circumstances on which those payments are based occur; and
- impairment of the net investment in the lease, as described in 7.3.130. [842-30-25-2, 25-9]

Impairment of the net investment in the lease

7.3.130 The lessor assesses its entire net investment in the lease for impairment, and recognizes any impairment loss, in accordance with the impairment guidance for financial instruments. A lessor does *not* separately evaluate the unguaranteed residual asset for impairment (except in accordance with 7.3.140), or review the estimated residual value of the underlying asset as lessors do under current US GAAP. When determining the loss allowance for a net investment in the lease, the lessor considers the collateral relating to the net investment in the lease. The collateral represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term (e.g. from the sale or re-lease of the asset for the remainder of the lease term) and excludes the cash flows that the lessor would expect to derive from the underlying asset after the end of the lease term (e.g. cash flows from re-leasing the asset after the end of the lease term). [842-30-35-3]

Sale of the lease receivable

7.3.140 If the lessor sells the lease receivable and retains an interest in the unguaranteed residual asset, the lessor no longer accretes the unguaranteed residual asset to its estimated future value over the lease term. The lessor reports any remaining unguaranteed residual asset at its carrying amount at the date of the sale of the lease receivable, and applies Topic 360 (property, plant, and equipment) to determine whether the unguaranteed residual asset is impaired. [842-30-35-4]

Accounting for the underlying asset at the end of the lease term

7.3.150 At the end of the lease term, the lessor reclassifies the net investment in the lease to the appropriate asset category in accordance with other US GAAP, measured at the carrying amount of the net investment in the lease. The lessor accounts for the underlying asset in accordance with other US GAAP. [842-30-35-5]

Accounting for lease terminations

7.3.160 If a sales-type or direct financing lease is terminated before the end of the lease term, the lessor:

- tests the net investment in the lease for impairment;
- reclassifies the net investment in the lease to the appropriate asset category in accordance with other US GAAP, measured at the sum of the carrying amount of the lease receivable (less amounts still expected to be received by the lessor) and the residual asset; and
- accounts for the underlying asset in accordance with other US GAAP. [842-30-40-2]

7.3.170 If a lease agreement is replaced by a new lease agreement with a new lessee, the lessor accounts for the termination of the original lease (see 7.3.160) and accounts for the new lease in same manner as it would any other new lease.

Example 7.1
Recognition of selling profit for a direct financing lease

7.3.180 Lessor LR leases a non-specialized machine to Lessee LE for three years. The following facts are relevant at the lease commencement date.

Lease payments:	Fixed payments of $10,500 per year in arrears
Renewal/purchase options:	None
Transfer of ownership:	No
Fair value of machine:	$40,000
Carrying amount of machine:	$36,000
Remaining economic life of machine:	5 years
Estimated future residual value:	$12,500
Residual value guarantee (third party other than LE):	$9,200
Rate implicit in the lease:	4.29%

7.3.190 In addition:

- At the commencement date, the present value of the future lease payments is 93% of the fair value of the machine (with the residual value guarantee), and 72% of the fair value of the machine (without the residual value guarantee).
- There are no prepaid lease payments and LR has not incurred any initial direct costs.

Lease classification

7.3.200 In this example, the lease is a direct financing lease as a result of the third-party (non-lessee) residual value guarantee, which is included in the present value test in Part B (see diagram in 7.2.50).

Initial measurement

7.3.210 At the commencement date, LR records the following entry.

	Debit	Credit
Lease receivable[1]	37,091	
Unguaranteed residual asset[2]	2,909	
Property, plant, and equipment		36,000
Deferred profit[3]		4,000
To recognize direct financing lease		

Notes:

1. Present value of: contractual lease payments ($10,500 x 3) + residual value guarantee ($9,200), discounted at 4.29%.
2. Present value of unguaranteed residual asset of $3,300 ($12,500 - $9,200), discounted at 4.29%.
3. Fair value of underlying asset ($40,000) - carrying amount ($36,000). This is the same as the difference between the lease receivable ($37,091) and the carrying amount of the machine, net of the unguaranteed residual asset ($33,091).

End of Year 1

7.3.220 LR records the following entry at the end of Year 1.

	Debit	Credit
Cash	10,500	
Unguaranteed residual asset[1]	125	
Deferred profit[2]	1,637	
Lease receivable[3]		8,909
Interest income[4]		3,353
To recognize interest, accretion, and deferred selling profit in Year 1		

Notes:

1. Accretion of unguaranteed residual asset ($2,909 × 4.29%).
2. Total lease income of $3,353 ($36,000 × 9.31%) - interest on lease receivable ($1,591) - accretion of unguaranteed residual asset ($125). 9.31% is the discount rate that would have been required at lease commencement for the lease receivable + the unguaranteed residual asset to equal $36,000.
3. Cash payment of $10,500 - interest on lease receivable of $1,591 ($37,091 × 4.29%).
4. Accretion of unguaranteed residual asset ($125) + interest on lease receivable ($1,591) + release of deferred profit ($1,637). Alternative calculation: $36,000 × 9.31%.

Effect on the financial statements

7.3.230 The following table summarizes the amounts arising in LR's balance sheet (in which LR presents its net investment in the lease, rather than the components in the table) and income statement.

Balance sheet					Income statement			
End of year	Lease receivable	Unguar. resid. asset	Deferred profit[1]	Net invest. in lease	Interest on receivable[2]	Residual accretion[2]	Earned profit[3]	Total income[3]
0	$37,091	$2,909	($4,000)	$36,000	$ –	$ –	$ –	$ –
1	28,182	3,034	(2,363)	28,853	1,591	125	1,637	3,353
2	18,891	3,164	(1,015)	21,040	1,209	130	1,348	2,687
3	9,200	3,300	–	12,500	809	136	1,015	1,960
	Totals				**$3,609**	**$391**	**$4,000**	**$8,000**

Notes:

1. Subsequent to lease commencement, deferred selling profit recognition = total income - interest on the lease receivable - unguaranteed residual asset accretion.
2. Interest on the lease receivable and unguaranteed residual asset accretion are calculated using the rate implicit in the lease that is derived by using the machine's fair value at lease commencement of $40,000 as the initial investment (4.29%).
3. Total income, including release of deferred profit, is allocated so that it is recognized at a constant rate equal to the discount rate derived by using the machine's carrying amount at lease commencement ($36,000) as the initial net investment (9.31%).

End of lease

7.3.240 LR records the following entry at the end of the lease.

	Debit	Credit
Property, plant, and equipment	12,500	
Net investment in the lease		12,500
To recognize termination of direct financing lease		

Example 7.2
Accounting for initial direct costs in a sales-type lease

Scenario 1: Fair value of underlying asset does not equal its carrying amount

7.3.250 Lessor LR leases a commercial truck to Lessee LE for five years. The following facts are relevant at the lease commencement date.

– Lease payments:	Fixed payments of $10,500 per year in arrears; none are prepaid
– Renewal/purchase options:	None
– Transfer of ownership:	No
– Fair value of truck:	$56,000
– Carrying amount of truck:	$53,000
– Total economic life of truck:	12 years
– Remaining economic life of truck:	6 years
– Estimated future residual value:	$15,000
– Initial direct costs:	$400

Lease classification

7.3.260 In this example, the lease is a sales-type lease because the lease term of five years represents a major part (i.e. 83%) of the underlying asset's remaining economic life (see diagram in 7.2.30).

Calculation of rate implicit in the lease

7.3.270 At lease commencement, the fair value of the truck is different from its carrying amount. Therefore, the initial direct costs will be expensed at lease commencement and the rate implicit in the lease is determined based on the fair value of the underlying asset, *without regard to initial direct costs*. The rate implicit in the lease is therefore 5.68%, determined as follows.

Year	Initial investment	Lease payments	Residual value	Net receipts/ payments
0	**$(56,000)**	$ -	$ -	$(56,000)
1		10,500	-	10,500
2		10,500	-	10,500
3		10,500	-	10,500
4		10,500	-	10,500
5		10,500	15,000	25,500
			Rate	**5.68%**

Scenario 2: Fair value of underlying asset equals its carrying amount

7.3.280 Assume the same facts as Scenario 1, except that, at the lease commencement date, coincidentally the truck has a fair value and a carrying amount to LR of $56,000.

7.3.290 In this scenario, because the fair value of the truck equals its carrying amount at lease commencement, the initial direct costs of $400 are considered when determining LR's implicit rate, and are deferred as part of the net investment in the lease as a result of the implicit rate determined. The rate implicit in the lease is therefore 5.45%, determined as follows.

Year	Initial investment	Lease payments	Residual value	Net receipts/ payments
0	**$(56,400)**	$ -	$ -	$(56,400)
1		10,500	-	10,500
2		10,500	-	10,500
3		10,500	-	10,500
4		10,500	-	10,500
5		10,500	15,000	25,500
			Rate	**5.45%**

Comparing Scenarios 1 and 2

7.3.300 Including the initial direct costs of $400 when determining the rate implicit in the lease in Scenario 2 results in deferring the initial direct costs and recognizing them in net income through lower interest income over the lease term as compared to Scenario 1 (in which the initial direct costs are expensed at lease commencement).

KPMG observation – Asymmetric measurement of the lessor's lease assets and the lessee's lease liability

7.3.310 The measurement of the lessor's lease receivable will differ from the measurement of the lessee's lease liability in many cases. The following are just some of the reasons for a difference.

- The **lessor's** lease receivable includes the present value of any residual value guarantee (whether obtained from the lessee or another third party unrelated to the lessor). The **lessee's** lease liability includes only the present value of amounts that it is probable of owing to the lessor under a residual value guarantee that it provides.
- The **lessor** always uses its implicit rate as the discount rate for the lease. The **lessee** typically uses its incremental borrowing rate as the discount rate for the lease because the information it would need to determine the lessor's implicit rate is generally not readily determinable (see KPMG observation at 5.6.140).
- In addition to the fact that the amount of initial direct costs for the lessee and the lessor will typically differ, the **lessor** will either expense initial direct costs at lease

commencement or include such amounts in its net investment in the lease – i.e. because the initial direct costs are deferred through the implicit rate, they are included in both the lease receivable and the unguaranteed residual asset. In contrast, the **lessee** includes initial direct costs in the measurement of its right-of-use asset, rather than as part of its lease liability.

7.3.320 Other measurement differences will arise in practice due to information asymmetry; for example, different assessments as to whether it is reasonably certain that the lessee will exercise a renewal or a purchase option.

KPMG observation – Selling profit deferred for direct financing leases at lease commencement and recognized over the lease term

7.3.330 Direct financing leases exist in Topic 842 because the Board concluded that a lease is not a sales-type lease unless the customer, in effect, obtains control of – i.e. the ability to direct the use of, and obtain substantially all the remaining benefits from – the underlying asset as a result of the lease. This customer perspective is consistent with the customer perspective of a sale in Topic 606. The Board considered that it would be inappropriate, and would potentially create structuring opportunities for entities that are typically sellers (rather than lessors), to recognize selling profit even if control does not pass to the customer by structuring a sale as a sales-type lease. [ASU 2016-02.BC95]

7.3.340 However, the Board still recognized that a lessor might effectively convert its risk arising from ownership of the underlying asset (i.e. asset risk) into credit risk. It concluded that the most faithful representation of the lessor's involvement in a lease in that case is to recognize a *financial* net investment in the lease and financial (interest) income on that net investment. [ASU 2016-02.BC96]

KPMG observation – Selling loss recognized at lease commencement for sales-type and direct financing leases

7.3.350 Even though a lessor defers selling *profit* arising from a direct financing lease under Topic 842, it recognizes at lease commencement any selling *loss* on a direct financing lease. If the lessor considers other applicable guidance (e.g. the long-lived asset or inventory impairment guidance), that guidance would generally result in recognition of a loss on the underlying asset. For example, the pricing in the lease might be evidence that the cash flows to be derived from the underlying asset will be less than its carrying amount, resulting in the recognition of an impairment. Therefore, the approach of recognizing a selling loss up-front is consistent with the idea that the presence of the selling loss might just be indicative of an existing impairment. [ASU 2016-02.BC98]

KPMG observation – Net investment in the lease assessed for impairment under financial instruments guidance

7.3.360 A lessor is required to assess the entire net investment in the lease for impairment using the impairment guidance for financial instruments. Although the unguaranteed residual asset does not meet the definition of a financial asset, the Board thought it would be complex and provide little benefit to users to require entities to separately assess the components of the net investment for impairment – i.e. assess the lease receivable in accordance with the financial instruments impairment guidance and the unguaranteed residual asset in accordance with long-lived assets impairment guidance. [ASU 2016-02.BC310]

7.3.370 Additionally, to be classified as a sales-type lease or a direct financing lease, the unguaranteed residual asset will generally be small in comparison to the lease receivable. Or, in some cases, there may be no unguaranteed residual asset at all; for example, if the lease is classified as a sales-type lease because it transfers ownership of the underlying asset to the lessee, or grants the lessee a purchase option that the lessee is reasonably certain to exercise. Because most of the net investment in the lease will comprise the lease receivable (i.e. a financial asset), it was deemed appropriate for a lessor to assess the entire net investment in the lease for impairment based on the guidance for financial instruments. [ASU 2016-02.BC311]

7.3.380 When determining the loss allowance for the net investment in the lease, a lessor considers the collateral related to the lease receivable. This is because it represents cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term. When a lessee defaults on its lease payments, however, the lessor retains its rights to that collateral. Therefore, it would be unusual for the lease receivable to be impaired when the residual asset is not also impaired. This further supports the Board's decision to require assessment of the entire net investment in the lease for impairment, rather than to assess each component separately. [ASU 2016-02.BC311]

KPMG observation – No requirement for lessors to reassess key lease estimates and judgments

7.3.390 Unlike lessees, lessors do *not* reassess key lease estimates and judgments after lease commencement (e.g. lease classification, lease term, the likelihood of the lessee to exercise of a purchase option, or the discount rate on sales-type and direct financing leases) unless the lease is modified and that modification is not accounted for as a separate contract (see section 7.7). The Board decided not to subject lessors to the same reassessment requirements as lessees primarily because of its decision to substantially retain lessor accounting under current US GAAP. This simplifies lessor accounting compared to lessee accounting and may limit volatility in the lessor's financial statements. Excluding lessors from the reassessment requirements also helps to align the lessor accounting guidance in Topic 842 with the guidance in current US GAAP. [ASU 2016-02.BC314]

7.3.400 However, while lessors will not reassess key *lease* estimates and judgments, in some cases a lessor will be required to reassess estimates of variable consideration that relates to a non-lease component of the contract if that variable consideration is part of the 'consideration in the contract' (see section 4.3).

KPMG observation – Leases with significant variable lease payments

7.3.410 For leases with significant variable lease payments (e.g. in some renewable energy arrangements), the undiscounted sum of the following may be less than the underlying asset's fair value and/or carrying amount at lease commencement: (1) the lease payments, and (2) the estimated residual value of the underlying asset at the end of the lease term. In that case, sales-type lease classification for these leases, which could occur based on the lease term compared to the remaining economic life of the asset or the specialized nature of the asset, would require loss recognition at lease commencement if one assumes that the discount rate for the lease must be positive, even if the lessor expects the lease to ultimately be profitable.

7.3.420 Topic 842 requires the lessor to use the rate implicit in the lease as the discount rate for the lease – i.e. to measure its net investment in the lease. That rate is defined in a way that generally requires the present value of (1) the lease payments, and (2) the estimated residual value of the underlying asset at the end of the lease term, to be no less than the underlying asset's fair value at lease commencement. For leases with significant variable lease payments, following that definition could mean that the lessor would be required to use a negative discount rate. Doing so would mean that no loss would be recognized at lease commencement unless the fair value of the underlying asset is less than its carrying amount.

7.3.430 It is not clear whether the Board considered the possibility (or expected) that discount rates could be negative based on the definition of the rate implicit in the lease. In addition, it is not clear to what extent the fact that Topic 606 may require up-front loss recognition in arrangements with significant variable (or contingent) consideration even if the seller expects the arrangement to ultimately be profitable factored into the Board's consideration of these leases. We expect the accounting for these transactions to generate further debate during the implementation period given the interplay between sales-type lease accounting and the revenue recognition guidance in Topic 606, and the current ambiguity around the Board's intent about lessor discount rates in these leases.

US GAAP different from IFRS – Different treatment of selling profit for direct financing leases

7.3.440 Lessors applying IFRS 16 recognize a profit or loss at commencement for a finance lease equal to the difference between the fair value and carrying amount of the underlying asset. IFRS 16 does not differentiate between finance leases that are classified as such only as a result of third-party residual value support (e.g. third-party residual value guarantees or buy-back agreements) and those that are classified as finance leases for other reasons. [IFRS 16.71]

7.3.450 As outlined in 7.2.60, third-party residual value support can result in a lease being classified as a direct financing lease, but not as a sales-type lease, under Topic 842. Any selling profit on a direct financing lease is deferred at lease commencement and recognized over the lease term. Consequently, for leases classified as direct financing leases under Topic 842, there will be a difference in lessor accounting between IFRS and US GAAP when there is selling profit that results from the lease.

7.3.460 Example 7.1 (Topic 842) and the corresponding IFRS solution in 7.3.480–490 illustrate the different accounting that would result in those scenarios. Practically, however, this difference in the guidance between IFRS 16 and Topic 842 may not result in a significant IFRS/US GAAP accounting difference because most leases that include third-party residual value support (namely, those of financial intermediaries who purchase the underlying asset contemporaneously with lease commencement) do not give rise to selling profit.

7.3.470 The FASB believes its differing accounting treatment for sales-type leases and direct financing leases substantially aligns the requirements for recognition of up-front profit in a lease with the requirements for recognition of a sale in Topic 606. The IASB decided that its central decision to significantly limit lessor accounting changes overrode any conceptual questions about whether leases that achieve finance lease accounting only through third-party involvement are consistent with the sale principle in IFRS 15, which focuses on the customer *obtaining* control of the asset, rather than on the seller's *transferring* of control. [IFRS 16.71(c)]

Comparison of lessor accounting between Topic 842 and IFRS 16

7.3.480 Using the fact pattern in Example 7.1 (Topic 842), the following table summarizes the amounts arising in Lessor LR's balance sheet (in which LR presents its net investment in the lease, rather than the components in the table) and income statement.

Balance sheet				Income statement			
End of year	Lease receivable	Unguar. resid. asset	Net investment in lease	Interest on receivable	Residual accretion	Earned profit[1]	Total income
0	$37,091	$2,909	$40,000	$ –	$ –	$4,000	$4,000
1	28,182	3,034	31,216	1,591	125		1,716
2	18,891	3,164	22,055	1,209	130		1,339
3	9,200	3,300	12,500	809	136		945
	Totals			**$3,609**	**$391**	**$4,000**	**$8,000**

Note 1:

Earned selling profit calculated in the same manner as deferred selling profit under Topic 842 (see 7.3.40).

7.3.490 As illustrated above, the timing of profit recognition and the periodic rate of return on LR's net investment in the lease may be significantly different for some direct financing leases under US GAAP compared to IFRS finance leases (and US GAAP sales-type leases).

Comparison with current US GAAP – Sales-type and direct financing leases

The concept of deferred selling profit does not exist in current US GAAP

7.3.500 Under current US GAAP, any selling profit in a lease that meets one of the criteria in paragraph 840-10-25-1 and both criteria in paragraph 840-10-25-42 is recognized at lease commencement. Selling profit is never deferred as it will be for a direct financing lease under Topic 842.

While the population of initial direct costs is changed, the accounting for initial direct costs is unchanged

7.3.510 Section 5.5 discusses that the definition of initial direct costs is substantially narrowed from that in current US GAAP. As a result, many entities will recognize significant origination costs for a lease as incurred that they do not recognize as incurred currently. Lessors in that situation will recognize greater margins on their lease income earned over the lease term (e.g. operating lease income or interest income on their direct financing leases) and potentially on their selling profit earned at lease commencement – i.e. if a sales-type lessor incurs origination costs that are expensed at lease commencement under current US GAAP (at the same time selling profit or loss is recognized), but are expensed when incurred under Topic 842.

7.3.520 However, the accounting for those costs that meet the definition of initial direct costs under Topic 842 is substantially consistent with the accounting for those costs that meet the definition of initial direct costs in current US GAAP (see section 7.3.1).

7.3.530 However, there is a *mechanical* difference in the accounting.

- Under current US GAAP, initial direct costs for direct financing leases are recognized as an asset and that asset is amortized to income together with the unearned income so as to produce a constant periodic rate of return on the net investment in the lease – i.e. using the effective interest method. [840-30-30-11]
- Under Topic 842, the rate implicit in the lease is such that initial direct costs eligible for deferral are included automatically in the net investment in the lease; there is no need to add them separately.

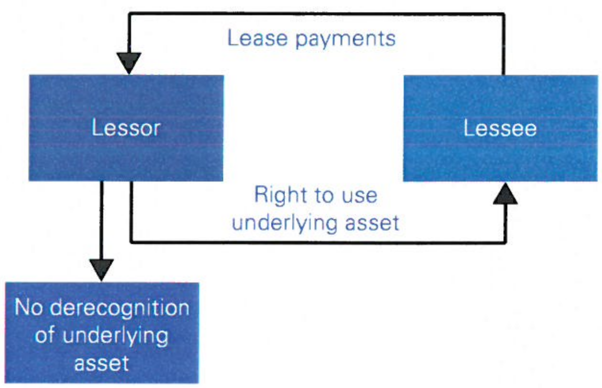
7.3.540 The result is that the rate implicit in the lease is the same as the constant periodic rate of return on the net investment in the lease. Although the accounting for initial direct costs under Topic 842 is mechanically different from current US GAAP, that changed methodology does not affect total assets or periodic net income.

7.3.550 Lessor accounting for initial direct costs for operating leases is consistent with current US GAAP – i.e. recognize initial direct costs as a separate asset and amortize to expense over the lease term on the same basis as lease income (see 7.4.10). [840-20-25-16, 35-2]

7.4 Operating leases

7.4.10 For operating leases, at the commencement date:

- The lessor continues to recognize the underlying asset and depreciate it over its estimated useful life.
- The lessor continues to measure the underlying asset in accordance with other US GAAP, including testing for impairment in accordance with the guidance on impairment or disposal of long-lived assets.
- Lease payments under the contract are recorded as receivables only when they are due and payable by the lessee. Consequently, there is no interest income recognition.
- Lease income is recognized on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which income is earned from the underlying asset.
- Variable lease payments are recorded as income in profit or loss in the period in which the changes in facts and circumstances on which those payments are based occur.
- Initial direct costs are initially deferred and recognized as expense over the lease term on the same basis as lease income. [842-30-25-10 – 25-11, 30-4]



KPMG observation – Operating lease accounting substantially unchanged from current US GAAP

7.4.20 Lessor accounting for operating leases is (in broad terms) substantially the same as operating lease accounting under current US GAAP.

7.4.30 However, operating lease income under Topic 842 may not always be the same as that recognized under current US GAAP. A difference is most likely to arise because of changes to the guidance on identifying and separating components of a contract, and allocating consideration in the contract to lease and non-lease components (see chapter 4). For example, differences in the separation and allocation guidance can affect the amount of lease and non-lease income recognized; this will result, in some cases, from lessors applying the allocation guidance in Topic 606. In addition, lessors may also see effects resulting from Topic 606 on their revenue recognition for non-lease components – i.e. potentially how they recognize revenue for some services or supply arrangements that accompany the lessor's leases.

KPMG observation – Operating leases give rise to lease receivables that will not be recognized

7.4.40 The Board concluded that all leases, including operating leases, give rise to a lease receivable for the lessor. When the lessor makes the underlying asset available for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee – the lessee controls the right of use and has a liability to make lease payments. Accordingly, the lessor has a lease receivable. The lessor controls that right to payment (e.g. it can decide to sell or securitize that right). [ASU 2016-02.BC75]

7.4.50 In deciding not to substantially change lessor accounting (and therefore to not require lessors to recognize those lease receivables), the Board made a cost-benefit decision that the conceptual merits for a substantial change to lessor accounting did not provide sufficient benefits to financial statement users (i.e. investors and analysts, bankers, etc.) to justify the costs to lessors of enacting that change. [ASU 2016-02.BC88–BC90]

7.5 Leveraged leases

7.5.10 Leveraged leasing transactions typically provide significant tax and financial reporting benefits for lessors applying US GAAP. Leveraged leases usually involve capital intensive assets such as airplanes and power plants that are leased for extended periods (e.g. 25 years or more). However, these transactions have become more infrequent in recent years due to changes in interest rates and investment tax incentives.

7.5.20 Topic 842 eliminates leveraged lease accounting for leases that commence on or after the effective date. Instead, a lessor accounts for all leases as sales-type, direct financing, or operating leases. Leveraged leases that *commence* prior to the effective date of Topic 842 are not subject to its requirements – i.e. leveraged lease accounting continues. However, leveraged leases that are *modified* after the effective date of Topic 842 are subject to Topic 842 at the effective date of the modification – i.e. grandfathering is terminated. [842-10-65-1(z); 842-50]

7.5.30 The exercise of a renewal option by the lessee 'that it was not previously reasonably assured to exercise' is considered a lease modification. If this occurs, the lease no longer is a leveraged lease and the lessor applies Topic 842 to the lease from the date of exercise – i.e. the lease loses its grandfathered status. [842-50-15-1]

7.5.40 The exercise of a lessee renewal option that is in the lease contract, regardless of whether the lessee was reasonably certain to exercise that option, is not considered a lease modification under any other circumstance in Topic 842.

KPMG observation – Decision to grandfather leveraged leases

7.5.50 The Board's decision to eliminate leveraged lease accounting was intended to reduce complexity in the lessor accounting requirements and to converge with IFRS, which has no specialized accounting for leveraged leases (see 7.5.70).

7.5.60 However, the Board decided to grandfather leveraged leases that commence prior to the effective date of Topic 842, on the basis that the costs for lessors to unwind their accounting would exceed the benefit to financial statement users of doing so. This decision requires lessors with leveraged leases to retain their existing systems and controls for those transactions until the leases are terminated, which may be several decades. Therefore, lessor accounting for similar leases may differ solely depending on whether the lease commences shortly before or shortly after the effective date. As a result, the decision to grandfather existing leveraged leases may make it difficult for financial statement users to compare the financial statements of those lessors to those of other lessors prepared under US GAAP and IFRS. [ASU 2016-02.BC397]

US GAAP different from IFRS – No leveraged lease guidance under IFRS

7.5.70 Current IFRS does not include guidance on leveraged leases; therefore, the IASB did not consider whether to retain such accounting or grandfather any existing leases subject to that accounting. Because IFRS does not have leveraged lease accounting, the FASB's decision to grandfather existing leveraged leases (which are often very long-term leases) will perpetuate the existing lessor accounting difference between IFRS and US GAAP for many years to come.

7.6 Collectibility

7.6.10 This section discusses how a lessor assesses collectibility for different types of leases, and the accounting implications.

7.6.20 A lessor does not reassess lease classification unless the lease is modified and that modification is not accounted for as a separate contract (see section 7.7). Therefore, changes in the assessment of collectibility after the commencement date do not affect the classification of the lease, regardless of whether the change is positive (i.e. collectibility becomes probable) or negative (i.e. collectibility is determined to no longer be probable). For example, a lease that was classified as an operating lease at lease commencement solely because of collectibility issues is not reclassified as a direct financing lease if collectibility subsequently becomes probable. [842-10-25-3(b)(2), 842-30-55-25 – 55-30, 55-40 – 55-43]

Sales-type leases

7.6.30 The collectibility of the lease payments and any amount necessary to satisfy a lessee residual value guarantee is assessed *after* a lease has been classified as a sales-type lease. The collectibility assessment does not affect the classification of the lease, but it can change the accounting outlined in section 7.3.

7.6.40 If collectibility of the lease payments, plus any amount necessary to satisfy a *lessee* residual value guarantee, is not probable at the commencement date, the lessor does *not* derecognize the underlying asset. Instead, the lessor recognizes lease payments received, including variable lease payments, as a deposit liability until the earlier of either of the following:

1. collectibility of the lease payments/lessee residual value guarantee becomes probable; or
2. either:
   - the contract has been terminated, and the lease payments received from the lessee are nonrefundable; or
   - the lessor has repossessed the underlying asset, has no further obligation under the contract to the lessee, and the lease payments received are nonrefundable. [842-30-25-3]

7.6.50 At the date that criterion (1) is met, the lessor: [842-30-25-4]

- derecognizes the carrying amount of the underlying asset;
- derecognizes the carrying amount of any deposit liability;
- recognizes a net investment in the lease on the basis of the remaining lease payments and the remaining lease term, using the rate implicit in the lease determined at the *lease commencement date;* and
- recognizes selling profit (loss), calculated as:

Selling profit (loss) = **Lease receivable** + **Carrying amount of deposit liability** − **Carrying amount of underlying asset, net of unguaranteed residual asset**

7.6.60 At the date that criterion (2) is met, the lessor derecognizes the carrying amount of any deposit liability, with a corresponding amount recognized as lease income. [842-30-25-5]

7.6.70 If collectibility is subsequently assessed as probable for a sales-type lease (i.e. after it was initially assessed as not probable at lease commencement), in accounting for that lease subsequent to the collectibility reassessment, the lessor uses the rate implicit in the lease determined at the lease commencement date. [842-30-25-4(c)]

7.6.80 If collectibility is probable at the commencement date for a sales-type lease, the lessor does not reassess whether collectibility is probable after the commencement date. Subsequent changes in the credit risk of the lessee are accounted for in accordance with the impairment guidance applicable to the net investment in the lease (see 7.3.130). [842-30-25-6]

Other leases

7.6.90 If collectibility is probable at the commencement date for a direct financing lease, the lessor does not reassess whether collectibility is probable after the commencement date. Subsequent changes in the credit risk of the lessee are accounted for in accordance with the impairment guidance applicable to the net investment in the lease (see 7.3.130). [842-30-25-6]

7.6.100 If collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee (provided by the lessee *or* another unrelated third party) is *not* probable at the commencement date:

- The lease cannot be classified as a direct financing lease (see diagram in 7.2.50), and is therefore an operating lease.
- Cumulative lease income is limited to the lesser of (a) the income that would be recognized in accordance with the guidance applicable to all operating leases, or (b) the amount of the lease payments, including variable lease payments, that have been collected from the lessee. [842-30-25-12]

7.6.110 If the assessment of collectibility changes after the commencement date, any difference between (a) and (b) is recognized as a current-period adjustment to lease income. [842-30-25-13]

7.6.120 Topic 842 includes examples that illustrate the accounting requirements for lease payments in which collectibility is not probable at the commencement date for a sales-type lease and an operating lease. [842-30-55-25 – 55-30, 55-40 – 55-43]

KPMG observation – Collectibility reassessment requirements will require ongoing effort

7.6.130 Topic 842 includes ongoing monitoring efforts for lessors with respect to collectibility. These include all of the following.

- For any lease for which collectibility of the lease payments and amounts necessary to satisfy a residual value guarantee is *not* probable at lease commencement, the lessor continually reassesses whether collectibility becomes probable.
- If the lease with collectibility concerns is a sales-type lease, the lessor monitors for either of the two specified events in 7.6.40 that would permit income recognition even in the absence of a conclusion that collectibility is probable.
- For operating leases only, the lessor monitors whether collectibility *remains* probable after lease commencement.

7.6.140 The following is a summary of how collectibility is assessed for different leases.

Type of lease	Collectibility probable at commencement?	After initial recognition
Sales-type	✔	No ongoing monitoring of collectibility; perform impairment test of net investment in lease (see 7.3.130).
	✘	Ongoing monitoring of collectibility.
Direct financing[1]	✔	No ongoing monitoring of collectibility; perform impairment test of net investment in lease (see 7.3.130).
Operating	✔	Ongoing monitoring of collectibility.
	✘	Ongoing monitoring of collectibility.

Note 1:

A lease cannot be classified as a direct financing lease if collectibility is not probable at lease commencement.

7.6.150 Because lessors are not required to reassess collectibility in the same way as under current US GAAP, additional processes or controls may need to be implemented to monitor for changes in collectibility and/or the occurrence of events that would trigger lease income recognition in relation to sales-type leases.

KPMG observation – Collectibility guidance for sales-type leases designed to prevent structuring opportunities

7.6.160 The guidance that applies to sales-type leases when collectibility of the lease payments, plus any amounts necessary to satisfy a lessee residual value guarantee, is not probable is similar to that applied by sellers of goods under Topic 606. The lessor guidance was developed in this manner to ensure that sellers of goods cannot circumvent the collectibility guidance in Topic 606 – i.e. recognize revenue earlier than would be permitted by Topic 606 – by structuring them as sales-type leases. [ASU 2016-02.BC104]

7.6.170 In contrast, because in the Board's view operating leases and direct financing leases are not similar to sales of the underlying asset, the Board concluded that the relevant collectibility guidance did not need to align with Topic 606. Instead, the guidance is mostly consistent with the collectibility guidance in current US GAAP.

US GAAP different from IFRS – IFRS 16 does not include collectibility guidance

7.6.180 Current IFRS does not include collectibility guidance for lessors. Given that the IASB wanted to limit changes to lessor accounting as much as possible, the IASB decided that it was not necessary to introduce collectibility guidance specific to lessors into IFRS 16.

Comparison with current US GAAP

Effects of collectibility uncertainties on lessor accounting

7.6.190 The following table summarizes the effects of collectibility uncertainties on lessor accounting under Topic 842 compared with current US GAAP based on what the classification of the lease would be if there were no collectibility uncertainties. [840-10-25-42(a)]

Current US GAAP	Topic 842
Sales-type lease	
– Lease classified (and accounted for) as an operating lease. – No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).	– No effect on lease classification. – Underlying asset not derecognized. – No lease income recognized; lease payments (and variable lease payments) received recognized as a deposit liability.
Direct financing lease	
– Lease classified (and accounted for) as an operating lease. – No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).	– Lease classified (and accounted for) as an operating lease. – Cumulative lease income restricted to lease payments (and variable lease payments) received.
Operating lease	
– Lease classified (and accounted for) as an operating lease. – No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).	– Lease classified (and accounted for) as an operating lease. – Cumulative lease income restricted to lease payments (and variable lease payments) received.
Leveraged lease	
– Lease classified (and accounted for) as an operating lease. – No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).	– N/A

Collectibility issues generally more punitive to lessors under Topic 842

7.6.200 The accounting result of collectibility issues will generally be more punitive under Topic 842 than it is under current US GAAP. Consider both of the following.

- The requirement to recognize lease payments (and variable lease payments) as a deposit liability for sales-type leases both results in later lease income recognition than under current US GAAP *and* results in the recognition of liabilities by the lessor when the lease payments (and variable lease payments) that have been received are non-refundable.
- The provision limiting cumulative lease income on operating leases with collectibility concerns to the lease payments (and variable lease payments) that have been received will, for the same operating lease, generally result in delayed income recognition as compared with current US GAAP, which does not include a similar *requirement* when collectibility of the minimum lease payments is not reasonably predictable.

Reassessing collectibility

7.6.210 Topic 842 includes ongoing monitoring efforts for lessors with respect to collectibility that were not required under current US GAAP. Additional processes or controls may need to be implemented by lessors to monitor for changes in collectibility and/or the occurrence of events that would trigger lease income recognition in relation to sales-type leases.

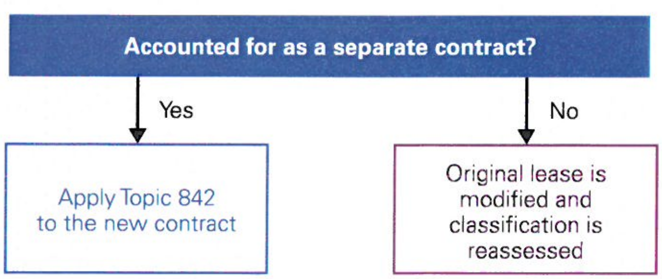
7.7 Lease modifications

7.7.10 A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease; for example, a change that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term. [842 Glossary]

7.7.20 A lease modification includes a change to the terms and conditions of the contract that contains the lease if that contract modification changes the 'consideration in the contract', and therefore changes the lease payments (see section 5.4) – i.e. changes the consideration for the lease.

7.7.30 The effective date of a lease modification is the date that the modification is approved by both the lessee and the lessor. [842 Glossary]

7.7.40 A key question that drives the accounting for a modification is whether the modification should be accounted for as a separate contract.



7.7.50 A modification is accounted for as a separate contract (see Example 6.16) when it both:

- grants the lessee an additional right of use that was not included in the original contract (e.g. the right to use an additional asset); and
- the lease payments increase commensurate with the stand-alone price for the additional right of use, as adjusted for the circumstances of the particular contract. [842-10-25-8]

7.7.60 An increase to the lease term (e.g. a modification changing the lease term from four to six years) does not grant the lessee an additional right of use. [842-10-25-11]

7.7.70 If a lease is modified and that modification is *not* accounted for as a separate contract, the entity reassesses the classification of the lease as of the effective date of the modification, based on the modified terms and conditions and the facts and circumstances as of that date (e.g. the fair value and remaining economic life of the underlying asset at that date). The accounting for lease modifications not accounted for as a separate contract depends on the classification of the modified lease. [842-10-25-9]

7.7.80 When a lessee exercises an option to extend a lease (including by electing not to exercise a termination option), to terminate a lease, or to purchase the underlying asset, the lessor accounts for the exercise of that option as a lease modification. [842-10-35-3]

7.7.90 While not stated in the guidance, we believe that the Board did not intend for a lessor to account for the exercise of an extension option already factored into the lessor's accounting; for example, an extension option the lessor previously concluded the lessee was reasonably certain to exercise, as a lease modification. Therefore, we believe that the guidance in 7.7.80 would apply only when the lessee exercises an option it was not reasonably certain to exercise. The 'modification' that results from the exercise of a termination option or a purchase option is effectively one that terminates the lease. That is, a lease no longer exists once the lessee has either terminated the lease or has purchased the underlying asset.

Operating lease modifications

7.7.100 If an operating lease is modified and the modification does not result in a separate contract, the lessor accounts for the modification as if the original lease is terminated, and a new lease commences on the effective date of the modification. [842-10-25-15]

Original lease	Modified lease	Requirements
Operating →	Operating	Lessor includes any prepaid or accrued lease rentals relating to the original lease in the lease payments for the modified lease.
Operating →	Sales-type or direct financing	Lessor derecognizes any deferred rent liability or accrued rent asset and adjusts the selling profit (loss) accordingly, which is deferred in the case of a direct financing lease.

Direct financing lease modifications

7.7.110 Lessor accounting for a direct financing lease modification that does not result in a separate contract can be summarized as follows. [842-10-25-16]

Modified lease is a	
Operating lease	Carrying amount of underlying asset = Net investment in original lease, immediately prior to effective date of modification
Sales-type lease	Account for modified lease in accordance with sales-type lease guidance in Subtopic 842-30 with effective date of modification as commencement date of lease[1]
Direct financing lease	Adjust discount rate so that initial net investment in modified lease = Carrying amount of net investment in original lease immediately prior to effective date of modification

Note 1:

In calculating the selling profit (loss) on the lease (see 7.3.40):

- the fair value of the underlying asset is its fair value at the effective date of the modification; and
- the carrying amount of the underlying asset is the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

Sales-type lease modifications

7.7.120 Lessor accounting for a sales-type lease modification that does not result in a separate contract can be summarized as follows. [842-10-25-17]

Modified lease is a	
Operating lease	Carrying amount of underlying asset = Net investment in original lease, immediately prior to effective date of modification
Sales-type or direct financing lease	Adjust discount rate so that initial net investment in modified lease = Carrying amount of net investment in original lease, immediately prior to effective date of modification

7.7.130 Topic 842 includes various examples illustrating the accounting requirements for lessor modifications. [842-10-55-190 – 55-209]

Example 7.3

Modification accounting – Operating lease remains an operating lease

Original lease

7.7.140 Lessee LE enters into a four-year lease with Lessor LR to lease a new crane for use in a construction project that LE expects will take four years to complete. LR also agrees to maintain the crane throughout the lease term.

– Payments:	Fixed payments of $60,000 per year in arrears
– Renewal/purchase options:	No
– Transfer of ownership:	None
– Fair value of crane:	$500,000
– Remaining economic life of crane:	15 year

7.7.150 The lease is an operating lease; it does not meet any of the criteria to be classified as a sales-type or direct financing lease.

7.7.160 LR is required to allocate the consideration in the contract to the separate lease and non-lease components based on each component's stand-alone selling price (see chapter 4). LR allocates the consideration in the contract as follows.

Component	Stand-alone price	Allocation	Calculation
Crane lease	$230,000	$220,800	(230,000/250,000) x 240,000
Maintenance	20,000	19,200	(20,000/250,000) x 240,000
	$250,000	**$240,000**	

7.7.170 Total consideration in the contract allocated to the lease component is $220,800, and therefore the lease payments equal $220,800. LR will recognize annual lease income of $55,200 ($220,800 ÷ 4 years). LR will account for the non-lease component in accordance with Topic 606.

Lease modification

7.7.180 At the beginning of Year 4, the construction project is projected to take three more years to complete, and LE and LR agree to extend the original lease by two years – i.e. the original four-year lease is extended to six years. The additional two years were not an option when the original lease was negotiated. The modification alters LE's right to use the crane, but it does not grant LE an additional right of use (see 7.7.40). Therefore, LR does not account for the modification as a separate contract.

7.7.190 At the effective date of the modification – i.e. at the beginning of Year 4 when LE and LR agree to the modification – the annual payments increase to $70,000, which includes the annual maintenance services. Total consideration in the modified contract for the remainder of the lease term is now $210,000 ($70,000 × 3 years). The modified lease continues to be classified as an operating lease based on the remaining lease term (3 years) as compared to the remaining economic life of the crane (12 years) and the fair value of the crane ($375,000).

7.7.200 For simplicity, assume that the stand-alone selling prices for a three-year lease and the related maintenance services at the beginning of Year 4 are the same as the stand-alone selling prices for the original four-year lease and the original four years of maintenance services. LR reallocates the remaining consideration in the modified contract at the effective date of the modification as follows.

Component	Stand-alone price	Allocation	Calculation
Crane lease	$230,000	$193,200	(230,000/250,000) x 210,000
Maintenance	20,000	16,800	(20,000/250,000) x 210,000
	$250,000	**$210,000**	

7.7.210 The remaining consideration in the contract allocated to the lease component is $193,200, and therefore the remaining lease payments for the modified lease equal $193,200. Consequently, LR will recognize annual lease income of $64,400 ($193,200 ÷ 3 years) for the three years remaining on the lease. LR will continue to account for the non-lease component in accordance with Topic 606.

Example 7.4
Modification accounting – Sales-type lease remains a sales-type lease

Original lease

7.7.220 Lessee LE enters into a 15-year lease for a passenger aircraft with Lessor LR. The following facts are relevant at the commencement date.

– Lease payments:	Fixed payments of $1 million per year in arrears
– Renewal/purchase options:	None
– Transfer of ownership:	No
– Fair value and carrying amount of aircraft:	$10 million
– Remaining economic life of aircraft:	17 years
– Estimated future residual value:	$2 million
– Rate implicit in the lease:	6.76%

7.7.230 At the commencement date, the lease term is for the major part (i.e. ≥ 75%) of the remaining economic life of the aircraft (it represents 88%). In addition, the present value of the lease payments is $9.25 million, or 93% of the fair value of the aircraft. That is, the present value of the lease payments amounts to substantially all of the fair value of the aircraft (i.e. ≥ 90%). Accordingly, the lease is classified as a sales-type lease (see diagram in 7.2.30).

Lease modification

7.7.240 At the beginning of Year 3, LE decides to gradually phase this aircraft model out of its fleet. LE asks LR to renegotiate the terms of the lease and LR agrees to a modification. The following facts are relevant at the effective date of the modification.

– Remaining lease term:	8 years
– Remaining lease payments:	Fixed payments of $1.025 million per year in arrears
– Renewal/purchase options:	None
– Transfer of ownership:	No
– Fair value of aircraft:	$9.35 million
– Carrying amount of net investment in the lease:	$9.33 million
– Estimated future residual value:	$5.5 million
– Residual value guarantee (lessee):	$5 million
– Rate implicit in the lease:	6.94%

7.7.250 The present value of the lease payments, plus the present value of the guaranteed residual value, is $9.06 million, or 97% of the fair value of the aircraft. Because the sum of (a) the present value of the lease payments and (b) the present value of the lessee residual value guarantee continues to equal or exceed substantially all the fair value of the aircraft, the lease continues to be a sales-type lease (see diagram in 7.2.30).

7.7.260 On the effective date of the modification, LR carries forward the balance of the net investment in the lease from immediately before the effective date of the modification of $9.33 million as the opening balance of the net investment in the modified lease.

7.7.270 To retain the same net investment in the lease even through the lease payments, the lease term, and the estimated residual value have all changed, LR adjusts the discount rate for the lease from the rate implicit in the modified lease of 6.94% to 6.98%. This adjusted rate of 6.98% is used to calculate interest income on the net investment in the lease throughout the remaining term of the modified lease and will result, at the end of the modified lease term, in a net investment balance that equals the estimated residual value of the underlying asset (guaranteed + unguaranteed) of $5.5 million.

Example 7.5

Modification accounting – Direct financing lease becomes an operating lease

Original lease

7.7.280 Lessee LE enters into a four-year lease for a piece of new, non-specialized equipment with Lessor LR. The following facts are relevant at the lease commencement date.

– Lease payments:	Fixed payments of $17,000 per year in arrears
– Renewal/purchase options:	None
– Transfer of ownership:	No
– Fair value and carrying amount of equipment:	$80,000
– Remaining economic life of equipment:	12 years
– Estimated future residual value:	$24,000
– Residual value guarantee (third party):	$18,000
– Rate implicit in the lease:	5.01%

7.7.290 In addition, both LE and the third-party residual value guarantor (unrelated to LR) are creditworthy counterparties.

7.7.300 The lease does not meet any of the criteria to be classified as a sales-type lease (see diagram in 7.2.30). Therefore, the lease is classified as a direct financing lease because the sum of (a) the present value of the lease payments ($60,264) and (b) the present value of the third-party residual value guarantee ($14,802) is substantially all (94%) of the fair value of the equipment ($75,066 ÷ $80,000), and collectibility of the lease payments, plus any amount from the third party necessary to satisfy the residual value guarantee, is probable.

7.7.310 At the lease commencement date, LR recognizes the following entry.

	Debit	Credit
Lease receivable	75,066	
Unguaranteed residual asset	4,934	
Property, plant, and equipment		80,000
To recognize direct financing lease		

7.7.320 At the end of Year 1, LR receives a lease payment of $17,000 from LE and recognizes interest income of $4,009 ($80,000 × 5.01%). Therefore, the carrying amount of the net investment in the lease is $67,009 ($80,000 + $4,009 - $17,000).

Lease modification

7.7.330 At the beginning of Year 3, LE and LR agree to modify the lease to extend the term by two years – i.e. the original four-year lease is extended to six years total.

The following facts are relevant at the effective date of the modification.

– Lease payments:	Fixed payments of $17,000 per year in arrears
– Renewal/purchase options:	None
– Transfer of ownership:	No
– Fair value of equipment:	$65,000
– Carrying amount of net investment in the lease:	$53,368
– Estimated future residual value:	$16,000
– Residual value guarantee:	None
– Rate implicit in the lease:	9.88%

7.7.340 The modified lease does not transfer title of the equipment to LE, and it does not meet any of the other criteria to be classified as a sales-type lease or the criteria to be classified as a direct financing lease (see diagrams in 7.2.30 and 7.2.50). Therefore, the modified lease is classified as an operating lease and, at the effective date of the modification, LR derecognizes the net investment in the lease, and recognizes the equipment at that amount.

	Debit	Credit
Property, plant, and equipment	53,368	
Net investment in the lease		53,368
To reclassify direct financing lease as operating lease		

7.7.350 Because collectibility of the lease payments is still probable (i.e. LE remains a creditworthy counterparty), LR will recognize the $68,000 ($17,000 × 4 years) in lease payments on a straight-line basis over the four-year remaining term of the modified lease. LR will also recognize depreciation on the equipment.

KPMG observation – Lessor versus lessee modifications guidance

7.7.360 The lessee and lessor modifications guidance is not aligned either conceptually or mechanically. For example, the lessee modifications guidance is based on the view that time periods within a lease are not distinct from each other, that the lessor transfers a 'good' (i.e. a right-of-use asset) at lease commencement. In contrast, the lessor modifications guidance is based on the cost-benefit decision to account for most leases as executory contracts (see KPMG's observation at 7.4.40–50), and therefore each period within a lease (e.g. each day, month, year) is distinct from those periods that precede it. The fact that the supplier (lessor) and customer (lessee) modification models are not symmetrical is consistent with the fact that the core lessee and lessor accounting models are not symmetrical within Topic 842. Instead, the Board concluded, for both conceptual and operational reasons, that the lessor modifications guidance should be premised on the contract modifications guidance in Topic 606. [ASU 2016-02.BC179]

KPMG observation – Lessor modifications guidance substantially aligns with new revenue recognition standard

7.7.370 The generally prospective accounting for lessor lease modifications, including the guidance on when to account for a modification as a separate contract, is substantially aligned with the contract modifications guidance in Topic 606, which also accounts prospectively for modifications in which the remaining goods or services to be transferred after the modification are distinct from those transferred prior to the modification. Similarly, Topic 606 accounts for a modification that adds one or more distinct goods or services as a separate contract if the increase in the transaction price is commensurate with the stand-alone selling price for the additional distinct good(s) or service(s). [ASU 2016-02.BC179]

7.7.380 Aligning the modifications guidance will make accounting for modifications to contracts that include lease and non-lease components simpler than if the guidance was not aligned (which it is not under current US GAAP). [ASU 2016-02.BC179]

KPMG observation – Non-cancellable period of the lease not fixed at lease commencement

7.7.390 We are aware of certain lease arrangements for which the non-cancellable period of the lease (see section 5.3) is not fixed or determinable at lease commencement. For example:

- a lessor may enter into an agreement whereby it will lease multiple underlying assets to the lessee, but the non-cancellable period for all of the underlying assets does not become fixed until the last one is deployed and that final date of deployment is unknown when earlier underlying assets are made available for the lessee's use; or
- the non-cancellable period of the lease may be for the duration of a project whose timeline is uncertain at the commencement date.

7.7.400 Section 4.3 discusses potential measurement issues that might arise when there are multiple commencement dates for leases in a single contract (or multiple contracts that are combined for accounting purposes – see section 4.7). However, Topic 842 does not address for lessors how to account for changes in the lease term after lease commencement that are not the result of a modification (including the exercise of a lessee extension or termination option).

7.7.410 While Topic 842 is clear that lessors do not reassess the lease term after lease commencement as lessees do (e.g. as a result of a significant event or significant change in circumstances – see section 6.6), there is no guidance in Topic 842 about how a lessor should address circumstances such as the examples in 7.7.390. Public Board discussions and FASB/IASB staff papers concerning reassessments all centered on when, if ever, a lessor should reassess lessee options to extend or terminate a lease. Those discussions and staff papers did not discuss circumstances in which the non-cancellable period of the lease was not known at lease commencement.

7.7.420 We believe that the Board did not intend for a lessor not to update an initial assessment of the lease term that was made at lease commencement when the non-cancellable period of the lease was not known at that time. To not update the lease term for this finalization of a key fact (i.e. the non-cancellable period of the lease), including undertaking an assessment of lessee extension or termination options based on the determination of that key fact after the commencement date, could result in counter-intuitive accounting results. For example, the lessor might recognize lease income over a period unrelated to even the non-cancellable period of the lease.

7.7.430 Consequently, we believe that a lessor *should* update its assessment of the lease term at the point in time the non-cancellable period of the lease becomes known when that occurs after lease commencement.

US GAAP different from IFRS – Modifications to finance leases

7.7.440 Under IFRS 16, for a modification to a finance lease that is not accounted for as a separate lease, a lessor accounts for the modification as follows.

- If the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor:
  - » accounts for the lease modification as a new lease from the effective date of the modification; and
  - » measures the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.
- Otherwise, the lessor applies the requirements of IFRS 9 (financial instruments). [IFRS 16.80]

7.7.450 In contrast, the guidance in Topic 842 for lessor modifications to sales-type and direct financing leases is prescriptive and is unrelated to the guidance for financial instruments (which is itself not converged with IFRS 9). Consequently, the accounting for equivalent modifications to sales-type/direct financing (IFRS: finance) leases that are not accounted for as separate contracts (IFRS: leases) will differ.

Comparison with current US GAAP – Modifications

Lessor modifications guidance substantially changed from current US GAAP

7.7.460 The Board received feedback that the lessor lease modification requirements under current US GAAP are overly complex. Topic 842 introduces more detailed, operable, and understandable guidance for how a lessor should account for a lease modification, including illustrative examples. Many will likely welcome the new guidance, because it will help to address significant practice issues that have become common in changing economic circumstances, and because it is substantially aligned with Topic 606. [840-10-25-51 – 25-52, 840-30-35-26 – 35-30]

Operating lease modifications that do not change the lease classification

7.7.470 Topic 842 will account for modifications to an operating lease that (1) is not accounted for as a separate contract and (2) does not change lease classification in a manner substantially similar to lessor accounting for modifications of this nature under current US GAAP.

7.8 Financial statement presentation

7.8.10 A lessor is required to present the following items arising from lease contracts in the scope of Topic 842.

Balance sheet

Sales-type and direct financing leases

7.8.20 Present the lessor's net investment in sales-type and direct financing leases separately from other assets. The lessor's net investment is subject to the same classification considerations as other assets in a classified balance sheet – i.e. current versus non-current. See 12.3.20 for the note disclosures required for the components of the total net investment in sales-type and direct financing leases – i.e. the carrying amount of lease receivables, unguaranteed residual assets, and any deferred selling profit on direct financing leases. [842-30-45-1 – 45-2]

Operating leases

7.8.30 Present the underlying asset and related depreciation expense using other US GAAP (e.g. Topic 360), as applicable. [842-30-45-6]

Income statement

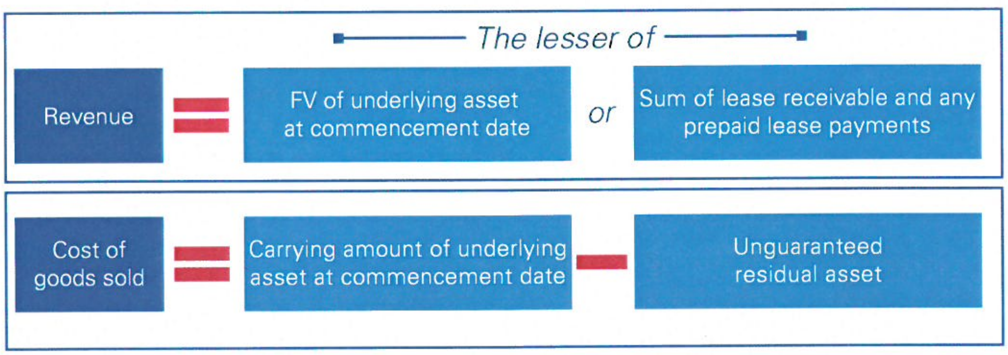
All leases

7.8.40 If a lessor does not separately present lease income, it discloses the line items in the income statement in which it includes lease income. [842-30-45-3]

Sales-type and direct financing leases

7.8.50 Present selling profit or loss recognized at lease commencement in a manner that best reflects the lessor's business model.

- If the lessor uses leases as an alternative to selling (e.g. many manufacturers and dealers), the lessor presents profit or loss at lease commencement on a gross basis as separate line items (e.g. as revenue and cost of goods sold). Revenue and costs of goods sold is recognized as follows.



- If the lessor uses lease arrangements for the purpose of financing, the lessor presents profit or loss at lease commencement on a net basis in a single line item (e.g. as a gain within other income). [842-30-45-4]

Statement of cash flows

7.8.60 Classify all cash receipts from leases as cash flows from operating activities. [842-30-45-5, 45-7]

US GAAP different from IFRS – IFRS 16 does not include lessor cash flow presentation guidance

7.8.70 IFRS 16 does not prescribe how lessors must classify cash receipts from leases. Consistent with current practice under US GAAP, under current IFRS, some lessors classify cash receipts from finance leases as cash flows from investing activities. Because IFRS 16 does not change the current IFRS (IAS 17) lessor cash flow presentation guidance, it is likely some lessors will continue to classify cash receipts from finance leases as cash flows from investing activities, which Topic 842 does not permit.

Comparison with current US GAAP – Presentation

Cash receipts from sales-type/direct financing leases

7.8.80 Topic 842 requires classification of all cash receipts from leases as cash flows from operating activities. Current US GAAP does not contain explicit cash flow guidance for lessors. Consequently, some lessors with leases that will be classified as sales-type or direct financing leases under Topic 842 currently classify cash receipts from those leases as cash flows from investing activities. Entities that follow that practice under current US GAAP will not be able to continue to do so under Topic 842.

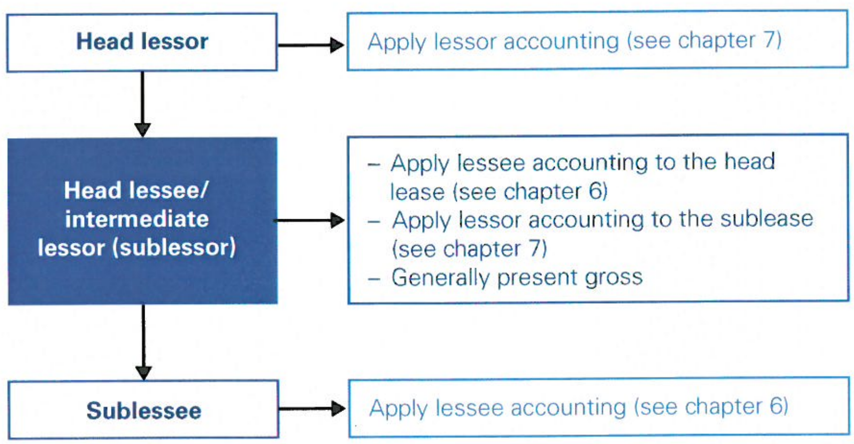
New lessor presentation requirements generally consistent with current US GAAP

7.8.90 In other respects, the lessor financial statement presentation requirements in Topic 842 are substantially the same as those in current US GAAP.

8 Subleases

How the standard works

The following chart summarizes the accounting for each party to a lease and sublease transaction.



We expect that most subleases under Topic 842 will be classified as operating leases by sublessors.

8.1 General requirements

8.1.10 A sublease is a transaction in which an underlying asset is re-leased by the lessee (head lessee, or sublessor) to a third party (sublessee), and the original lease (head lease) between the lessor (head lessor) and the lessee remains in effect. [842 Glossary]

8.1.20 The sublessor and sublessee classify a sublease with reference to the underlying asset subject to the lease, rather than with reference to the right-of-use asset. This means that, in determining the classification of the sublease, the sublessor and the sublessee consider:

- the term of the sublease as compared to the remaining economic life of the underlying asset – rather than, for example, the remaining term of the head lease; and
- the present value of the sum of the sublease payments and any residual value guarantee provided by the sublessee as compared to the fair value of the underlying asset – rather than the fair value of the head lease right-of-use asset. [842-10-25-6]

Head lessor

8.1.30 The head lessor continues accounting for the lease as it did before (see chapter 7), whether the head lessee enters into a sublease, or sells or transfers the head lease to a third party (see chapter 7). [842-30-35-7]

8.1.40 If the head lease agreement is replaced by a new agreement with a new lessee, the head lease is considered terminated, and the new lease classified and accounted for as a separate transaction. [842-30-40-3]

Sublessee

8.1.50 A sublessee classifies and accounts for the sublease as it would any other lease (see chapter 6). From the sublessee's perspective, the fact that the lease is a sublease has no effect on its accounting for the lease. Practically, this is because a sublessee likely will not know the terms and conditions of the head lease, and on some occasions may not even know that the lease is a sublease, making it difficult to apply the lease classification guidance with reference to the head right-of-use asset.

8.2 Accounting by the sublessor

8.2.10 The head lease and the sublease will generally be accounted for separately – i.e. as two separate units of account. This is because, even if the contracts are entered into at or near the same date, the sublessee is generally a third party unrelated to the head lessor. Two or more contracts are potentially combined under Topic 842 only if they are entered into at or near the same time and with the same counterparty (or a related party of the counterparty) – see section 4.7. [ASU 2016-02.BC115]

8.2.20 In accounting for the sublease, the sublessor follows these steps.

Step 1:	Determine the discount rate for the sublease.
Step 2:	Determine the classification of the sublease.
Step 3:	Account for the sublease.

Discount rate for the sublease

8.2.30 The sublessor in a sublease transaction uses the rate implicit in the sublease to determine classification of the sublease, and to measure the net investment in the sublease if it is classified as a sales-type or direct financing lease. The rate implicit in the sublease is the rate that balances the following equation. [842-20-35-15]

PV of sublease payments + **PV of residual value of head lease ROU asset[1]** = **FV of head lease ROU asset[1]** + **Sublessor deferred IDCs[2]**

Notes:

1. The residual value and the fair value of the head lease right-of-use asset are estimated as of the sublease commencement date.
2. These are initial direct costs that relate to the sublease. They do not include the sublessor's initial direct costs of the head lease.

8.2.40 However, if the rate implicit in the lease cannot be readily determined, a sublessor may use the discount rate established for the head lease; for example, the sublessor's incremental borrowing rate at the commencement date of the head lease. [842-20-35-15]

Classification of the sublease

8.2.50 The classification of the sublease as an operating or a finance lease is determined in the same manner as any other lease (see chapter 7). [842-10-25-2 – 25-3]

Account for the sublease

8.2.60 The sublease is accounted for as an operating, sales-type, or direct financing lease in the same manner as any other operating, sales-type, or direct financing lease (see chapter 7).

8.2.70 The accounting for the head lease depends on whether the sublessor is relieved of its primary obligation under that lease (see 8.2.80–110).

Sublessor not relieved of its primary obligation under the head lease

8.2.80 If the sublessor is not relieved of its primary obligation under the head lease, the sublessor accounts for the head lease in one of the following ways depending on the classification of the sublease: [842-20-35-14]

- **Sublease is an operating lease.** The sublessor:
  - continues to account for the head lease as it did before sublease commencement (see chapter 6); and
  - continues to assess the head lease right-of-use asset for impairment (see section 6.5). However, if the lease cost of the head lease for the term of the sublease exceeds the sublease income anticipated for that same period, this is an indicator that the carrying amount of the head lease right-of-use asset may not be recoverable.
- **Sublease is a sales-type or a direct financing lease.** The sublessor:
  - derecognizes the head lease right-of-use asset using the guidance in Subtopic 842-30 on the derecognition of underlying assets by lessors in sales-type and direct financing leases (see section 7.3);
  - beginning at sublease commencement, increases the lease liability to reflect interest on the lease liability each period using the effective interest method, and reduces the lease liability to reflect the lease payments made during the period; and
  - assesses its net investment in the sublease for impairment using the financial instruments impairment guidance (see section 7.3.3).

Sublessor relieved of its primary obligation under the head lease

8.2.90 If the sublessor is relieved of its primary obligation under the head lease, the head lease is considered terminated, and the sublessor derecognizes the head lease right-of-use asset and head lease liability, with the difference recognized as profit or loss. [842-20-40-3]

8.2.100 Any consideration paid or received on termination that was not already included in the lease payments is included in the calculation of the profit or loss recognized on lease termination. Such consideration might arise, for example, if the lease term of the head lease did not reflect the lessee exercising a termination option. [842-20-40-3]

8.2.110 If a sublease is a termination of the head lease and the head lessee is secondarily liable, the sublessor (as head lessee) recognizes the guarantee obligation using the guidance in Topic 405. Whether or not explicit consideration was paid for that guarantee, the head lessee becomes a guarantor. The guarantee obligation is initially measured at fair value, and that amount reduces (increases) the profit (loss) recognized on lease termination. [842-20-40-3, 405-20-40-2]

Example 8.1

Classification and accounting for a sublease transaction by a sublessor

8.2.120 Sublessor SR leased a non-specialized warehouse for designing paint schemes for cars that it manufactures.

Head lease

8.2.130 The following facts about the head lease (operating lease) at the commencement date are relevant.

– Noncancellable lease term:	15 years
– Renewal options:	15 years (3 options of 5 years each)
– Purchase option/transfer of ownership:	None
– Residual value guarantee:	None
– Lease payments:	Fixed payments of $30,000 per year in arrears, with a 3% increase each year after Year 1
– Present value of lease payments:	$349,914
– Fair value of warehouse:	$500,000
– Remaining economic life of warehouse:	30 years
– SR's incremental borrowing rate:	6% (rate implicit in the lease not available)

Sublease

8.2.140 At the end of Year 2 of the lease, SR acquires on-line design software that eliminates its need for the warehouse. SR subleases the warehouse to Sublessee SE for the remainder of the head lease term, but SR is not relieved of its primary obligation to the head lessor under the head lease.

8.2.150 The following additional facts about the sublease at the sublease commencement date are relevant.

– Non-cancellable lease term:	13 years
– Renewal options:	None
– Purchase option/transfer of ownership:	None
– Residual value guarantee:	None
– Lease payments:	Fixed payments of $32,000[1] per year in arrears, with a 3% increase each year after Year 1
– Present value of lease payments:	$332,257
– Fair value of warehouse:	$505,000
– Rate implicit in the sublease:	Not readily determinable[2]

Notes:

1. The anticipated sublease income exceeds SR's head lease cost for the period of the sublease because of an increase in market rents during the first two years of the head lease.
2. The rate implicit in the sublease is not readily determinable, because the fair value of the head lease right-of-use asset is not readily determinable.

Step 1: Determine the discount rate for the sublease

8.2.160 Because the rate implicit in the sublease is not readily determinable, SR uses the discount rate it established for the head lease: 6%.

Step 2: Determine lease classification of the sublease

8.2.170 SR classifies the sublease as an operating lease, based on the following (see section 7.2):

- there is no transfer of ownership and there is no option for SL to purchase the warehouse;
- the sublease term represents only 46% (i.e. not a major part) of the remaining economic life of the warehouse – i.e. of the underlying asset, not the right-of-use asset; this is calculated based on a sublease term of 13 years, and a remaining economic life of the warehouse at sublease commencement of 28 years;
- the present value of the sublease payments represents only 66% (i.e. not substantially all) of the fair value of the warehouse at sublease commencement; and
- the warehouse is not highly specialized.

Step 3: Account for the sublease

8.2.180 In this example, SR is not relieved of its primary obligation to the head lessor. The accounting is therefore as follows.

- Because the sublease is classified as an operating lease, SR does not make any accounting entries for the sublease of the warehouse to SE at the sublease commencement date.
- Because sublease income anticipated during the sublease term exceeds SR's expected lease cost for the head lease over that same period of time, the execution of the sublease is not an indicator that the head lease right-of-use asset may be impaired.
- Absent additional events (e.g. a change to the head lease term resulting from a reassessment or a modification to the head lease *or* the sublease), SR will continue to account for the head lease throughout the remainder of the head lease term as if it had not entered into the sublease.
- SR will account for the sublease as it would for any other operating lease for which it is the lessor.

8.2.190 To see the calculations supporting this example, and the effect of the accounting on the financial statements compared to IFRS, see 8.2.420–440.

KPMG observation – Sublease classification

8.2.200 A sublessor classifies a sublease with reference to the underlying asset, not the right-of-use asset arising from the head lease. The Board determined that applying the lease classification guidance with reference to the underlying asset would be more operational for sublessors because, for example, it may be difficult to determine the fair value of the right-of-use asset in the head lease. [ASU 2016-02.BC116]

8.2.210 The Board also reasoned that classifying a sublease with reference to the underlying asset would result in more consistent lease classification outcomes for similar leases. For example, if sublease classification were determined on the basis of the remaining economic life of the head lease right-of-use asset, it would be difficult to understand and explain the following when the same underlying asset is being leased, under potentially similar terms, and with similar periods of use: why the head lessor (or any other lessor) would classify the head lease as an operating lease, while the sublessor might classify the sublease as a sales-type or direct financing lease. [ASU 2016-02.BC116]

8.2.220 The sublease classification requirements in Topic 842 will generally result in operating lease classification for most subleases.

KPMG observation – Determining the rate implicit in the sublease

8.2.230 Topic 842 does not provide explicit guidance for determining the rate implicit in a sublease; however, we believe that the definition of the rate implicit in the lease and the specific guidance in Topic 842 means that the rate would be calculated as outlined in 8.2.30. In addition, we believe that the rate implicit in a sublease will often not be 'readily determinable' because determining the fair value of a right-of-use asset may be difficult and highly subjective in many cases. Therefore, in classifying and accounting for the sublease, a sublessor will likely use the discount rate for the head lease.

8.2.240 Topic 842 is not explicit as to whether the Board intended for the sublessee to use the sublessor's implicit rate in determining the discount rate for the lease if that rate is readily determinable. However, we expect that the rate implicit in the sublease will almost never be 'readily determinable' for a sublessee. This is because the sublessee would need to have insight into all of the following to determine that rate:

- the fair value of the sublessor's right-of-use asset, which will likely be impossible to determine in most cases because the sublessee will likely not know the terms and conditions of the head lease;
- the sublessor's estimated residual value of the head lease right-of-use asset, which it will likely not have; and
- the sublessor's initial direct costs resulting from the sublease, which the sublessee will likely not know unless the sublessor provides that information to the sublessee.

8.2.250 Consequently, we believe that a sublessee will, in virtually all if not all cases, use its incremental borrowing rate as the discount rate for the sublease.

KPMG observation – Sublease presentation by sublessors

8.2.260 Topic 842 does not provide explicit guidance on the presentation of the net investment in a sales-type or direct financing sublease for sublessors. The standard simply says that sublessors apply the lessor accounting requirements of Subtopic 842-30. This indicates that sublessors are required to present their net investment in subleases separately from other assets on the balance sheet. But it is not clear whether an entity's net investment in sales-type and direct financing subleases should be presented separately from its net investment in sales-type and direct financing leases for which it is the head lessor.

8.2.270 Determining the appropriate presentation – i.e. presenting the entity's net investment in sales-type and direct financing subleases separately from the entity's net investment in sales-type and direct financing head leases – may depend on the extent of the differences in risks between the two types of net investment. However, we expect these instances to be infrequent, because the number of entities with sales-type or direct financing head leases and sales-type or direct financing subleases may be small *and* because we believe that relatively few subleases for any entity will be sales-type or direct financing subleases.

KPMG observation – Terms of the sublease require changes to the accounting for the head lease

Initial assessment of the sublease

8.2.280 Two parties may enter into a sublease where the non-cancellable period of the sublease, or the sublease term (i.e. including one or more optional periods), exceeds the lease term for the head lease. The act of entering into the sublease is a significant event within the control of the sublessor that directly affects the assessment of the lease term. Therefore, the sublessor will update the head lease term to be at least equal to the sublease term. See section 6.6.1 for additional examples of events that would trigger a reassessment of the lease term. [842-10-55-28]

8.2.290 Similarly, if the head lease includes a lessee option to purchase the underlying asset, the terms of the sublease provide that option to the sublessee, and the sublessee is reasonably certain to exercise that option, the sublessor would update its accounting for the head lease to reflect that it is reasonably certain to exercise its purchase option to fulfill the contract with the sublessee.

Sublease reassessments

8.2.300 Topic 842 requires sublessors to apply the lessor accounting guidance to the sublease. Under Topic 842, lessors do not reassess the lease term or lessee purchase options after the commencement date unless the lease is modified (and that modification is not accounted for as a separate contract). Therefore, we believe that sublessors would not be required to monitor for any changes to the *sublessee's* facts or circumstances in accounting for the head lease. Rather, consistent with any other lease for which it is a lessee (i.e. not subject to a sublease), the sublessor would only reassess its accounting for the head lease upon the occurrence of a significant event or change in circumstances within *its* control. For example, while the sublessor may be aware of the sublessee constructing significant leasehold improvements or making significant customizations to the underlying asset, because the sublessee's actions in doing so are not within the sublessor's control, they would not trigger a reassessment.

8.2.310 A sublessor will, however, need to monitor for changes in the amount it is probable of owing to the head lessor under any residual value guarantee it has provided to the head lessor.

US GAAP different from IFRS – Sublease classification

8.2.320 IFRS 16 requires a sublessor to classify a sublease in one of two ways.

- The sublease is classified as an operating lease if the sublessor accounts for the head lease applying the recognition and measurement exemption applicable to short-term leases;
- Otherwise, a sublessor classifies a sublease by reference to the right-of-use asset arising from the head lease (rather than by reference to the underlying asset). This means that, in determining classification of the sublease, the sublessor and the sublessee consider:
  - » the term of the sublease compared to the remaining term of the head lease (rather than the remaining economic life of the underlying asset); and
  - » the present value of the sum of the sublease payments and any residual value guarantee provided by the sublessee compared to the fair value of the right-of-use asset (rather than the fair value of the underlying asset). [IFRS 16.B58]

8.2.330 In contrast, Topic 842 requires an entity (i.e. a sublessee and sublessor) to classify a sublease by reference to the underlying asset. Because of these differences, most subleases under Topic 842 will be classified as operating leases, while most subleases under IFRS 16 will be classified as finance leases.

8.2.340 There also is no specific guidance in IFRS 16 on classifying subleases by sublessees because there is only one type of lease for lessees (i.e. a finance lease) – see 6.2.490–510.

Rate implicit in a sublease

8.2.350 Under IFRS 16, consistent with Topic 842:

- a sublessor uses the rate implicit in the sublease as the discount rate for the sublease, *if it is readily determinable*, to measure its net investment in the sublease; and
- if the rate implicit in the sublease is not readily determinable, which will usually be the case, a sublessor may use the discount rate established for the head lease. [IFRS 16.68]

8.2.360 However, unlike Topic 842, if a sublessor uses the discount rate for the head lease, IFRS 16 requires the sublessor to adjust the discount rate established for the head lease for any initial direct costs associated with the sublease. IFRS 16 does not further explain or illustrate how that adjustment is made.

Example 8.2
Sublease differences from IFRS 16

8.2.370 Continuing Example 8.1, Sublessor SR accounts for the **sublease** as follows under IFRS 16.

Step 1: Determine the discount rate for the sublease

8.2.380 Consistent with Example 8.1, because the rate implicit in the sublease is not readily determinable, SR uses the discount rate for the head lease. There are no initial direct costs incurred in relation to the sublease; therefore, no adjustment to the head lease discount rate is required in applying IFRS 16.

Step 2: Determine lease classification of the sublease

8.2.390 The sublease is classified as a finance lease under IFRS 16 because it conveys to the sublessee substantially all of the risks and rewards of the right-of-use asset – the sublease is for the entire remaining term of the head lease.

Step 3: Account for the sublease

8.2.400 At the commencement date of the sublease, SR:

- derecognizes the right-of-use asset relating to the head lease that it transfers to Sublessee SE and recognizes the net investment in the sublease;
- recognizes any difference between the carrying amounts of the right-of-use asset and the net investment in the sublease in profit or loss; and
- continues to recognize the lease liability relating to the head lease, which represents the lease payments owed to the head lessor.

8.2.410 During the term of the sublease, SR recognizes both interest income on the sublease and interest expense on the head lease.

Comparison of sublease accounting between Topic 842 and IFRS 16

8.2.420 The following calculations are based on Example 8.1 (Topic 842) and Example 8.2 (IFRS 16), and illustrate in detail the solutions under the respective standards.

From lease head commencement through sublease commencement (at end of Year 2) – Balance sheet comparison for head lease

	ROU asset		Lease liability
	FASB	IASB	FASB and IASB
Balance at head lease commencement	$349,914	$ 349,914	$349,914
ROU asset amortization/lease liability reduction first two years	(32,946)	(46,656)	(19,450)
Derecognize ROU asset at sublease commencement	–	(303,258)	–
Balance immediately after sublease commencement	**$316,968**	**$ –**	**$330,464**

Journal entry at sublease commencement

8.2.430 Under Topic 842, because the sublease is classified as an operating lease, Sublessor SR does not make any accounting entries for the sublease of the warehouse to Sublessee SE at the sublease commencement date.

8.2.440 Under IFRS 16, SR makes the following entry to recognize the sublease as a finance lease at the end of Year 2:

	Debit	Credit
Lease receivable[1]	332,257	
ROU asset		303,258
Profit or loss (gain)		28,999
To recognize finance sublease		

Note 1:

There is no unguaranteed residual right-of-use asset because the sublease is for the entire term of the original lease.

From sublease commencement to end of sublease term – Balance sheet comparison

	FASB	IASB	FASB and IASB
End of Year	ROU asset (head lease)	Lease receivable (sublease)	Lease liability (head lease)
2	$316,968	$332,257	$330,464
3	299,598	320,192	318,465
4	281,508	306,444	304,791
5	262,597	290,882	289,313
6	242,758	273,368	271,894
7	221,874	253,754	252,387
8	199,819	231,883	230,634
9	176,459	207,587	206,469
10	151,649	180,687	179,714
11	125,234	150,992	150,180
12	97,048	118,300	117,664
13	66,910	82,393	81,950
14	34,629	43,042	42,810
15	–	–	–

From sublease commencement to end of sublease term – Income statement comparison

	FASB			IASB			
End of Year	Sublease income	Head lease expense	Net income (loss)	Gain (loss) on sublease	Interest income (sublease)	Interest expense (head lease)	Net income (loss)
2	$ –	$ –	$ –	$28,999	$ –	$ –	$28,999
3	38,443	(37,198)	1,245	–	19,935	(19,828)	107
4	38,443	(37,198)	1,245	–	19,212	(19,108)	104
5	38,443	(37,198)	1,245	–	18,387	(18,287)	100
6	38,443	(37,198)	1,245	–	17,453	(17,359)	94
7	38,443	(37,198)	1,245	–	16,402	(16,314)	88
8	38,443	(37,198)	1,245	–	15,225	(15,143)	82
9	38,443	(37,198)	1,245	–	13,913	(13,838)	75
10	38,443	(37,198)	1,245	–	12,455	(12,388)	67
11	38,444	(37,198)	1,246	–	10,841	(10,783)	58
12	38,444	(37,197)	1,247	–	9,060	(9,011)	49
13	38,444	(37,197)	1,247	–	7,098	(7,059)	39
14	38,444	(37,197)	1,247	–	4,944	(4,916)	28
15	38,444	(37,197)	1,247	–	2,582	(2,568)	14
Total	**$499,764**	**$(483,570)**	**$16,194**	**$28,999**	**$167,507**	**$(166,602)**	**$29,904**

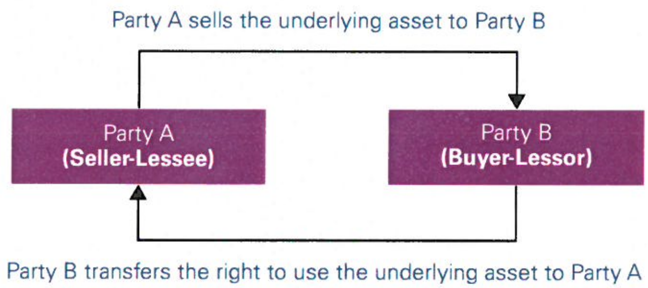
Comparison with current US GAAP – Classification and accounting for subleases by sublessors

8.2.450 In practice, subleases are very common. Applying Topic 842 will not have a significant effect on the sublessor's accounting for the sublease; for example, sublease classification and sublease income recognition are going to be effectively unchanged from current US GAAP. In addition, the sublessor's accounting for the head lease will be substantially unchanged for *finance* leases; under both current US GAAP and Topic 842, the sublessor continues to recognize the finance lease asset unless the sublessor is relieved of its primary obligation under the head lease. However, the sublessor's recognition of a right-of-use asset and lease liability for a head operating lease is a substantial change to the sublessor's accounting for the head operating lease from current US GAAP. [840-30-35-12]

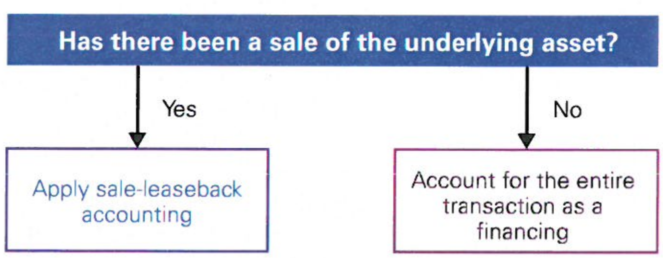
9 Sale-leaseback accounting

How the standard works

In a sale-leaseback transaction, one entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and then leases that asset back from the buyer-lessor.



The driver of the accounting is whether a sale (seller-lessee) and purchase (buyer-lessor) has occurred. This determination is made by each party applying the guidance in Topic 606 for determining whether (1) there is a contract between the parties, and (2) a customer has obtained control of a good.



If a lessee controls the underlying asset, including an underlying asset that is under construction in a so-called build-to-suit arrangement, before the commencement date of the lease, it is a sale-leaseback transaction. This means that the lessee recognizes the underlying asset on-balance sheet (e.g. during construction in a build-to-suit arrangement).

9.1 Determining whether a sale/purchase has occurred

9.1.10 For a sale (and purchase) to occur in the context of a sale-leaseback transaction, the following conditions need to be met:

- there is a contract between the parties based on the contract identification guidance in Topic 606; and
- the seller-lessee has transferred control of the asset to the buyer-lessor based on the guidance on satisfying performance obligations in Topic 606. [842-40-25-1, 606-10-25-1 – 25-8, 25-30]

Control principle in Topic 606
Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

9.1.20 The following are indicators that control has transferred in accordance with the control principle. [606-10-25-30]

Indicators that control has transferred include a customer having...

… a present obligation to pay	… physical possession	… legal title	… risks and rewards of ownership	… accepted the asset

9.1.30 The existence of the leaseback does not, by itself, preclude an entity from concluding that control of the underlying asset has been transferred to the buyer-lessor. However, the buyer-lessor has not obtained control of the underlying asset if:

- the leaseback results in a lease that would be classified as a finance lease (by the seller-lessee) or as a sales-type lease (by the buyer-lessor); or
- the contract contains a substantive seller-lessee repurchase option with respect to the transferred asset, *unless* the option:
  - » is exercisable only at the fair value of the asset on the exercise date; and
  - » there are alternative assets, substantially the same as the transferred asset, readily available in the marketplace. [842-40-25-2 – 25-3]

9.1.40 If a contract exists and the buyer-lessor obtains control of the underlying asset, the transaction is accounted for as a sale and a leaseback by both the seller-lessee and the buyer-lessor. [842-40-25-4]

9.1.50 If the transfer of the asset to the buyer-lessor is not a sale, both parties to the transaction account for the transfer of the underlying asset as a financing arrangement – i.e. as a 'failed sale' by the seller-lessee, and as a 'failed purchase' by the buyer-lessor. The accounting for failed sale-leaseback transactions is discussed in section 9.3. [842-40-25-5]

9.1.60 The term 'readily available' is used in multiple places within Topic 842, and we believe that its use is intended to be consistent throughout the standard. Accordingly, in the context of the seller-lessee repurchase option criterion (see 9.1.30), we believe that the test is whether another asset, substantially the same, is available for purchase separately from the buyer-lessor or from other suppliers.

9.1.70 In some cases, an entity enters into a sale-leaseback transaction in which the asset is either:

- subject to an existing operating lease; or
- subleased or intended to be subleased by the seller-lessee to another entity under an operating lease – i.e. the entity is or will be a sublessor. [842-40-55-18]

9.1.80 The existence of a sublease does not, by itself, prevent the buyer-lessor from obtaining control of the asset – i.e. from concluding that a sale/purchase has occurred – and also does not prevent the seller-lessee from controlling the asset before its transfer to the buyer-lessor. The seller-lessee is subject to the same requirements for determining whether the transfer of the asset is a sale with or without the sublease. [842-40-55-19]

9.1.90 A seller-lessee residual value guarantee of the transferred asset does not automatically preclude a conclusion that a sale/purchase has occurred. However, it is a relevant consideration in determining whether the buyer-lessor has obtained control of the asset. This is because a seller-lessee residual value guarantee may suggest that the buyer-lessor has not taken on the significant risks and rewards of ownership of the asset, which is one of the indicators to consider in evaluating whether a customer has obtained control of an asset in Topic 606 (see 9.1.20). [842-40-55-21, 606-10-25-30]

Example 9.1
Determining whether a sale/purchase has occurred

9.1.100 Seller-Lessee SL enters into a contract (that meets the contract identification criteria in Topic 606) with Buyer-Lessor BL for the sale-leaseback of a machine. The machine has a remaining economic life of five years, and its fair value is $100,000. Title to the machine transfers to BL, and payment of the transaction price for the machine is payable to SL at commencement of the leaseback.

Scenario 1: Seller-lessee repurchase option does not preclude sale/purchase accounting

9.1.110 In addition to the basic facts in 9.1.100, the following facts are relevant.

– Leaseback term:	3 years
– Leaseback payments:	Fixed payments of $28,000 per year in arrears
– SL's incremental borrowing rate[1]:	7%
– Expected residual value:	$30,000
– Residual value guarantee:	None
– Purchase option:	Fair value of machine at date of exercise

Note 1:

The rate implicit in the lease is not readily determinable.

9.1.120 In addition:

- The machine is produced widely such that there are alternative machines, substantially the same as the transferred machine, readily available in the marketplace.
- The leaseback would not be classified as a finance lease by SL, or as a sales-type lease by BL, applying the relevant criteria for lease classification – see section 6.2 (lessees) and section 7.2 (lessors).

9.1.130 Both SL and BL conclude that there is a sale/purchase of the machine:

- the leaseback is not classified as a finance/sales-type lease; and
- SL's repurchase option does not preclude sale/purchase accounting, because:
  - » the strike price is the fair value of the machine on the exercise date; and
  - » there are alternative machines, substantially the same as the transferred machine, readily available in the marketplace.

9.1.140 Lastly, the transfer of control indicators in Topic 606 indicate that control of the asset transfers to BL at commencement of the leaseback. That is because, even though SL retains physical possession of the machine, the following occur at commencement:

- title transfers to BL;
- SL has a present right to payment of the transaction price for the machine; and

- BL assumes the significant risks and rewards of ownership – e.g. BL is now responsible for (or will benefit from) any changes in the residual value of the transferred machine.

Scenario 2: Seller-lessee repurchase option results in failed sale/purchase

9.1.150 The facts in this scenario are the same as in Scenario 1, except that the machine has been designed and modified specifically for Seller-Lessee SL's commercial needs. Therefore, there are no alternative assets substantially the same as the transferred machine readily available in the marketplace.

9.1.160 In this scenario, no sale/purchase of the asset occurs. SL's repurchase option precludes sale/purchase accounting for both SL and Buyer-Lessor BL. In addition, while stated not to be the case in *this* scenario, in a similar scenario the specialized design and modification of the machine *could* lead to a conclusion that the machine will have no alternative use to BL at the end of the leaseback term, and therefore that the leaseback is a finance/sales-type lease (also resulting in a failed sale/purchase).

Scenario 3: Seller-lessee residual value guarantee

9.1.170 Assume the same facts as in Scenario 1, except that:

- Seller-Lessee SL guarantees $20,000 of the expected $30,000 expected residual value of the machine; and
- SL does not have a repurchase option.

9.1.180 Consistent with Scenario 1, even though SL retains physical possession of the machine, the following occur at commencement:

- title transfers to Buyer-Lessor BL; and
- SL has a present right to payment.

9.1.190 These indicators provide evidence that BL has obtained control of the machine. However, the significant residual value guarantee provided by SL calls into question whether BL has the significant risks and rewards of ownership, an indication that control may not have transferred to BL. While BL can potentially obtain the rewards of ownership, the residual value guarantee substantially limits BL's risk. Because of the significant residual value guarantee provided by SL, which results in conflicting control indicators, there is judgment in determining whether control of the machine transfers to BL at commencement of the leaseback.

9.1.200 In this scenario, ultimately both SL and BL conclude that a sale/purchase has occurred. They base their respective decisions on the following.

- BL can direct the use of the machine in the same way as any other lessor can direct the use of an asset subject to a lease – e.g. it can sell the asset (subject to the leaseback); and
- BL can obtain substantially all of the remaining benefits related to the machine – it is entitled to either the entirety of the proceeds from a sale, or to the cash payments from the leaseback and the residual benefits of the machine after the leaseback term.

9.1.210 In making this determination, the parties assign greater weight to the benefits that BL obtains from the asset than the risk protection from the residual value guarantee provided by SL. For further discussion, see KPMG's observation at 9.1.310–330.

Scenario 4: Leaseback is a finance/sales-type lease

9.1.220 In addition to the basic facts in 9.1.100, the leaseback term is for *four* years.

9.1.230 Because the leaseback term is for the major part of the remaining economic life of the machine (four-year lease term compared to five-year remaining economic life), the leaseback would be classified as a finance lease by SL, and as a sales-type lease by BL. Therefore, no sale (from the perspective of SL) or purchase (from the perspective of BL) occurs. Instead, both parties will account for the transaction as a financing arrangement (see section 9.3).

KPMG observation – Leaseback does not preclude sale/purchase accounting

9.1.240 The Board's decision that the presence of the leaseback does not, in isolation, prevent the buyer-lessor from obtaining control of the underlying asset appears to potentially conflict with the following in Topic 606 (and the basis for conclusions to ASU 2014-09):

- defining control of an asset as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset; and
- the Board's description of the ability to direct the use of an asset as the customer's right to deploy that asset in its activities, to allow another entity to deploy that asset in its activities, or to restrict another entity from deploying that asset. [606-10-25-25, ASU 2014-09.BC120]

9.1.250 Following that guidance, it appears that the buyer-lessor in a sale-leaseback transaction does not obtain the ability to direct the use of the asset (as defined in Topic 606) until the end of the leaseback term.

9.1.260 Consequently, the Board's decision appears to be based largely on its view that a lessor's accounting for a lease should not differ solely because it purchased the underlying asset from the lessee rather than from a third party. The Board observed that a sale-leaseback scenario is not substantively different from many lessor scenarios in which the lessor purchases the underlying asset from a third party only after the terms and conditions of the lease are agreed with the lessee. In those scenarios, similar to a sale-leaseback transaction, the lessor may not take possession of the underlying asset prior to commencement of the lease (i.e. it may be delivered directly to the lessee) *and* it has no ability to direct its use until after the end of the lease term. [ASU 2016-02.BC352(a)]

KPMG observation – Finance/sales-type leaseback

9.1.270 The Board concluded that in a finance/sales-type lease, the lessee in effect obtains control of the underlying asset – i.e. rather than solely a right to control the use of the underlying asset. Therefore, the Board decided that it would be inappropriate to account for a sale and finance/sales-type leaseback transaction as a sale and a leaseback, because that would be akin to permitting recognition of a gain by the seller-lessee on a round-trip sale – i.e. the buyer-lessor would obtain control of the asset only to immediately transfer control of the asset back to the seller-lessee. Instead, the Board decided that no sale from the seller-lessee to the buyer-lessor occurs in the first place. [ASU 2016-02.BC67, BC352(b)]

KPMG observation – Repurchase options

Approach different from Topic 606

9.1.280 The Board's decision to permit sale/purchase accounting in a sale-leaseback transaction when the seller-lessee has a repurchase option in some, limited circumstances appears to represent a departure from the Board's stated aim of recognizing a sale/purchase only when the requirements for a sale in Topic 606 are met. This is because Topic 606 precludes accounting for a transaction as a sale if the seller has any substantive option to repurchase the good sold, regardless of the strike price or the nature of the good – i.e. whether or not there are alternative assets substantially the same as the transferred asset readily available in the marketplace. [ASU 2016-02.BC352(c)]

9.1.290 The Board's decision to permit sale/purchase accounting in those limited circumstances reflects the discomfort that some Board members had with a seller-lessee recognizing a liability for the consideration received from the buyer-lessor solely because it has the *option* to reacquire the asset and may only do so by paying its fair value when the option is exercised. Other Board members, when reaching this decision, noted that the basis for conclusions to ASU 2014-09 also appears to at least suggest that a repurchase option permitting the seller to repurchase an asset that is readily available in the marketplace at its then-prevailing fair value does not constrain a customer in its ability to direct the use of, and obtain substantially all the benefits from, the asset. [ASU 2014-09.BC425]

Assessing whether assets are substantially the same – implications for real estate and other assets

9.1.300 For a seller-lessee repurchase option not to preclude sale/purchase accounting, there must be alternative assets, substantially the same as the transferred asset, readily available in the marketplace. The basis for conclusions, as well as the Board's discussion of this requirement at a public meeting, are instructive as to the intended application of this criterion:

- The basis for conclusions and the Board's discussion suggest that Board members do not think that real estate assets can be substantially the same as each other. In the Board's view, no two real estate assets occupy the same unique space; therefore, even if two real estate assets are similar (e.g. in size, design, function), they are not substantially the same. Consequently, it appears that the Board's intent is that *any* seller-lessee repurchase option for a real estate asset will preclude sale/purchase accounting in a sale-leaseback transaction.
- In communicating its intent with respect to real estate, the Board appears to have signaled that 'substantially the same' is a high threshold. An asset, whether or not real estate, that is merely 'similar' to another asset is not substantially the same as that asset. Judgment will be required to determine whether two non-real estate assets are substantially the same, but in general we believe that those two assets will have to be nearly identical (e.g. the same make and model). [ASU 2016-02.BC352(c)]

KPMG observation – Conflicting transfer of control indicators

9.1.310 The Board observed that substantial judgment may be required in determining whether a sale/purchase has occurred. This is because the transfer of control evaluation in Topic 606 is largely indicator-based (see 9.1.20) and, in a sale-leaseback transaction, those indicators will almost always provide conflicting evidence. For example, while the buyer-lessor will typically obtain title to the asset and have a present obligation to pay the seller-lessee for that asset, the seller-lessee typically retains physical possession of the asset. The indicator about customer acceptance may frequently not be applicable. Consequently, the indicator that the 'customer has the significant risks and rewards of ownership of the asset' may often receive significant attention in the evaluation, because it is the indicator that may be most likely to vary from transaction to transaction. For example, a significant seller-lessee residual value guarantee of the asset may suggest that the buyer-lessor does not have the significant risks *and* rewards of ownership of the asset. In that case, the control indicators would be split. [606-10-25-25, 25-30, ASU 2016-02.BC353]

9.1.320 Particularly when the indicators provide conflicting evidence, we believe that it is important to consider that, while Topic 606 provides five indicators to consider in determining when a buyer obtains control of an asset, it also requires entities to consider the overall control *principle* (see 9.1.10).

9.1.330 We believe that consideration of the control principle may suggest that the absence of exposure to risks (e.g. because of a seller-lessee residual value guarantee) is less important than the ability to obtain the remaining benefits from the asset. In that case, the buyer-lessor's ability to obtain the remaining benefits from the asset (e.g. to sell the asset, subject to the leaseback, and obtain all of the proceeds from that sale) may provide more persuasive evidence about whether a sale/purchase has occurred than whether the seller-lessee has provided protection against some of the risks of ownership (e.g. decreases in the market value of the asset). This is illustrated in Example 9.1, Scenario 3.

KPMG observation – Seller-lessee and buyer-lessor might reach different conclusions

9.1.340 It is possible that a seller-lessee and a buyer-lessor in a sale-leaseback transaction will not come to the same conclusion about whether a sale/purchase has occurred. This could occur for any of the following reasons:

- Different judgments or estimates (e.g. as to discount rate for the lease) result in the two entities reaching different conclusions about whether the leaseback is a finance lease (lessee) or a sales-type lease (lessor).
- Different judgments about the nature of the asset (e.g. whether assets substantially the same as the transferred assets are readily available in the marketplace) could result in different conclusions about the effect of a seller-lessee repurchase option.
- The two entities could reach different conclusions about whether a sale/purchase has occurred in applying the control indicators. [ASU 2016-02.BC352(c), BC353]

US GAAP different from IFRS – Sale-leaseback transactions

Effect of repurchase options

9.1.350 While, in some limited circumstances under Topic 842, a seller-lessee option to repurchase the transferred asset will not preclude sale/purchase accounting, *any* substantive seller-lessee repurchase option will preclude sale/purchase accounting under IFRS 16. [IFRS 16.99, BC262(c), IFRS 15.BC427]

Effect of leaseback classification

9.1.360 Topic 842 precludes sale/purchase accounting in the context of a sale-leaseback transaction if the leaseback would be classified as a finance lease by the seller-lessee (or as a sales-type lease by the buyer-lessor). IFRS 16 includes no similar prohibition. Rather, under IFRS 16, the more significant the leaseback (e.g. the leaseback is classified as a finance lease by the buyer-lessor), the less of the gain from the sale of the asset the seller-lessee will recognize at the time of sale. [IFRS 16.99–100, BC264]

Comparison with current US GAAP – Sale-leaseback transactions

Different sale-leaseback accounting for real estate versus other assets eliminated

9.1.370 Current US GAAP has different guidance for sale-leaseback transactions of real estate versus other assets. Under Topic 842, the same guidance applies to all sale-leaseback transactions, regardless of whether the underlying asset is real estate. [840-40-25-9 – 25-18]

Sale-leaseback accounting now easier to achieve for real estate; more difficult for other assets

9.1.380 Sale-leaseback transactions in the US involving equipment often contain an option for the seller-lessee to repurchase the equipment. Such options generally do not result in a failed sale under Topic 840 unless the repurchase option is a bargain repurchase option. Topic 842 will make it more difficult for many equipment sale-leaseback transactions to qualify for sale-leaseback accounting. [840-40-25-9 – 25-18]

9.1.390 Conversely, current US GAAP results in a failed sale for real estate sale-leaseback transactions if the seller-lessee has any continuing involvement (including a repurchase option at any strike price) with the real estate other than a normal leaseback. Failed sales are common in real estate sale-leaseback transactions as a result. Because Topic 842 supersedes the current US GAAP continuing involvement provisions, and the sale requirements in Topic 606 are generally considered to be less onerous, it will generally be easier for real estate sale-leaseback transactions to qualify for sale-leaseback accounting under Topic 842 than under current US GAAP. However, a seller-lessee repurchase option will generally still preclude sale-leaseback accounting for a real estate sale-leaseback transaction (see KPMG observation at 9.1.300). [840-40-25-9 – 25-18]

No 'failed purchase' accounting

9.1.400 When the transfer of the asset does not qualify as a sale/purchase based on the relevant guidance in Topic 606, Topic 842 will require the buyer-lessor to account for a sale-leaseback transaction as a 'failed purchase' (see section 9.3). In contrast, current US GAAP never requires the buyer-lessor to account for a failed purchase, even if the seller-lessee accounts for the transaction as a failed sale.

Sale-leaseback accounting is not prohibited for capital (finance) leasebacks

9.1.410 Current US GAAP does not prohibit a seller-lessee from concluding that a sale has occurred in the context of a sale-leaseback transaction solely because the seller-lessee would classify the leaseback as a capital lease. [840-40-25-2]

9.2 Accounting for a sale-leaseback transaction

9.2.10 When a sale/purchase occurs in the context of a sale-leaseback transaction, at the point in time that the buyer-lessor obtains control of the asset (under Topic 606), the seller-lessee:

- recognizes the transaction price (i.e. the sale price) as determined in accordance with the guidance on determining the transaction price in Topic 606, adjusted for any off-market terms; and
- derecognizes the carrying amount of the underlying asset. [842-40-25-4(a), 606-10-25-30, 32-2 – 32-7]

9.2.20 Subject to any adjustment for off-market terms, this results in recognition of the full amount of the gain or loss on the sale of the asset.

9.2.30 A seller-lessee accounts for the leaseback under the lessee accounting model (see chapter 6). [842-40-25-4(a)(3)]

9.2.40 A buyer-lessor accounts for the:

- purchase of the underlying asset in a sale-leaseback transaction consistent with the guidance that would apply to any other purchase of a nonfinancial asset (subject to any off-market adjustment) – i.e. without the presence of a leaseback; and
- leaseback under the lessor accounting model (see chapter 7). [842-40-25-4(b)]

9.2.1 Determining whether the sale price is off-market

9.2.50 Unless the sale-leaseback transaction is between related parties (see 9.2.90), the sale/purchase is accounted for at fair value. Therefore, both the seller-lessee and the buyer-lessor need to assess whether the transaction is at fair value – i.e. at market terms. [842-40-30-1]

9.2.60 In making its assessment as to whether the transaction is at fair value, an entity uses the formula that is more readily determinable:

- the sale price of the asset versus the fair value of the asset; or
- the present value of the lease payments versus the present value of market rental payments. [842-40-30-1]

9.2.70 A sale-leaseback transaction is not off-market solely because the sale price or the leaseback payments include a significant variable component. In determining whether the sale price is at fair value, the entity considers those variable payments that it reasonably expects to receive (or make) on the basis of all reasonably available information (e.g. historical, current, and/or forecast). For the seller-lessee, this includes estimating any variable consideration to which it expects to be entitled under the guidance on estimating variable consideration (*before* consideration of the constraint on variable consideration) in Topic 606. [842-40-30-3, 606-10-32-5 – 32-9]

9.2.80 Sale-leaseback transactions are generally interdependent and negotiated as a package. Consequently, the parties could negotiate off-market terms for either the sale or the leaseback, and recoup the difference through the other part of the transaction – i.e. through a negotiated sales price above fair value and lease payments above market rates, or vice versa. Although the two formulas in 9.2.60 may give different results, the Board decided that either comparison is an acceptable way to identify whether the accounting for the transaction needs to be adjusted due to the presence of off-market terms. However, the decision about which comparison to use is not a free choice; entities are required to maximize the use of observable prices and information, which is consistent with using the comparison that is more readily determinable. [ASU 2016-02.BC363–BC364]

9.2.90 If the sale-leaseback transaction is between related parties, neither the seller-lessee nor the buyer-lessor makes any adjustment for off-market terms. Instead, the entity discloses the off-market nature of the transaction (see 12.3.10). [842-40-30-4]

KPMG observation – Gain recognition consistent with that for any nonfinancial asset

9.2.100 The Board concluded that if the sale and the leaseback are at market terms, the transfer of control of the asset (i.e. the sale) to the buyer-lessor is separate and distinct from the buyer-lessor's transfer of a right to use that asset to the seller-lessee. Consequently, the presence of the leaseback should neither preclude the sale of the asset, nor alter the accounting for that sale (except as necessary to adjust for off-market terms). [ASU 2016-02.BC359–BC360]

KPMG observation – Related party transactions

9.2.110 The Board decided that recognizing sale-leaseback transactions between related parties based on contractual terms is consistent in concept with the Board's decision that an entity should account for a related party lease in accordance with its enforceable terms and conditions of that lease. An entity should not account for the transaction in accordance with a subjective determination of its economic substance. [ASU 2016-02.BC362]

9.2.2 Adjusting the gain or loss for off-market terms

9.2.120 If, based on the evaluation in section 9.2.1, the sale-leaseback transaction is not at fair value the entity – whether the seller-lessee or the buyer-lessor – adjusts the sale price so that the transaction is recognized at fair value:

- **Deficit.** If the sale price is less than fair value, an adjustment is made to increase the sale price of the asset. The corresponding debit is recognized as a rent prepayment.
- **Excess.** If the sale price is greater than fair value, an adjustment is made to decrease the sale price of the asset. The corresponding credit is recognized as additional financing provided by the buyer-lessor to the seller-lessee. [842-40-30-2]

9.2.130 When there is an excess and additional financing is recognized, both the seller-lessee and the buyer-lessor allocate a portion of each contractual lease payment to both the lease and the additional financing.

- The amount allocated to each by the seller-lessee is the amount necessary to ensure that the lease liability and the additional financial liability both equal zero at the end of the lease term.
- The amount allocated to each by the buyer-lessor is the amount necessary to reduce its financial asset and any net investment in a direct financing leaseback to zero at the end of the lease term. [842-40-30-1 – 30-2, 55-23 – 55-30]

9.2.140 Operating lease cost (seller-lessee) or income (buyer-lessor) is determined based on the total amount of the contractual payments allocated to the lease.

9.2.3 Accounting for the leaseback

9.2.150 When a sale-leaseback transaction qualifies for sale/purchase accounting, both the seller-lessee and the buyer-lessor account for the leaseback in the same manner as any other lease – see chapter 6 (lessees) and chapter 7 (lessors). [842-40-25-4]

Example 9.2
Gain recognized by seller-lessee in a sale-leaseback transaction

9.2.160 Seller-Lessee SL sells a building to Buyer-Lessor BL and leases it back. The following facts are relevant at the point in time that BL takes control of the building:

– Carrying amount of building:	$1.5 million
– Sale price (and fair value[1]) of the building:	$2.5 million
– Lease term:	4 years
– Lease payments:	Fixed payments of $325,000 per year in arrears
– SL's incremental borrowing rate[2]:	10%
– Lease incentives/initial direct costs:	None

Notes:

1. Based on recent sale prices of comparable buildings in the area, which are more readily determinable than market rentals for the four-year leaseback.
2. The rate implicit in the lease is not readily determinable.

9.2.170 As illustrated in the entries below, SL recognizes the full amount of the gain on the sale of the building, consistent with how it would recognize the gain resulting from the sale of any other nonfinancial asset.

	Debit	Credit
Cash	2,500,000	
Building		1,500,000
Gain on sale[1]		1,000,000
To recognize sale in sale-leaseback transaction		
ROU asset[2]	1,030,206	
Lease liability[3]		1,030,206
To recognize leaseback in sale-leaseback transaction		

Notes:

1. Sale price ($2.5 million) - carrying amount of the building ($1.5 million).
2. Lease liability ($1,030,206) + prepaid rent (nil) + initial direct costs (nil) - lease incentives (nil).
3. Four payments of $325,000 (paid in arrears), discounted at 10%.

US GAAP different from IFRS – Partial (IFRS 16) versus full (Topic 842) gain recognition

9.2.180 Both Topic 842 and IFRS 16 require the seller-lessee and the buyer-lessor to adjust the sale price of the asset for off-market terms and determine the amount of that adjustment similarly. Both standards also require the buyer-lessor to account for the purchase of the asset in the same manner as any other purchase of a nonfinancial asset. [IFRS 16.100(b), 101–102]

9.2.190 However, Topic 842 and IFRS 16 differ as to how much gain or loss should be recognized by the seller-lessee at the point in time that the buyer-lessor obtains control of the asset. Under Topic 842, the seller-lessee recognizes the full amount of any difference between the sale price (as adjusted for any off-market terms) and the carrying amount of the asset as a gain or loss at the time of sale. In contrast, under IFRS 16, the seller-lessee recognizes only the portion of that gain or loss that relates to the residual asset that the lessor controls at the end of the leaseback (the rights transferred to the buyer-lessor). [IFRS 16.100, IE11, BC266]

9.2.200 IFRS 16 calculates the partial gain or loss as follows.

(Adjusted Sale Price - Carrying Amount) ÷ Fair Value of the Asset × (Fair Value of the Asset - Present Value of the Leaseback Payments)

9.2.210 Example 9.2 demonstrates the accounting under Topic 842, which can be compared to the IFRS 16 gain calculation in 9.2.220–230.

Comparison of sale-leaseback accounting between Topic 842 and IFRS 16

9.2.220 Using the fact pattern in Example 9.2 (Topic 842), Seller-Lessee SL would recognize the following entry under IFRS 16.

	Debit	Credit
Cash	2,500,000	
ROU asset	618,124	
Building		1,500,000
Lease liability		1,030,206
Gain on sale		587,918

9.2.230 The differences between this journal entry under IFRS 16 and the journal entry under Topic 842 are the calculations of the following.

- The **right-of-use asset** retained through the leaseback of the office building is a proportion of its previous carrying amount: ($1,500,000/$2,500,000) x $1,030,206 = $618,124.
- SL recognizes only the portion of the **gain on sale** that relates to the rights transferred to BL: ($2,500,000 - $1,500,000) ÷ $2,500,000 x ($2,500,000 - $1,030,206) = $587,918.

Comparison with current US GAAP – Gain/loss recognition different

Accounting for a gain or loss on a sale-leaseback transaction

9.2.240 The ability to recognize a gain immediately on recognition of a sale-leaseback transaction is a change from current US GAAP. Under current US GAAP, the recognition of any gain or loss on the sale of the underlying asset in a sale-leaseback transaction depends on the rights retained by the seller-lessee. These thresholds are illustrated by the following table. [840-40-25.3 – 25.5]

Minor | **More than minor, but less than substantially all** | **Substantially all**

0% **10%** **90%** **100%**

9.2.250 Under current US GAAP, gains or losses realized by a seller-lessee are accounted for as follows.

- Transactions resulting in a realized **loss** by the seller-lessee:
  - » Fair value of underlying asset < Carrying amount of underlying asset = Recognize the loss immediately.
  - » Fair value of underlying asset > Carrying amount of underlying asset = Account for the loss as a prepayment of rent.

- Transactions resulting in a realized **gain** by the seller-lessee (i.e. fair value > carrying amount):
  - When the seller-lessee retains only a *minor* portion of the right to the remaining use of the asset sold (i.e. < 10%), recognize the full gain immediately.
  - When the seller retains *more than a minor, but less than substantially all*, of the remaining use of the asset sold (i.e. between 10% and 90%):
    - Operating leasebacks: Recognize a gain to the extent that the profit on sale exceeds the present value of the minimum lease payments.
    - Capital leasebacks: Recognize a gain to the extent that the profit on the sale exceeds the carrying amount of the underlying asset on the date of sale.
- When the seller-lessee retains *substantially all* of the risks and benefits incidental to the ownership of the underlying asset (i.e. > 90%), defer and amortize any profit over the lease term. [840-40-25-3 – 25-4]

Related party transactions

9.2.260 Under current US GAAP, entities recognize the economic substance of a related party lease rather than its legal form, which includes evaluating the economic substance of sale-leaseback transactions. The requirement to evaluate related party sale-leaseback transactions solely based on their legal form is, therefore, a difference between current US GAAP and Topic 842. [840-10-25-26]

Example 9.3
Accounting for a sale-leaseback transaction with off-market terms

9.2.270 Assume the same facts as Example 9.2, except for the following.

- The building's observable fair value on the date of the sale is $2 million – i.e. the sale price exceeds the building's observable fair value by $500,000.
- The market rental payments are $198,800 per year – i.e. the present value of the contractual lease payments exceeds the present value of market rental payments by $400,037.
- Buyer-Lessor BL applies a discount rate of 10% to the additional financing provided to Seller-Lessee SL, determined in accordance with Subtopic 835-30 (imputation of interest).

9.2.280 Because the terms of the transaction are not at market, both parties record an adjustment to recognize the transaction at fair value, as an initial step in accounting for the sale-leaseback transaction.

Seller-lessee accounting

9.2.290 SL uses the fair value of the asset to determine the extent to which the sale/purchase is off-market (see section 9.2.1), because the fair value of the asset is more readily determinable than market rentals for the leaseback. This means that:

- the gain on sale is calculated with reference to the fair value of $2 million; and
- the excess of $500,000 ($2.5 million - $2 million) is recognized as additional financing.

9.2.300 SL records the following journal entry when BL obtains control of the building.

	Debit	Credit
Cash	2,500,000	
Building		1,500,000
Financial liability[1]		500,000
Gain on sale[2]		500,000
To recognize sale in sale-leaseback transaction		
ROU asset[3]	530,206	
Lease liability[4]		530,206
To recognize leaseback in sale-leaseback transaction		

Notes:

1. Contractual sale price ($2.5 million) - fair value of the building ($2 million).
2. Adjusted sale price ($2 million) - carrying amount of the building ($1.5 million).
3. Lease liability ($530,206) + prepaid rent (nil) + initial direct costs (nil) - lease incentives (nil).
4. $1,030,206 (see Example 9.2) - off-market adjustment ($500,000).

Comparison of sale-leaseback accounting between Topic 842 and IFRS 16

9.2.310 Using the fact pattern in Example 9.3 (Topic 842), Seller-Lessee SL would recognize the following entry under IFRS 16.

	Debit	Credit
Cash	2,500,000	
ROU asset	397,655	
Building		1,500,000
Lease liability		530,206
Financial liability		500,000
Gain on sale		367,449
To recognize sale-leaseback transaction		

9.2.320 The difference between this journal entry under IFRS 16 and the journal entry under Topic 842 is the calculation of the following.

- The **right-of-use asset** retained through the leaseback of the office building is a proportion of its previous carrying amount: ($1,500,000 ÷ $2,000,000) x $530,206 = $397,655.
- SL recognizes only the portion of the **gain on sale** that relates to the rights transferred to BL: ($2,000,000 - $1,500,000 ÷ $2,000,000 x ($2,000,000 - $530,206) = $367,449.

Comparison with current US GAAP – Leaseback classification

9.2.330 Under Topic 842, a leaseback cannot be classified as a finance lease for the seller-lessee or a sales-type lease (for the buyer-lessor). All leasebacks are classified as an operating lease by the seller-lessee, and as an operating lease or a direct financing lease by the buyer-lessor. There are no similar prohibitions on leaseback classification under current US GAAP. [840-40-25-2, 25-8]

9.3 Accounting for failed sale-leaseback transactions

9.3.10 A failed sale-leaseback transaction occurs when the transaction does not meet the requirements for a sale under Topic 606 (see section 9.1). Instead, the transaction is accounted for as a financing transaction by both the seller-lessee and buyer-lessor.

- The seller-lessee recognizes any proceeds received from the buyer-lessor as a financial liability (financing method) and does not derecognize the transferred asset. The seller-lessee continues to depreciate the transferred asset.
- The buyer-lessor does not recognize the transferred asset and accounts for any proceeds paid to the seller-lessee as a receivable (financial asset). [842-40-25-5]

9.3.20 In applying the financing method, the seller-lessee adjusts the interest rate on its financial liability to ensure that:

- interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the lease term or the term of the financing – i.e. there is not negative accretion on the liability over the shorter of the lease term or the term of the financing; and
- the carrying amount of the underlying asset will not exceed the financing obligation at the earlier of (1) the end of the lease term, and (2) the date on which control of the underlying asset transfers to the buyer-lessor – i.e. there is not a built-in loss. [842-40-30-6]

9.3.30 Example 2 in Subtopic 842-40 demonstrates the accounting for a failed sale-leaseback transaction. [842-40-55-31 – 55-38]

9.3.40 A failed sale-leaseback transaction may not remain a failed transaction for the entire term of the leaseback. For example:

- the buyer-lessor may obtain control of the asset (and therefore complete the sale/purchase) before the end of the leaseback term if a seller-lessee repurchase option that precluded sale/purchase accounting expires; or
- the control guidance in Topic 606 may suggest that the buyer-lessor has not obtained control of the asset at the leaseback commencement date, but may suggest otherwise before the end of the leaseback term. [ASU 2016-02.BC369, 842-40-55-31 – 55-38]

9.3.50 If an initially failed sale-leaseback transaction qualifies for sale/purchase accounting before the end of the leaseback term:

- the seller-lessee derecognizes the remaining financial liability and the carrying amount of the asset, and recognizes a gain for the difference; and
- the buyer-lessor derecognizes its remaining financial asset and recognizes the transferred asset at that same amount. [842-40-55-31 – 55-38]

9.3.60 Both parties then account for the remaining leaseback in accordance with the applicable lessee and lessor guidance from the date the sale/purchase is deemed to occur for accounting purposes. However, they both use the discount rate for the lease that would have been established at the contractual lease commencement date. This only matters for the buyer-lessor if the leaseback is a direct financing lease because a buyer-lessor cannot have a sales-type leaseback and will not recognize lease assets for an operating leaseback. [842-40-55-31 – 55-38]

9.3.70 Example 2 in Subtopic 842-40 indicates that the seller-lessee uses the lease commencement date discount rate because that rate more closely reflects the interest rate that would have been considered by the buyer-lessor in pricing the lease. [842-40-55-31 – 55-38]

KPMG observation – Failed sale-leaseback that later qualifies for sale-leaseback accounting

9.3.80 In Example 2 in Subtopic 842-40, neither the seller-lessee nor the buyer-lessor assesses the classification of the lease at the date that the transaction qualifies for sale-leaseback accounting. Although not stated explicitly, we believe that it was the Board's intention for the parties *not* to reassess lease classification. This is based on the following reasoning:

- The lease classification guidance in Topic 842 makes no mention of reassessing lease classification in the context of failed sale-leaseback transactions. That guidance provides that an entity should *only* reassess lease classification upon a modification of the lease or, for lessees, a change in the lease term or the assessment of a lessee purchase option.
- The sale-leaseback guidance requires ongoing reassessment of whether a failed sale-leaseback transaction qualifies for sale-leaseback accounting. A requirement to reassess lease classification in a scenario like that in Example 2 might also suggest that, if the sale-leaseback transaction failed because of the classification of the leaseback as a finance/sales-type lease, the parties would be required to continually reassess lease classification based on changing assumptions (e.g. changes in fair value of the asset) and the passage of time (e.g. changes in the remaining economic life of the asset). [842-10-25-1]

US GAAP different from IFRS – Less guidance under IFRS for failed sale-leaseback transactions

9.3.90 IFRS 16 does not include some of the guidance about accounting for failed sale-leaseback transactions that Topic 842 does. Therefore, it is unclear whether there is either or both: (1) guidance in Topic 842 that may not be considered acceptable under IFRS 16 or (2) approaches that would appear to be permissible under IFRS 16 (i.e. because no guidance is specified) that would not be acceptable under Topic 842.

Adjusting the discount rate for failed sale-leaseback transactions

9.3.100 IFRS 16 does not include guidance similar to that discussed in 9.3.20 on adjusting the discount rate used by a seller-lessee, under certain circumstances, in accounting for a failed sale and leaseback transaction. A discount rate used by a seller-lessee in accordance with that guidance would be an acceptable application of IFRS 16 only if that discount rate would be acceptable under IFRS 9 (financial instruments). In contrast, it would seem clear that a discount rate not established in accordance with that discussed in 9.3.20 would not be acceptable under US GAAP.

Failed sale-leaseback transaction that later qualifies for sale-leaseback accounting

9.3.110 As outlined in the KPMG observation at 9.3.80, Example 2 in Subtopic 842-40 illustrates the accounting for a failed sale-leaseback transaction that later qualifies for sale-leaseback accounting. That example, which is authoritative under US GAAP, provides guidance that is not provided in IFRS 16 (including within the non-authoritative sections of IFRS 16 – i.e. the illustrative examples and the basis for conclusions). IFRS 16 does not provide guidance of the nature provided in Example 2 or paragraph BC369 of ASU 2016-02 about any of the following (in the scenario of a failed sale-leaseback transaction that later qualifies for sale-leaseback accounting):

- the sale price for the seller-lessee;
- the carrying amount of the purchased asset for the buyer-lessor; or
- the discount rate to use in accounting for the lease (i.e. Topic 842 stipulates use of the discount rate established at the contractual commencement date).

9.3.120 Therefore, there is at least the potential for diversity between entities applying Topic 842 and those applying IFRS 16.

Comparison with current US GAAP

Seller-lessee accounting for 'failed' sale-leaseback transactions is generally consistent with current practice

9.3.130 Consistent with Topic 842, a failed sale-leaseback transaction under current US GAAP is generally accounted for as a financing transaction. However, unlike Topic 842, current US GAAP also permits use of the deposit method when the sale price of the underlying asset is paid to the seller-lessee over time. [840-40-25-11]

Adjusting the discount rate for failed sale-leaseback transactions

9.3.140 While practice under current US GAAP has developed in a manner similar to the guidance on adjusting the discount rate in a failed sale-leaseback transaction under Topic 842 (see 9.3.60), current US GAAP does not have explicit guidance of this nature.

9.4 Lessee control of the underlying asset

9.4.10 If the lessee controls the underlying asset before the commencement date of the lease, it is a sale-leaseback transaction and the accounting described in sections 9.2–9.3 applies. However, obtaining legal title alone, especially if title is obtained only momentarily, does not mean that the lessee controls the underlying asset before the commencement date. [842-40-55-1 – 55-2, 55-5]

KPMG observation – Effect of legal title on control consistent with Topic 606

9.4.20 The guidance in Subtopic 842-40 stipulating that having legal title to an asset, especially if that legal title is only obtained momentarily (often referred to as 'flash title') before it is transferred to another entity, does not mean a lessee controls the underlying asset before lease commencement is consistent with the guidance in Topic 606, which treats legal title only as an indicator of control and also provides specific guidance that obtaining flash title to a good does not mean an entity controls that good. [ASU 2016-02.BC400]

9.4.1 Lessee involvement in the construction or design of the underlying asset

9.4.30 A lessee may enter into a lease in which the underlying asset needs to be constructed or redesigned for use by the lessee. Depending on the terms and conditions of the contract, the lessee may be required to make payments related to the construction or design of the asset. [842-40-55-3]

9.4.40 If a lessee incurs costs relating to the construction or design of an underlying asset before the commencement date, it applies other US GAAP (e.g. Topic 330 on inventory or Topic 360 on property, plant, and equipment) to account for such costs. However, costs relating to the construction or design of the underlying asset do not include payments made for the right to use the underlying asset (i.e. lease payments), regardless of the timing of those payments or the form of the consideration; for example, a lessee might contribute materials or labor for the construction or redesign of the underlying asset. [842-40-55-4]

9.4.50 If a lessee controls an underlying asset that is under construction (or redesign) before the commencement date of the lease, it is a sale-leaseback transaction and the accounting described in sections 9.2–9.3 applies. Any one (or more) of the following would demonstrate that the lessee controls an underlying asset that is under construction (or redesign) before the commencement date of the lease.

- The lessee has the right to obtain the partially-constructed underlying asset at any point during the construction period (e.g. by making a payment to the lessor).
- The lessor has an enforceable right to payment for its performance to date and the asset does not have an alternative use to the owner-lessor.
- The lessee legally owns (1) both the land and the property improvements that are under construction, or (2) the non-real estate asset (e.g. a ship or aircraft) that is under construction.
- The lessee controls the land on which the property improvements will be constructed (which includes where the lessee transfers the land to the owner-lessor, but that transfer does not qualify as a sale – e.g. because of a lessee repurchase option) and does not enter into a lease of the land prior to the beginning of the construction that, together with the renewal options, permits the lessor or another related party to lease the land for substantially all of the economic life of the property improvements.[1]
- The lessee is leasing the land on which the property improvements will be constructed, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements and does not enter into a sublease of the land prior to the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements.[1] [842-40-55-5]

Note 1:

'Options' refers to all renewal options, regardless of whether it is reasonably certain that those options will be exercised. In other words, this criterion considers the maximum possible lease term, rather than the 'lease term' as defined in Topic 842 (see section 5.3). [842-40-55-40 – 55-44]

9.4.60 The list in 9.4.50 is not all-inclusive. There may be other facts or circumstances that demonstrate that a lessee controls an underlying asset that is under construction before the commencement date.

9.4.70 Example 3 in Subtopic 842-40 includes an illustration in which the lessee controls the underlying asset that is under construction before the commencement date, as well as one in which the lessee does not control the underlying asset that is under construction before the commencement date. [842-40-55-6, 55-39 – 55-44]

Example 9.4

Determining whether lessee controls the underlying asset before the commencement date

9.4.80 Lessee LE and Owner-Lessor LR enter into a contract whereby LR will construct (whether itself or using subcontractors) a building to LE's specifications and lease that building to LE once construction is completed. The following facts are relevant.

– Economic life of building:	40 years
– Lease term:	20 years
– Lease payments:	Fixed payments of $500,000 per year in arrears, with a 3.5% increase each year after Year 1
– Cost overruns:	Agreed percentage payable by LE

9.4.90 In addition:

- LE does not legally own the building and does not have a right under the contract to obtain the building while it is under construction; for example, LE does not have the right to purchase the construction in process from LR.
- Although the building is being developed to LE's specifications, it is not so customized to LE that the building does not have an alternative use to LR.

Scenario 1: Lessee controls the building as it is being constructed

9.4.100 LE controls the land on which the building is to be constructed. As part of the contract, LE agrees to lease the underlying land to LR for 25 years, beginning at the end of the construction period. The contract does not permit LR to renew the land lease.

9.4.110 In this scenario, LE controls (i.e. is the accounting owner of) the building as it is being constructed, because:

- LE controls the land on which the building will be constructed; and
- the lease of the building does not both (1) grant LR the right to use the land *before* the beginning of the construction period, and (2) permit LR to use the land for substantially all of the economic life of the building (25 out of 40 years).

9.4.120 Because LE controls the building, both LE and LR apply the guidance on sale-leaseback transactions (see sections 9.2–9.3).

Scenario 2: Lessee does not control the building as it is being constructed

9.4.130 LE leases the land on which the building is to be constructed. LE has a 20-year lease of the underlying land, and four seven-year renewal options – i.e. the lease has a maximum possible term of 48 years. Therefore, LE's lease of the underlying land, together with the renewal options, is for at least substantially all of the economic life of the building under construction.

9.4.140 LE enters into a sublease that gives LR the right to use the underlying land for 25 years, commencing immediately before the beginning of construction of the building. The sublease has two 10-year renewal options available to LR.

9.4.150 None of the circumstances outlined in 9.4.50 exists.

- LE is neither the legal nor the accounting owner of the land, and will not legally own the building while it is being constructed.
- LE does not have the right to obtain the building (e.g. by purchase) from LR during the construction period.
- The building has an alternative use to LR.
- While LE is leasing the land on which the building will be constructed, LE has subleased that land to LR prior to the start of construction for a term that, together with renewal options available to LR, is at least substantially all of the 40-year economic life of the building (45 years exceeds the 40-year economic life of the building).

9.4.160 In this scenario, there are no other circumstances that, individually or in combination, suggest that LE controls the building as it is being constructed. Therefore, LE does not control the building as it is being constructed.

KPMG observation – Control of an underlying asset under construction derived from Topic 606

9.4.170 The Board observed that, in concept, the evaluation as to whether a lessee controls an underlying asset that is under construction is similar to the evaluation undertaken in the new revenue recognition standard (paragraph 606-10-25-27) to determine whether a performance obligation is satisfied over time. Under the guidance in Topic 606, a customer obtains control of a good as it is being produced (or modified), and therefore the entity satisfies its performance obligation to transfer that good over time, when either or both:

- The entity's performance creates or enhances an asset (e.g. work in process) that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

9.4.180 We believe it was the Board's view that the evaluation of whether a lessee controls an underlying asset that is under construction (i.e. whether a customer controls an asset as it is being constructed that it will lease after the construction period) should be similar to the evaluation of whether a customer controls an asset as it is being constructed (or modified) that it will own after the construction period. [ASU 2016-02.BC400]

US GAAP different from IFRS – No IFRS implementation guidance on control of an underlying asset under construction

9.4.190 Topic 842 and IFRS 16 include substantially similar guidance with respect to the following.

- A lessee shall apply other US GAAP or IFRS in accounting for costs relating to the construction or design of an underlying asset. [IFRS 16.B44]
- Payments for the right to use an underlying asset are lease payments. [IFRS 16.B44]
- If a lessee controls the underlying asset before lease commencement, the arrangement is a sale-leaseback transaction. [IFRS 16.B46]
- Having legal title alone does not mean a lessee controls the underlying asset before the commencement date. [IFRS 16.B45]

9.4.200 However, IFRS 16 does not provide guidance specific to determining whether a lessee controls an underlying asset that is under construction before the commencement date (as Topic 842 does in paragraph 842-40-55-5 and in Example 3 in Subtopic 842-40). Entities applying IFRS 16 will be expected to apply only the control principle in paragraph B46 to all transactions. [IFRS 16.B43–B47]

Comparison with current US GAAP – Lessee control over asset under construction guidance different from current US GAAP build-to-suit guidance

9.4.210 Topic 842 and current US GAAP both treat the lessee as the accounting owner of an underlying asset that is under construction in some circumstances and, in these situations, the transaction is subject to the sale-leaseback transactions guidance when construction of the asset is completed and the lease term commences. However, Topic 842 and current US GAAP determine whether the lessee is the accounting owner of an underlying asset that is under construction differently. [840-40-15-5]

9.4.220 Under current US GAAP, the lessee is the accounting owner of the asset during the construction period if the lessee either:

- takes on substantially all of the construction-period risks, determined through a 'maximum guarantee test'; or
- engages in one or more activities specifically outlined in the guidance as prohibited involvement. Such activities include, but are not limited to, indemnifying the owner-lessor or its lenders of pre-existing environmental risks (when the risk of loss is more than remote), taking title to the asset at any point during the construction period, or paying construction project costs directly (other than some limited exceptions).

9.4.230 Topic 842 eliminates the current build-to-suit guidance about determining whether a lessee controls the underlying asset during the construction period. Instead, it requires an evaluation of whether a lessee is the accounting owner of an underlying asset under construction based on whether it 'controls' that asset before the commencement date of the lease. [840-40-55-2 – 55-15]

10 Income taxes

How the standard works

- Topic 842 does not contain tax accounting guidance and only minor, conforming amendments to Topic 740 were made as part of ASU 2016-02. These amendments do not change the basic requirements of Topic 740.
- The adoption of Topic 842 will likely impact an entity's calculation of deferred tax assets and liabilities even though tax laws may not be directly impacted. The following changes will have the most impact on an entity's accounting for deferred taxes.
  - For **lessees**, the recognition of right-of-use assets and lease liabilities for operating leases will require entities to recognize new deferred tax assets and deferred tax liabilities not previously recognized.
  - For **seller-lessees** in sale-leaseback transactions, a failed sale under Topic 842 could result in new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes.
  - For **lessors**, the deferral of selling profit for some direct financing leases could create new (or larger) deferred tax assets.
  - For **buyer-lessors** in sale-leaseback transactions, a failed purchase could result in new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes.
- In addition, Topic 842 may impact the computation of state and local income-based taxes as a result of changes to the apportionment formula.

10.1 Deferred taxes

Comparison with current US GAAP – Mechanics of income tax accounting the same

10.1.10 A basic principle of Topic 740 (income taxes) is to recognize deferred taxes for the future tax consequences of events that are recognized in the financial statements or tax returns, but not yet in both. Future tax consequences result from differences between the tax basis and the financial statement carrying amounts of assets and liabilities. Basis differences that have future tax consequences are either taxable temporary differences (that will result in future taxable amounts) or deductible temporary differences (that will result in future deductible amounts). Deferred tax liabilities are recognized for taxable temporary differences and deferred tax assets are recognized for deductible temporary differences.

10.1.20 Topic 842, consistent with current US GAAP, will create book/tax differences. However, because Topic 842 results in the recognition of more assets and liabilities than current US GAAP, the adoption of Topic 842 may require entities to record new, or adjust existing, deferred tax assets and liabilities.

10.1.30 Under current US GAAP for operating leases, a lessee generally records a deferred tax asset for the accrued rent liability that exists, which equals the difference between the cumulative rent deductible for income tax purposes, sometimes based on the cash paid, and the cumulative rent recognized for book purposes (generally on a straight-line basis). Since the underlying asset is not recognized by the lessee for book purposes, nor is any right-of-use asset, the only temporary difference created is the difference between the rent expense recognized for tax purposes and book purposes. However, because Topic 842 requires recognition of a right-of-use asset and a lease liability that have no tax basis, deferred tax accounts will be established to recognize these basis differences.

10.1.40 Aside from this difference, while the amounts may change due to the new requirements of Topic 842 in comparison to current US GAAP, the mechanics of accounting for the income tax consequences of lease agreements remain substantially unchanged.

Lessee considerations – operating leases

10.1.50 Under Topic 842, a lessee in an operating lease records a lease liability and a right-of-use asset (see section 6.3) on the commencement date (see section 5.1). For tax purposes, the lease will generally be a true tax lease (the income tax equivalent of an operating lease), in which a right-of-use asset and a lease liability are not recognized on the tax ledger. As a result, the operating lease gives rise to two separate temporary differences: (1) a temporary difference related to the right-of-use asset, and (2) a temporary difference related to the lease liability. If an operating lease contains uneven lease payments, an additional temporary difference may be identified by the entity.

Lessee considerations – finance leases

10.1.60 For finance leases, a lessee recognizes the following (see chapter 6):

- right-of-use asset (on the commencement date);
- lease liability (on the commencement date);
- interest expense on the lease liability each period of the lease term; and
- amortization of the right-of-use asset each period of the lease term.

10.1.70 A lessee amortizes the right-of-use asset on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the economic benefits of the right-of-use asset. Amortization is recognized over the period from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. If the lessee is reasonably certain to exercise a purchase option to acquire the underlying asset, the lessee amortizes the right-of-use asset over the period to the end of the underlying asset's useful life.

10.1.80 For tax purposes, finance leases are often treated as either true tax leases or non-tax leases (which is the income tax equivalent of a sales-type lease). Under a true tax lease, the lessor maintains ownership of the asset and the related deductions for depreciation and the lessee is able to deduct rental payments for use of the asset. Compare this with a non-tax lease: Although legal ownership of the asset remains with the lessor in a non-tax lease, the lessor is not considered to have substantial risks and rewards of ownership because the lease is more akin to a financing transaction (e.g. because the lessee has a nominal purchase option at the end of the lease). As a result, the lessee receives the tax benefits of ownership and is able to deduct (1) the related depreciation for the asset, and (2) the portion of the payments that are considered interest, but is not permitted to deduct the total rental payments. The lessor recognizes interest income.

10.1.90 As a result of different classification requirements for book and tax purposes, it is possible for a finance lease to be classified as a true tax lease. In those situations, the lessee will record a right-of-use asset and a lease liability at lease commencement, and subsequently will recognize interest expense and right-of-use asset amortization. For the tax provision, the lessee will have temporary differences related to the right-of-use asset and the lease liability since those do not exist for tax purposes.

Lessor considerations

10.1.100 A lessor classifies leases as operating, direct-financing, or sales-type leases for book purposes. For tax purposes, those leases are generally treated as true tax leases or as non-tax leases – i.e. similar to a sales transaction. For direct-financing or sales-type leases, the present value of the lease payments during the lease term plus the present value of the expected residual value of the underlying asset at the end of the lease term are recognized as the lessor's net investment in the lease (see section 7.3.2). In some jurisdictions and fact patterns, the lease may be considered a true tax lease, where the lessor will be considered to own the asset for tax purposes and will deduct the depreciation for the asset and recognize taxable income for the rental income. In other jurisdictions and fact patterns, the lease may be treated as a non-tax lease for tax purposes. In this situation, the lessor would recognize a taxable gain or loss on the sale of the asset and will recognize interest income over the lease term for the financing provided to the lessee that is repaid through the payments under the lease.

10.1.110 The deductible amount scheduled in each future year is based on the depreciation to be recognized for tax purposes in those future years. The taxable amount scheduled in each future year generally is based on the present value of amounts to be received in each future year or on the future principal reductions in the lease receivable.

Sale-leaseback considerations

10.1.120 As discussed in chapter 9, an entity entering into a sale-leaseback transaction will apply the specific requirements of Topic 606 (and other sale-leaseback specific considerations, such as whether the leaseback would be classified as a finance/ sales-type lease) to determine whether the transfer of the asset is a sale.

10.1.130 If the transfer of the asset is considered a sale, the seller-lessee recognizes the transaction price for the sale (determined in accordance with Topic 606) when the buyer-lessor obtains control of the asset (which may be adjusted for off-market terms), derecognizes the carrying amount of the sold asset, and accounts for the lease in accordance with Topic 842.

10.1.140 The buyer-lessor recognizes the asset at its purchase price (which would be adjusted for off-market terms) and accounts for the lease in accordance with Topic 842. If the transfer of the asset is not deemed a sale (or purchase for the buyer-lessor), the seller-lessee does not derecognize the asset, continues to depreciate the asset, and accounts for any amounts received as a financial liability. The buyer-lessor does not recognize the asset and accounts for any amounts paid as a receivable in accordance with other Topics.

10.1.150 If the form of the transaction is respected for tax purposes, a sale-leaseback transaction generally enables the seller-lessee to deduct the full rental payments that it makes to the buyer-lessor for tax purposes. In addition, the entity typically recognizes a gain or loss related to the sale of the asset. The gain may qualify as capital gains and the loss may be deductible in full as an ordinary loss for tax purposes depending on the specific situation. If the form of the transaction is not respected for tax purposes, a sale-leaseback is generally treated as a secured financing for tax purposes, in which case the seller-lessee is not treated as transferring tax ownership of the underlying asset and continues to take deductions for depreciation, as well as deductions for interest on financing provided by the buyer-lessor.

Lease origination costs

10.1.160 Generally, for both lessees and lessors, costs incurred to originate a lease are capitalized for tax purposes unless they are de minimis (not exceeding $5,000 in the aggregate per lease for US federal purposes), in which case they may be deductible. The result in that case would be a temporary difference, which is accounted for by recording a deferred tax liability equal to the tax effect of the net carrying amount of the initial direct costs that were capitalized for book purposes.

10.1.170 Under Topic 842, many types of lease origination costs will not meet the definition of initial direct costs (see section 5.5), and therefore will be expensed as incurred for book purposes. Those lease origination costs that meet the definition of initial direct costs are capitalized and recognized as expense over the lease term; an exception is sales-type leases in which the fair value of the underlying asset differs from its carrying amount at lease commencement (see section 7.3.2). For lessees, those initial direct costs are a component of the right-of-use asset (see section 6.3), and as a result impact the measurement of the deferred tax liability associated with the right-of-use asset.

Example 10.1

Deferred tax measurement of operating leases under current US GAAP (lessee)

10.1.180 Lessee LE leases a building from Lessor LR. The lease is classified as an operating lease. LE has a tax rate of 30%. The following facts are also relevant.

- The total rent payments are $166,535, which equals the sum of the lease payments for the term of the lease of $14,527 in Year 1, and escalating 3% per year thereafter for a lease period of 10 years, paid in arrears.
- LE incurs $5,000 in lease origination costs that meet the current GAAP definition of initial direct costs, which are capitalized for book and tax purposes. LE does not deduct the initial direct costs for tax purposes, even though they would be considered de minimus (see 10.1.160).
- The total cost of the lease is $171,535 ($166,535 total lease payments + $5,000 in initial direct costs). Therefore, the annual lease expense recognized for book purposes is $17,154 ($171,535 ÷ 10 years).
- Assume that the lease is a true tax lease for income tax purposes and that rent is deductible for tax purposes as paid.

10.1.190 During the first year of the lease, LE recognizes lease expense as follows (for book purposes).

	Debit	Credit
Lease expense	17,154	
Accrued rent liability		2,127
Capitalized initial direct costs		500
Cash		14,527

10.1.200 At the end of the first year of the lease, LE has deductible expenses of $15,027 for tax purposes (actual cash rent paid + Year 1 amortization of the initial direct costs ($5,000 ÷ 10 years) and lease expense of $17,154 for book purposes (straight-line lease expense, which includes $500 in Year 1 amortization of the initial direct costs). As a result, LE recognizes a current tax benefit of $4,508 ($15,027 × 30%).

	Debit	Credit
Income taxes payable	4,508	
Current income tax expense (benefit)		4,508

10.1.210 The accrued rent liability of $2,127 would constitute a temporary difference that would need to be tax-effected to calculate the related deferred tax asset. LE would record the following journal entry.

	Debit	Credit
Deferred tax asset[1]	638	
Deferred income tax expense (benefit)		638

Note 1:

$2,127 × 30%.

10.1.220 The total income tax benefit for Year 1 of the lease is therefore $5,146 ($4,508 + $638), which equals 30% of the book lease expense for Year 1 of $17,154.

Example 10.2

Deferred tax measurement of operating leases under Topic 842 (lessee)

10.1.230 Assume the same lease and the same facts as in Example 10.1, except for the following.

- The $5,000 in lease origination costs do not meet the definition of initial direct costs under Topic 842, and therefore are expensed as incurred for book purposes.
- The rate implicit in the lease is not readily determinable, so LE uses its incremental borrowing rate of 10% as the discount rate for the lease.
- LE determines the cost of the lease to be $166,535 (sum of the lease payments for the term of the lease of $14,527 in Year 1 and escalating 3% per year thereafter for a lease period of 10 years). Therefore, the annual lease expense to be recognized for book purposes is $16,654 ($166,535 ÷ 10 years).

At lease commencement

10.1.240 LE recognizes a right-of-use asset and lease liability as follows.

	Debit	Credit
Right-of-use asset[1]	100,000	
Lease liability		100,000

Note 1:

Present value of the lease payments, discounted at 10%.

10.1.250 For tax purposes, the right-of-use asset and the lease liability are not recognized, resulting in temporary differences, while the lease origination costs are deferred for tax purposes (see Scenario 1). Therefore, LE recognizes a deferred tax asset associated with the lease liability, a deferred tax liability associated with the right-of-use asset, and another deferred tax asset associated with the lease origination costs that are capitalized for tax purposes, but not for book purposes.

	Debit	Credit
Deferred tax asset[1]	30,000	
Deferred income tax expense (benefit)[1]		30,000
Deferred income tax expense (benefit)[2]	30,000	
Deferred tax liability[2]		30,000
Deferred tax asset[3]	1,500	
Deferred income tax expense (benefit)[3]		1,500

Notes:

1. 30% x $100,000 carrying amount of the lease liability.
2. 30% x $100,000 carrying amount of the right-of-use asset.
3. 30% x $5,000 lease origination costs deferred for tax purposes only.

10.1.260 Lastly, LE expenses the lease origination costs for book purposes (when they are incurred).

	Debit	Credit
Operating expense	5,000	
Cash		5,000

During the first year of the lease

10.1.270 LE recognizes lease expense along with the lease payment as follows (for book purposes).

	Debit	Credit
Lease expense	16,654	
Right-of-use asset amortization		6,654
Lease liability (interest accretion)		10,000
Lease liability	14,527	
Cash (Year 1 lease payment)		14,527

10.1.280 At the end of the first year of the lease:

- the carrying amount of the lease liability is $95,473 – i.e. the present value of the nine future payments, discounted at 10%;
- the carrying amount of the right-of-use asset is $93,346 – i.e. $95,473 carrying amount of the lease liability - $2,127 (representing the difference between Year 1 lease cost of $16,654 and the Year 1 lease payment of $14,527 – i.e. accrued rent); and
- the tax basis of the deferred lease origination costs is $4,500 ($5,000 - [$5,000 initial balance ÷ 10 years]).

10.1.290 Therefore:

- the carrying amount of the deferred tax asset related to the lease liability is $28,642 ($95,473 × 30%);
- the carrying amount of the deferred tax liability related to the right-of-use asset is $28,004 ($93,346 × 30%); and
- the carrying amount of the deferred tax asset related to the tax-deferred lease origination costs is $1,350 ($4,500 × 30%).

10.1.300 LE records the following for book purposes related to income taxes to adjust the deferred tax asset and deferred tax liability for the changes in the carrying amount of the lease liability and the right-of-use asset, respectively; as well as to recognize the tax effect of the current year tax deductible payments.

	Debit	Credit
Deferred income tax expense (benefit)[1]	1,358	
Deferred tax asset[1]		1,358
Deferred tax liability[2]	1,996	
Deferred income tax expense (benefit)[2]		1,996
Deferred income tax expense (benefit)[3]	150	
Deferred tax asset[3]		150
Income taxes payable[4]	4,508	
Current income tax expense (benefit)[4]		4,508

Notes:

1. $30,000 initial deferred tax asset - $28,642 end of Year 1 deferred tax asset related to the lease liability.
2. $30,000 initial deferred tax liability - $28,004 end of Year 1 deferred tax liability related to the right-of-use asset.
3. $1,500 initial deferred tax asset - $1,350 end of Year 1 deferred tax asset related to the origination costs.
4. Tax deductible lease expense of $15,027 (cash paid for Year 1 lease payment [$14,527] + Year 1 tax amortization of lease origination costs [$500]) × 30%.

10.1.310 The total income tax benefit for Year 1 is, therefore, $6,496 ($4,508 current tax benefit + $1,988 [$1,996 - $1,358 + $1,350] net deferred tax benefit), which equals 30% of the sum of (1) the book lease expense for Year 1 of $16,654 and (2) the expensed lease origination costs of $5,000.

Example 10.3

Direct financing lease for book purposes (Topic 842) treated as non-tax lease (similar to a sale transaction) for tax purposes (lessor)

10.1.320 Lessor LR leases a piece of equipment to Lessee LE. The following facts are relevant at the commencement date.

– Lease term:	3 years
– Lease payments:	Fixed payments of $10,500 per year (paid in arrears); no variable lease payments
– Lease options:	None
– Expected future residual value:	$12,500
– Residual value guarantee:	$9,200 (third party other than LE)
– Initial direct costs:	None
– Rate implicit in the lease:	4.29%
– Fair value:	$40,000
– Tax basis:	$29,000
– Book carrying amount:	$36,000
– Remaining economic life of equipment:	5 years
– LR's tax rate:	30%

10.1.330 For book purposes, the lease is a direct financing lease. For tax purposes, the lease qualifies as a non-tax lease and therefore it is treated as a sale for income tax purposes.

10.1.340 At lease commencement, LR recognizes the following for book purposes (exclusive of income tax effects).

	Debit	Credit
Lease receivable[1]	37,091	
Unguaranteed residual asset[2]	2,909	
Property, plant, and equipment		36,000
Deferred selling profit[3]		4,000

Notes:

1. Present value of the $10,500 annual contractual lease payments and the $9,200 guaranteed residual value, discounted at 4.29%.
2. Present value of the unguaranteed residual value ($3,300 = $12,500 - $9,200 guarantee), discounted at 4.29%.
3. Deferred selling profit = fair value of the underlying asset ($40,000) less its carrying amount ($36,000). This is the same as the difference between the lease receivable ($37,091) and the carrying amount of the underlying asset, net of the unguaranteed residual value ($33,091).

10.1.350 Because the lease is treated as a sale for income tax purposes, LR records the following entry to recognize the income tax effects of the lease on the commencement date.

	Debit	Credit
Current income tax expense (benefit)[1]	3,300	
Income taxes payable[1]		3,300
Deferred tax asset[2]	1,200	
Deferred income tax expense (benefit)[2]		1,200
Deferred tax liability[3]	2,100	
Deferred income tax expense (benefit)[3]		2,100

Notes:

1. 30% tax effect of tax gain of $11,000 ($40,000 tax sales price less $29,000 tax carrying amount).
2. 30% tax effect of the deferred profit of $4,000 ($40,000 fair value - $36,000 book carrying amount).
3. 30% tax effect of previous book-tax basis difference of $7,000 ($36,000 book carrying amount less $29,000 tax carrying amount) – i.e. reduction of the previous deferred tax liability that existed because of the greater book carrying amount of the equipment compared to the tax basis in the equipment.

10.1.360 At the end of Year 1, LR recognizes the following journal entry.

	Debit	Credit
Cash (lease payment received)	10,500	
Unguaranteed residual asset[1]	125	
Deferred profit[2]	1,637	
Lease receivable[3]		8,909
Interest income[4]		3,353

Notes:

1. Discount rate of 4.29% x unguaranteed residual asset balance of $2,909.
2. Total lease income of $3,353 (calculated as the initial net investment in the lease of $36,000 x 9.31%) less interest on lease receivable ($1,591 = 4.29% discount rate x carrying amount of $37,091) less accretion of unguaranteed residual asset ($125 = 4.29% discount rate x carrying amount of $2,909). **Note**: 9.31% is the discount rate that would have been required at lease commencement for the lease receivable plus the unguaranteed residual asset to equal the fair value of the underlying asset ($40,000) less the deferred selling profit ($4,000).
3. Total contractual payments of $10,500 less interest on lease receivable of $1,591.
4. Accretion of unguaranteed residual asset ($125) plus interest income on lease receivable ($1,591) + release of deferred profit ($1,637).

10.1.370 At the end of Year 1, LR records the following journal entry to account for the tax effects of the lease.

	Debit	Credit
Current income tax expense (benefit)[1]	515	
Income tax payable[1]		515
Deferred income tax expense (benefit)[2]	491	
Deferred tax asset[2]		491

Notes:

1. 30% tax effect x ($40,000 tax basis in the financing x 4.29% = $1,716). This is also the 30% tax effect of Year 1 interest income on the lease receivable ($1,591) and the unguaranteed residual asset ($125). The interest on the deferred selling profit of $1,637 is not factored in because there is no deferred selling profit for tax purposes.
2. 30% tax effect of the change in the deferred profit of $1,637.

Example 10.4

Sale-leaseback transaction accounted for as a sale and a leaseback for book purposes and for tax purposes (seller-lessee)

10.1.380 Seller-Lessee SL sells a piece of land to unrelated Buyer-Lessor BL and at the same time reaches an agreement to lease the land back for 10 years. The following facts are relevant at the date of the transaction.

– Contractual sale price:	$3.5 million
– Fair value of the land:	$2.8 million
– Carrying amount of the land:	$2 million
– Tax basis in the land:	$2 million
– Leaseback term:	10 years
– Leaseback payments:	Fixed payments of $200,000 per year (paid in arrears); no variable lease payments
– Leaseback options:	None
– Initial direct costs:	None
– Rate implicit in the lease:	Not readily determinable
– SL's incremental borrowing rate:	6%
– SL's tax rate for ordinary income and capital gains:	30%

10.1.390 In addition:

- The transaction is accounted for as a sale and a leaseback (i.e. the transaction is not a failed sale) for both book and tax purposes.
- The leaseback is a true tax lease for tax purposes.

10.1.400 At the date that the sale is completed and the leaseback commences, SL recognizes the following journal entry for book purposes (exclusive of income tax effects).

	Debit	Credit
Cash (sales price of asset)	3,500,000	
Gain[1]		800,000
Land		2,000,000
Financing liability[2]		700,000
Right-of-use asset[3]	772,017	
Lease liability[3]		772,017

Notes:

1. $2.8 million fair value - $2 million carrying amount.
2. $3.5 million sales price - $2.8 million fair value.
3. Present value of 10 annual lease payments of $104,892, discounted at 6%; $104,892 = $200,000 contractual leaseback payment - $95,108 allocated to repayment of the $700,000 financing liability.

10.1.410 For tax purposes, SL recognizes the $1.5 million difference between the contractual sales price of $3.5 million and the tax basis in the land of $2 million as a gain on the sale of the land. In addition, because the leaseback is a true tax lease, SL does not have any lease asset or lease liability for tax purposes.

10.1.420 Consequently, at the date the sale is completed and the leaseback commences, SL recognizes the following income tax effects for book purposes.

	Debit	Credit
Current income tax expense (benefit)[1]	450,000	
Current tax payable[1]		450,000
Deferred tax asset[2]	210,000	
Deferred income tax expense (benefit)[2]		210,000
Deferred tax asset[3]	231,605	
Deferred income tax expense (benefit)[3]		231,605
Deferred income tax expense (benefit)[4]	231,605	
Deferred tax liability[4]		231,605

Notes:

1. 30% tax effect on taxable gain of $1.5 million ($3.5 million contractual purchase price less $2 million tax basis carrying amount).
2. 30% x $700,000 carrying amount of the financing liability.
3. 30% x $772,017 carrying amount of the lease liability.
4. 30% x $772,017 carrying amount of the right-of-use asset.

10.1.430 During the first year of the leaseback, for book purposes, SL recognizes the following journal entry (exclusive of income tax effects).

	Debit	Credit
Interest expense[1]	42,000	
Operating lease cost[2]	104,892	
Lease liability[3]	58,571	
Financing liability[4]	53,108	
Right-of-use asset[5]		58,571
Cash		200,000

Notes:

1. 6% discount rate x $700,000 financial liability.
2. Total lease payments of $1,048,920 ÷ 10-year lease term.
3. $104,892 (portion of $200,000 annual payment allocated to the lease) - $46,321 accretion of the lease liability (6% × $772,017).
4. $95,108 (portion of $200,000 annual payment allocated to the financial liability) - $42,000 interest on the financial liability (6% × $700,000).
5. Total lease cost of $104,892 less accretion on lease liability of $46,321.

10.1.440 During the first year of the leaseback, for tax purposes, SL deducts the $200,000 rental payment from its taxable income and SL recognizes all of the following for book purposes related to income taxes.

	Debit	Credit
Current tax payable[1]	60,000	
Current income tax expense (benefit)[1]		60,000
Deferred tax liability[2]	17,571	
Deferred income tax expense (benefit)[2]		17,571
Deferred income tax expense (benefit)[3]	17,571	
Deferred tax asset[3]		17,571
Deferred income tax expense (benefit)[4]	15,932	
Deferred tax asset[4]		15,932

Notes:

1. 30% tax effect of the $200,000 contractual lease payment, fully deductible in the year paid.
2. 30% tax effect of the Year 1 change in the book carrying amount of the right-of-use asset of $58,571.
3. 30% tax effect of the Year 1 change in the book carrying amount of the lease liability of $58,571.
4. 30% tax effect of the Year 1 change in the book carrying amount of the financing liability of $53,108.

Example 10.5

Failed equipment sale-leaseback transaction for book purposes; sale and true tax leaseback for tax purposes

10.1.450 On January 1, 20X9, Seller-Lessee SL has a piece of equipment that it has decided to sell to Buyer-Lessor BL and lease back for liquidity purposes. The following facts are relevant at the date of the transaction.

– Contractual sale price:	$1 million
– Fair value of the equipment:	$1 million
– Carrying amount of the equipment:	$900,000
– Tax basis in the equipment:	$750,000
– Leaseback term:	5 years
– Remaining economic life of the equipment:	10 years, which is also the remaining useful life of the equipment
– Expected future residual value:	$450,000
– Leaseback payments:	Fixed payments of $170,000 per year (paid in arrears); no variable lease payments
– Leaseback renewal or termination options:	None
– Initial direct costs:	None
– Rate implicit in the leaseback:	Not readily determinable by SL; 7.5381% for BL
– SL's incremental borrowing rate:	7%
– SL's tax rate for ordinary income and capital gains:	30%

10.1.460 In addition:

- There is a fixed price repurchase option for SL to repurchase the equipment at any time during the fifth year of the leaseback; therefore, the transaction is a failed sale for book purposes.
- The transaction is a sale and leaseback for tax purposes; the leaseback is a true tax lease for tax purposes.

Scenario 1: Seller-lessee accounting

10.1.470 On January 1, 20X9, SL records the following journal entry to account for the failed sale (exclusive of tax effects).

	Debit	Credit
Cash	1,000,000	
Financing liability		1,000,000

10.1.480 On January 1, 20X9, SL records the following journal entry to account for the sale date tax effects of the transaction.

	Debit	Credit
Current income tax expense (benefit)[1]	75,000	
Income taxes payable[1]		75,000
Deferred tax liability[2]	45,000	
Deferred income tax expense (benefit)[2]		45,000
Deferred income tax expense (benefit)[3]	270,000	
Deferred tax liability[3]		270,000
Deferred tax asset[4]	300,000	
Deferred income tax expense (benefit)[4]		300,000

Notes:

1. 30% tax effect of sales price ($1,000,000) - tax basis carrying amount ($750,000).
2. Reversal of existing deferred tax liability ($900,000 - $750,000) x 30%.
3. 30% tax effect of the basis difference between the carrying amount of the equipment for book purposes ($900,000) and the tax basis (nil).
4. 30% tax effect of the financing liability ($1,000,000), which has no tax basis.

10.1.490 On December 31, 20X9, SL records the following entry to record the payment made to BL under the terms of the sale-leaseback agreement, and depreciation on the equipment that continues to be recognized by SL due to the failed sale (exclusive of income tax effects).

	Debit	Credit
Interest expense[1]	70,000	
Financing liability[2]	100,000	
Cash		170,000
Depreciation expense[3]	90,000	
Accumulated depreciation[3]		90,000

Notes:

1. $1,000,000 principal balance × 7% (SL's incremental borrowing rate).
2. Payment of $170,000 - interest component of $70,000.
3. $900,000 book carrying amount at beginning of the year ÷ 10 years.

10.1.500 Also on December 31, 20X9, SL records the following journal entry for the income tax effects of the first year of the arrangement.

	Debit	Credit
Income taxes payable[1]	51,000	
Current income tax expense (benefit)[1]		51,000
Deferred tax liability[2]	27,000	
Deferred income tax expense (benefit)[2]		27,000
Deferred income tax expense (benefit)[3]	30,000	
Deferred tax asset[3]		30,000

Notes:

1. Year 1 lease payment for tax purposes of $170,000 × 30%, which is fully deductible in the year paid.
2. 30% of the change in the book carrying amount of the equipment, which decreased from $900,000 to $810,000 as a result of depreciation ($90,000) during the year.
3. 30% of the change in the book carrying amount of the financing liability, which decreased from $1,000,000 to $900,000 during the year.

Scenario 2: Buyer-lessor accounting

10.1.510 On January 1, 20X9, BL records the following journal entry to account for the failed sale (exclusive of income tax effects).

	Debit	Credit
Financing receivable	1,000,000	
Cash		1,000,000

10.1.520 On January 1, 20X9, BL records the following journal entry to account for the sale date income tax effects of the transaction.

	Debit	Credit
Deferred tax asset[1]	300,000	
Deferred income tax expense (benefit)[1]		300,000
Deferred income tax expense (benefit)[2]	300,000	
Deferred tax liability[2]		300,000

Notes:

1. 30% tax effect of $1,000,000 of equipment recognized as an asset for tax purposes, but not recognized for book purposes (failed purchase).
2. 30% tax effect of the financing receivable recognized for book purposes, but not for tax purposes.

10.1.530 On December 31, 20X9, BL records the following journal entry to record the payment from SL under the terms of the sale-leaseback agreement (exclusive of income tax effects).

	Debit	Credit
Cash	170,000	
Interest income[1]		60,000
Financing receivable[2]		110,000

Notes:

1. $1,000,000 principal balance × 6%. Consistent with Example 2 in Subtopic 842-40, BL determined this rate of interest based on the guidance in Subtopic 835-30.
2. Payment of $170,000 - interest component of $60,000.

10.1.540 On December 31, 20X9, BL records the following journal entry to account for the first year income tax effects of the arrangement.

	Debit	Credit
Deferred income tax expense (benefit)[1]	60,000	
Deferred tax asset[1]		60,000
Deferred tax liability[2]	33,000	
Deferred income tax expense (benefit)[2]		33,000
Income tax payable[3]	9,000	
Current income tax expense (benefit)[3]		9,000

Notes:

1. 30% tax effect of decrease in the tax basis of the equipment resulting from MACRS depreciation. MACRS depreciation for the year ended December 31, 20X9 is $200,000.
2. 30% tax effect of the change in the book carrying amount of the financing receivable (30% × $110,000).
3. 30% tax effect of the true tax lease income of $170,000 earned in the first year of the leaseback - 30% tax effect of MACRS tax depreciation of equipment of $200,000.

Changes to the accounting for deferred taxes

10.1.550 The following changes to the accounting for leases, resulting from the issuance of Topic 842, will have the most impact on an entity's accounting for deferred taxes (and are the scenarios illustrated in the examples in this chapter).

Lessees

10.1.560 For lessees, the recognition of right-of-use assets and lease liabilities for operating leases. This will require entities to recognize new deferred tax assets and deferred tax liabilities that were not previously recognized.

10.1.570 For seller-lessees in sale-leaseback transactions, changes to the sale-leaseback guidance mean that many equipment sale-leaseback transactions accounted for as a sale and a leaseback under current US GAAP may be failed sales under Topic 842. This could create new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes. For example, while the seller-lessee may be considered to have sold the asset for tax purposes, it may still have the asset, as well as a financing liability, in its accounts for book purposes.

10.1.580 The following table highlights the effect of the changes in Topic 842 on various combinations of book and tax lease classification for lessees.

Book classification	Tax classification	Primary impact of Topic 842
Operating	True tax lease (tax operating lease)	New deferred tax balances because assets and liabilities are created with no tax basis (see Example 10.2).
Operating	Non-tax lease (tax sales type lease)	Smaller deferred tax balances because there will be book *and* tax basis assets and liabilities going forward, rather than only tax basis assets and liabilities.
Finance	True tax lease	No significant change, amounts may vary.
Finance	Non-tax lease	No significant change, amounts may vary.

$ Lessors

10.1.590 For lessors, the deferral of selling profit for some direct financing leases could create new (or larger) deferred tax assets in that those leases will frequently be non-tax leases for tax purposes and the entire tax profit on the lease (sale price - tax basis of the asset) will be recognized for tax purposes at the time of sale.

10.1.600 For buyer-lessors in sale-leaseback transactions, the new requirements that can result in a buyer-lessor having a failed purchase of the transferred asset could result in new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes. This is because the buyer-lessor might own the asset and be earning taxable lease income from the seller-lessee from the leaseback for tax purposes, but have a financing receivable and be earning interest income for book purposes.

10.1.610 The following table highlights the effect of the changes in Topic 842 on various combinations of book and tax lease classification for lessors.

Book classification	Tax classification	Primary impact of Topic 842
Operating	True tax lease	No significant change; amounts may vary
Operating	Non-tax lease	No significant change; amounts may vary
Sales-type	True tax lease	No significant change; amounts may vary
Sales-type	Non-tax lease	No significant change; amounts may vary
Direct financing	True tax lease	No significant change; amounts may vary
Direct financing	Non-tax lease	No significant change; amounts may vary[1]

Note 1:

More significant changes from current US GAAP may result if, under Topic 842, a direct financing lease results in selling profit that is required to be deferred and recognized over the lease term (see Example 10.3).

KPMG observation – Leases denominated in a foreign currency

10.1.620 For leases denominated in a foreign currency, the right-of-use asset is a non-monetary asset while the lease liability is a monetary liability. Therefore, when accounting for a lease that is denominated in a foreign currency, the lease liability is remeasured using the current exchange rate, while the right-of-use asset is remeasured using the exchange rate as of the lease commencement date (see section 6.4). As a result, the exception on recognizing a deferred tax asset or liability for differences related to assets and liabilities that are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates will apply to the right-of-use asset but will not apply to the lease liability under Topic 842. [842-20-55-10, 740-10-25-3(f)]

KPMG observation – Tax effects of initial direct costs

10.1.630 It is expected that some lease origination costs that will be deferred for tax purposes, and generally amortized on a straight-line basis over the lease term, will not meet the narrow definition of initial direct costs under Topic 842 (see section 5.5). Therefore, new deferred tax assets may arise, reflecting those origination costs that are deferrable for tax purposes, but must be expensed as incurred for book purposes. [Master Glossary, 740-10-25-2(b)]

KPMG observation – Related party leases

10.1.640 Under current US GAAP, a related party lease is not recognized based on the written terms and conditions if they differ from the substance of the arrangement. However, under Topic 842 only the legally enforceable terms and conditions are considered. This change in the book accounting for related party leases could result in additional temporary differences for entities that engage in leasing activities with related parties at other than arm's length terms. [842-20-55-12, 740-10-25-2(b)]

KPMG observation – Leveraged leases

10.1.650 Topic 740 includes an exception to its basic requirements related to leveraged leases. Topic 842 eliminates leveraged lease accounting prospectively – i.e. for all leases that commence on or after the effective date of Topic 842. Therefore, once Topic 842 becomes effective, and as the grandfathered leveraged leases gradually expire, this exception in Topic 740 will no longer be relevant. The Board retained this exception in ASU 2016-02 because of its decision to grandfather existing leveraged leases. [740-10-25-3(c)]

10.2 State and local income tax implications

10.2.10 Although domestic tax laws may remain unchanged on the adoption of Topic 842, and most states that use a property factor already include the value of leased assets in the apportionment formula, the requirement to bring all leases (other than those qualifying for the short-term exemption – see section 6.3.1) on the balance sheet may impact the apportionment of taxable income in some states. Entities should consider the need to review both state and local income tax laws to determine the impact of Topic 842, if any.

10.2.20 An entity will need to consider the impact of any changes, if applicable, on its state apportionment factors in its assessment of any necessary valuation allowance. Most states that use a property factor already require leased assets to be included in the factor and provide a valuation method for including such assets. In general, the Uniform Division of Income for Tax Purposes Act, which has been widely adopted by the states, provides that property rented by the taxpayer is valued at eight times the net annual rental rate. Nevertheless, the effect of including leases on the balance sheet may change the apportionment of taxable income in some states.

10.2.30 For measuring state deferred tax assets and liabilities, an entity should assume that temporary differences will reverse in the tax jurisdictions in which the related assets or liabilities are expected to be realized or settled, and therefore would apply the enacted tax rate for that particular state for measuring deferred taxes. Entities generally should not assume that taxable or deductible amounts related to temporary differences in a tax jurisdiction will be shifted to a different tax jurisdiction through future intercompany transactions.

10.3 Change in US federal tax accounting method

10.3.10 Generally, a change in book accounting method (e.g. in accounting for leases) will not be deemed to constitute a change in underlying facts for US federal tax procedural purposes. If a new tax accounting method is required or desirable because the book accounting method changes, an entity must obtain permission from the IRS in advance of the change. The filing procedures and timing vary based on whether the change is automatic or requires advance consent from the IRS.

10.3.20 An entity that changes to a tax accounting method identified in published IRS guidance (i.e. currently Rev. Proc. 2015-14) is deemed to be automatically approved by the IRS when the copy of Form 3115, Application for Change in Accounting Method, is filed and, at the same time, generally receives audit protection for prior years. For book purposes, the timing of recognizing the effects of a change in tax accounting methods will depend on when the entity determines to make the change, when Form 3115 is filed, and whether the entity is changing from an impermissible method to a permissible method.

10.3.30 When a tax accounting method change is outside the automatic procedures, IRS approval of the change is not automatic. The entity will need to consider the US GAAP requirements on accounting for tax uncertainties to determine whether it is appropriate to account for the change before it receives approval (i.e. the consent letter).

10.3.40 The adoption of Topic 842 may result in a change in the pattern of recognizing income and expenses for financial reporting purposes for an entity. An entity should consider whether a tax accounting method change is appropriate and the related tax adjustment. An unfavorable adjustment (i.e. the income inclusion catch-up adjustment that is the difference between the tax accounting on the old method and new method as of the beginning of the year of change) would generally be spread over four years for US federal tax purposes. This would also create an additional temporary difference for the portion of the effect of the tax accounting method change that has not yet been recognized for tax purposes.

10.4 Transfer pricing

10.4.10 The classification of leases may impact both the lessee and lessor from a transfer pricing perspective. Changes to the amount and timing of lease revenue and lease expense as a result of adopting Topic 842 could have an effect on transfer pricing, specifically as it relates to using revenue or profit-based methods for establishing the transfer pricing.

10.4.20 Entities use transfer pricing to determine the appropriate amount to charge for intercompany transactions. Intercompany transactions are eliminated from the consolidated results for book purposes, but are not eliminated in each taxing jurisdiction for tax purposes. As a result, an entity utilizes transfer pricing to help determine each member of the group's taxable income.

10.4.30 While each taxing authority has different rules and thresholds, the transactions must usually be priced at arm's length. Under the arm's length standard, governments evaluate whether intercompany transactions are priced similar to arm's length transactions. Arm's length transactions help ensure that an entity is not inappropriately allocating income to any particular tax jurisdiction.

10.4.40 Entities may lease assets to one another for various reasons. If a finance lease is obtained from a related party, the interest rate and related terms generally should be the same (or within a reasonable range) compared to what it would receive from an unrelated party in an arm's length transaction. For a true tax lease, an entity will need to determine that the rental rates are appropriate and are considered to be at arm's length. Entities should carefully consider the classification of the leases from both a lessor and lessee perspective.

10.4.50 An entity may need to consider whether its transfer pricing studies and supporting documentation should be revised or updated once the standard has been adopted.

11 Leases acquired in a business combination

How the standard works

In summary, the following is recognized as part of the acquisition accounting:

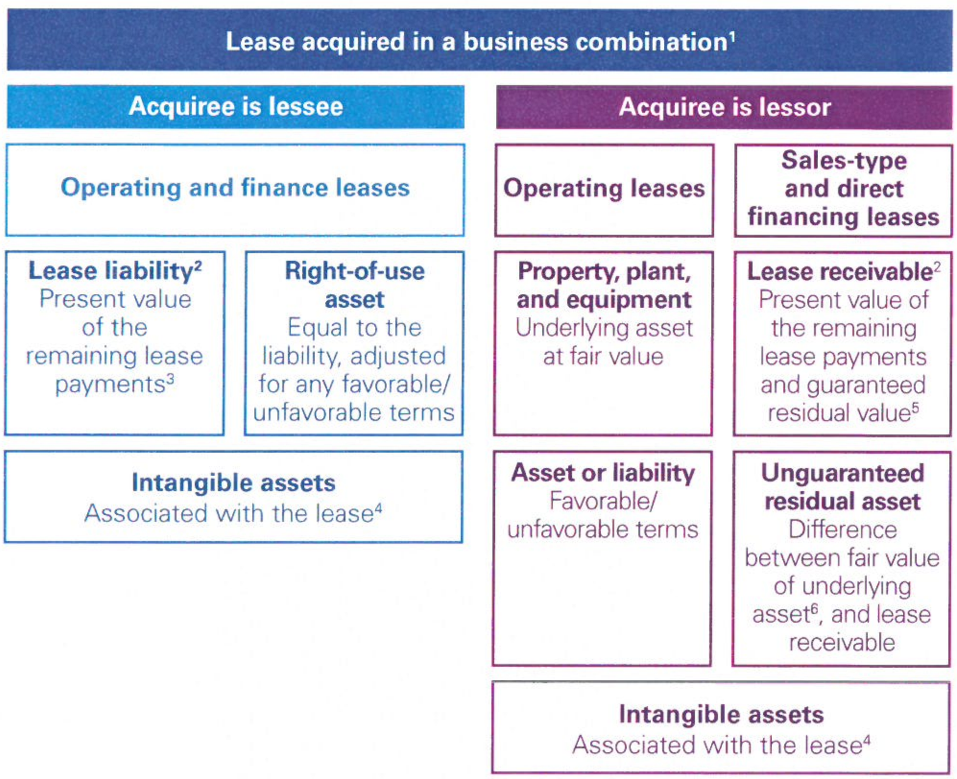
Acquiree is lessee	Acquiree is lessor	
Operating or finance lease	**Operating lease**	**Sales-type or direct financing lease**
– Right-of-use asset – Lease liability	– Property, plant, and equipment – Asset or liability (off-market lease terms)	– Lease receivable – Unguaranteed residual asset
In all cases, any related intangible assets (e.g. a customer relationship)		

In all cases, the lease assets and lease liabilities are measured as if the lease were a new lease of the acquirer at the acquisition date.

11.1.10 Topic 842 includes only limited guidance on accounting for leases acquired in a business combination. Most of the guidance on this topic, including more detailed guidance on the initial and subsequent measurement of assets and liabilities related to lease contracts acquired in a business combination, is included in Topic 805 (business combinations), which was amended by ASU 2016-02.

11.1.20 The following chart summarizes the acquirer's initial accounting at the acquisition date. As the chart highlights: [805-20-25-10A, 25-12, 25-28A, 30-24 – 30-25]

- If the acquiree is a lessee, the same assets and liabilities are recognized regardless of whether the lease is an operating or finance lease.
- If the acquiree is a lessor, the assets and liabilities recognized depend on the classification of the lease.
- In all cases, there may be one or more intangible assets related to the lease, such as a customer relationship.



Notes:

1. The acquirer retains the acquiree's lease classification unless the lease is modified as part of the business combination, and that modification is not accounted for as a separate contract. [805-20-25-8, 842-10-55-11, 842-50-25-2]
2. The lease liability (lessee) or lease receivable (lessor in a sales-type or direct financing lease) is measured as if the lease were a new lease at that date – i.e. as if the acquisition date were the lease commencement date. [805-20-30-24, 30-25(a)]
3. Discounted at the rate implicit in the lease if readily determinable, or otherwise using the *acquirer's* incremental borrowing rate. [805-20-30-24]

4. Even if a lease is at market terms, there may be other identifiable intangible assets associated with the lease; for example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market, or other future economic benefits that qualify as an identifiable intangible asset, such as an in-place lease asset or a customer relationship. Such identifiable intangible assets are recognized at fair value in the acquisition accounting. [805-20-25-10A]
5. Discounted at the rate implicit in the lease. [805-20-30-25]
6. The terms and conditions of the lease are taken into account in determining the fair value of the underlying asset in a sales-type or direct financing lease. See KPMG observation at 11.1.320–330. [805-20-30-25]

Prepaid or accrued rent

11.1.30 Prepaid or accrued rent (of lessees or lessors) is not recognized in the acquisition accounting because those amounts do not meet the definition of an asset or a liability. Instead, the remaining lease payments affect whether the lease, as of the acquisition date, is at market terms. This means that if the lease payments are significantly front- or back-loaded, at the acquisition date this may result in a conclusion that the terms and conditions of the lease from the acquisition date are off-market. [ASU 2016-02.BC415]

Practical expedient for lessees only

Short-term leases

11.1.40 An acquirer may elect, as an accounting policy election (by class of underlying asset), not to recognize right-of-use assets or lease liabilities for leases that, at the acquisition date, have a remaining lease term of 12 months or less. In that case, the acquirer does not recognize any asset or liability for favorable or unfavorable terms relative to market. [805-20-25-28B]

11.1.50 This election applies to all of an acquirer's acquisitions – i.e. it cannot be applied to select leases that meet the criterion, or to select acquisitions. [805-20-25-28B]

Acquired lease is a grandfathered leveraged lease

11.1.60 If an entity acquires a grandfathered leveraged lease on or after the effective date of Topic 842, the lease is subject to the leveraged lease guidance in Subtopic 842-50 unless the lease is modified. If the lease is modified, the acquirer accounts for the lease in accordance with Topic 842 as if it were a new lease from the acquisition date. [842-10-65-1(z)(1)]

Post-acquisition accounting

11.1.70 Subsequent to the acquisition date, the acquirer applies the subsequent measurement guidance in Topic 842 to leases acquired in a business combination. The acquirer accounts for any intangible assets associated with the lease in accordance with Topic 350 (intangibles – goodwill and other).

11.1.80 Leasehold improvements acquired in a business combination are amortized from the acquisition date over the shorter of the useful life of the leasehold improvements and the remaining lease term at the date of acquisition. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee amortizes the leasehold improvements to the end of their useful life. [805-20-35-6]

Example 11.1
Accounting for an acquired lease (operating lease)

Scenario 1: Lease is at market terms at the acquisition date (acquiree is the lessee)

11.1.90 Company AR acquires Lessee LE, which leases its main transportation hub from Lessor LR. The hub comprises a large building and surrounding land near a major airport that serves as a storage and processing facility.

11.1.100 The following facts about the underlying lease (an operating lease, properly classified) are relevant.

– Lease term:	25 years
– Lease payments:	Fixed payments of $1 million per year in arrears, with a 3% increase each year after Year 1
– Residual value guarantee:	None
– Options:	None
– At lease commencement:	
» Fair value of building and surrounding land:	$30 million
» Remaining economic life of building:	45 years
» LE's incremental borrowing rate:	7%

11.1.110 The following facts at the *acquisition date* are relevant.

– Lease term remaining:	19 years
– Lease terms:	At market
– Accrued rent liability:	$2,281,816[1]
– AR's incremental borrowing rate:	8%[2]

11.1.120 AR recognizes a lease liability and a right-of-use asset. There are no other identifiable intangible assets associated with the lease (see 11.1.20).

– Lease liability:	$14,177,968[3]
– Right-of use asset:	$14,177,968[4]
– Intangible assets (associated with the lease):	None

11.1.130 AR retains LE's classification of the lease and accounts for the remainder of the lease as if it is a new operating lease for the same facility.

Notes:

1. The difference between the lease payments made through the end of Year 6 of \$6,468,410 and the straight-line lease cost recognized of \$8,750,220 ((\$36,459,250 total lease payments ÷ 25) x 6).
2. AR cannot readily determine LR's implicit rate for the lease.
3. The present value of the remaining lease payments due under the lease.
4. Equal to the lease liability. No adjustment is required to the right-of-use asset because the terms of the lease are at market at the acquisition date. The right-of-use asset is also not adjusted for LE's pre-acquisition accrued rent liability, which is not carried forward in the acquisition accounting.

Scenario 2: Lease is at market terms at the acquisition date (acquiree is the lessor)

11.1.140 Assume the same facts as in Scenario 1 except for the following.

- Company AR is acquiring Lessor LR, rather than Lessee LE.
- The building and the land (i.e. the assets subject to the lease with LE) have fair values of \$16 million and \$12 million, respectively.

11.1.150 Because the acquiree is the lessor in the operating lease, AR recognizes the land and building, but no other assets:

– Land:	\$12 million[1]
– Building:	\$16 million[2]
– Asset or liability (off-market lease terms):	N/A
– Intangible assets (associated with the lease):	None (in this scenario)

Notes:

1. AR recognizes the land at its fair value. AR will not depreciate the land subsequently.
2. AR recognizes the building at its fair value. AR will depreciate the building over its remaining useful life, which is not necessarily the same as its remaining economic life (see section 5.7).

11.1.160 Consistent with Scenario 1, AR does not recognize an accrued rent asset for the difference between the income recognized by LR on a straight-line basis prior to the acquisition date and the lease payments made through the acquisition date by LE – i.e. the \$2,281,816 calculated in Scenario 1.

Scenario 3: Lease is at below-market rates at the acquisition date (acquiree is the lessee)

11.1.170 Assume the same facts as in Scenario 1 except that, at the acquisition date, the terms of the lease to Lessee LE are considered favorable as compared to market terms. Although the Year 7 lease payment is reasonable compared to market rental terms, lease payments in this market should be increasing by 4% per year thereafter.

Contractual payments in Years 7 to 25 (undiscounted):	$29,990,840	$1,194,052 in Year 7, increasing by 3% each of the 18 years thereafter
Market-based payments in Years 7 to 25 (undiscounted):	$33,040,903	$1,194,052 in Year 7, increasing by 4% each of the 18 years thereafter

11.1.180 Company AR recognizes a lease liability and a right-of-use asset. Consistent with Scenario 1, there are no other identifiable intangible assets associated with the lease (see 11.1.20).

– Lease liability:	$14,177,968
– Right-of use asset:	$15,278,427[1]
– Intangible assets (associated with the lease):	None

Note 1:

While the lease liability at the acquisition date is the same as in Scenario 1 (based on contractual lease payments), the right-of-use asset is $15,278,427. This is because the asset is based on the present value of the *market-based* rental payments.

The difference between the right-of-use asset and the lease liability of $1,100,459 reduces the goodwill recognized in AR's acquisition accounting, and will be recognized as additional operating lease cost over the 19-year remaining lease term.

Scenario 4: Lease is at below-market rates at the acquisition date (acquiree is the lessor)

11.1.190 Assume the same facts as in Scenario 3 except that Company AR is acquiring Lessor LR, rather than Lessee LE. In addition, AR's rate implicit in the lease at the acquisition date is 7.85%.

11.1.200 Because the acquiree is the lessor in the operating lease, AR considers recognition of the following.

Land:	$12 million
Building:	$16 million
Asset or liability (off-market lease terms):	$1,119,754 (liability)[1]
Intangible assets (associated with the lease):	None

Note 1:

The difference between the present value of the remaining lease payments ($14,348,787) and the present value of the remaining market-based rental payments ($15,468,541) is recognized as an *unfavorable lease liability* in AR's acquisition accounting.

This liability increases the goodwill recognized by AR in the acquisition accounting, and will be recognized as additional lease income over the 19-year remaining lease term.

Example 11.2

Accounting for an acquired lease (finance/sales-type lease)

Scenario 1: Acquiree is the lessor

11.1.210 Company AR acquires Lessor LR, which leases manufacturing equipment to its customers. The following facts about one of those leases (a sales-type lease, properly classified) to Lessee LE are relevant.

– Lease term:	5 years
– Lease payments:	Fixed payments of $165,000 per year in arrears, with a 4% increase each year after Year 1
– End of lease:	Ownership transfers to LE for no additional consideration
– At lease commencement:	
» Fair value of the equipment:	$700,000
» Rate implicit in the lease:	8.49%

11.1.220 The following facts at the *acquisition date* are relevant.

– Lease term remaining:	4 years
– Lease terms:	At market
– Fair value of the equipment:	$600,000
– Rate implicit in the lease:	8.08%

11.1.230 The underlying asset is not recognized in AR's acquisition accounting. In its acquisition accounting, AR recognizes a lease receivable of $600,000, which equals the remaining lease payments of $728,694 discounted at the acquisition date implicit rate of 8.08%. There is no unguaranteed residual asset to recognize because LE obtains ownership of the equipment at the end of the lease term. Subsequent to the acquisition date until the end of the lease term, AR accounts for the acquired lease in the same manner as it would any other sales-type lease.

Scenario 2: Acquiree is the lessee

11.1.240 Assume the same facts as in Scenario 1, except that Company AR is acquiring Lessee LE, rather than Lessor LR. The rate implicit in the lease is not readily determinable and AR's incremental borrowing rate is 7% at the acquisition date.

11.1.250 As part of its acquisition accounting, AR recognizes a lease liability of $615,018 (the remaining lease payments of $728,694 discounted at AR's incremental borrowing rate of 7%) and a right-of-use asset for the same amount. Because the lease is at market terms, there is no adjustment to the right-of-use asset from the amount of the lease liability. Subsequent to the acquisition date, AR accounts for the lease in the same manner as it would any other finance lease.

KPMG observation – Measurement of lease assets and lease liabilities is not at fair value

11.1.260 The business combinations guidance generally requires all assets acquired and liabilities assumed to be measured at fair value as of the acquisition date. However, the Board concluded that requiring acquirers to measure lease assets and lease liabilities at fair value was not justifiable from a cost-benefit perspective. This is because of the likely difficulties and cost of obtaining reliable fair value measurements for those items, particularly right-of-use assets. [ASU 2016-02.BC416–BC417]

11.1.270 However, the Board believes that the measurement requirements for acquired lease assets and lease liabilities will, at least in many cases, reasonably approximate fair value. For example, the Board observed that, for lessors, the acquisition-date net investment in the lease measured under Topic 805 (as amended) will generally equal the acquisition-date fair value of the underlying asset; for lessees, the net carrying amount of the right-of-use asset and the lease liability recognized by the acquirer will generally approximate the fair value of the lease. [ASU 2016-02.BC416–BC417]

KPMG observation – In-place leases may trigger recognition of additional assets

11.1.280 An acquirer may identify value associated with leases in place at the acquisition date. Value related to in-place leases may reflect, for example, the value associated with avoiding the costs of originating the acquired in-place leases, as well as the value associated with the avoidance of holding costs that would be incurred if an asset intended to be leased was acquired without a lessee. Origination costs comprise the costs to execute similar leases, including marketing costs, leasing commissions, legal, and other related costs.

11.1.290 Neither Topic 842 nor Topic 805 (current or as amended by ASU 2016-02), explicitly address the recognition of in-place lease intangible assets. However, consistent with our view under current US GAAP (which also does not explicitly address in-place lease intangible assets), we believe that an acquirer should separately measure an intangible asset for in-place leases on a lease-by-lease basis.

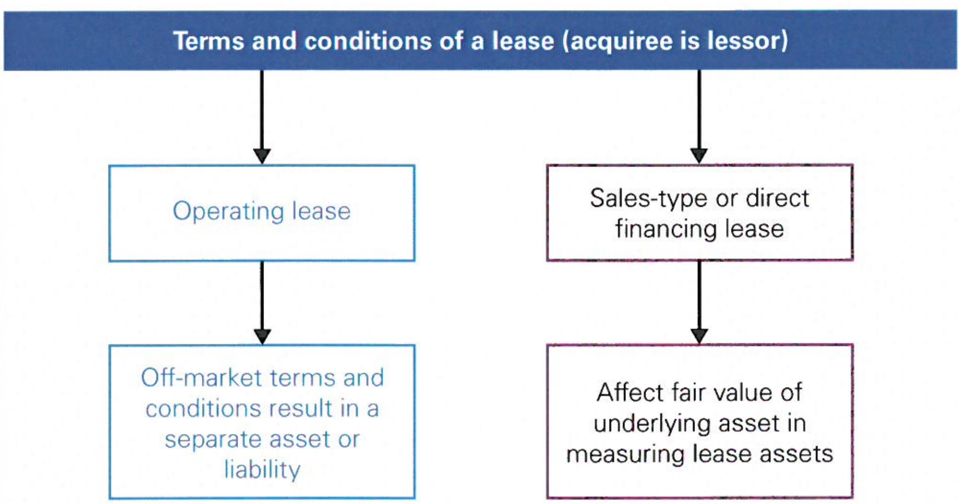
11.1.300 Generally, we would expect that the intangible asset recognized in accordance with Topic 805 (as amended) for in-place leases would be recognized and reported separately in the financial statements. It would not be combined with the acquired lease assets (i.e. lessee right-of-use assets, or lessor lease receivables and unguaranteed residual assets), or with other lease-related intangibles (e.g. favorable lease assets or unfavorable lease liabilities of operating lessors).

KPMG observation – Accounting for lease assets and lease liabilities acquired in an asset acquisition is unclear

11.1.310 Topic 805 (current or as amended by ASU 2016-02) does not contain guidance on the accounting for leases acquired in an asset acquisition – i.e. from the acquisition of assets that have a lease attached that do not constitute a business. In our experience, practice under current US GAAP is mixed. In some cases, the acquired leases are accounted for in the same manner as they would be if they were acquired in a business combination; in other cases, lease-related intangibles are not recognized separately from the acquired underlying assets.

KPMG observation – Type of lease impacts measurement of underlying asset's fair value when acquiree is the lessor

11.1.320 When the acquiree is the lessor, the terms and conditions of a lease are factored into the acquisition accounting differently depending on the type of lease.



11.1.330 This difference means that acquirers of lessors will use different assumptions in measuring the fair value of the underlying asset depending on the classification of the lease to which the underlying asset relates. The Board's decisions in this regard appear to principally stem from its desire to retain current lessor accounting in most respects. Under current US GAAP, acquirers generally already consider lease terms and conditions in valuing lessor lease assets for acquired sales-type or direct financing leases and recognize favorable (unfavorable) assets (liabilities) for acquired operating leases.

KPMG observation – Acquiree failed sale or failed purchase in a sale-leaseback transaction

11.1.340 Consistent with current practice when the acquiree is a seller-lessee in failed sale-leaseback transaction, under Topic 842 and Topic 805 (as amended) we believe that the business combination does not eliminate the failed sale (if acquiree is the seller-lessee) or the failed purchase (if the acquiree is the buyer-lessor). The acquirer would continue with the failed sale/purchase accounting until the transaction meets the requirements in Subtopic 842-40 for a sale/purchase. The assets and liabilities of the acquiree related to the failed sale-leaseback transaction (e.g. the underlying asset and financial liability if the seller-lessee or the financial receivable if the buyer-lessor) are still subject to any appropriate adjustments to those assets and liabilities as required by Topic 805.

US GAAP different from IFRS – Lease terms and conditions in measuring the fair value of acquired underlying assets

11.1.350 In measuring the acquisition-date fair value of an underlying asset that is subject to an operating lease in which the acquiree is the lessor, IFRS 3 (business combinations, as amended by IFRS 16) requires that the acquisition-date fair value of an underlying asset take into account the terms and conditions of the lease. Acquirers applying IFRS will not recognize favorable lease assets or unfavorable lease liabilities for leases in which the acquiree is a lessor. [IFRS 16.B42]

11.1.360 Unlike IFRS, an acquirer applying the guidance in Topic 805 (as amended) will *not* take into account the terms and conditions of the lease when determining the acquisition-date fair value of an underlying asset subject to an *operating* lease in which the acquiree is the lessor. Instead, consistent with current US GAAP and current IFRS, the acquirer recognizes a separate intangible asset or liability to the extent the terms and conditions of the lease are not at market.

11.1.370 Therefore, in some cases, an acquirer will measure an acquired underlying asset subject to an operating lease differently under US GAAP than under IFRS and US GAAP acquirers may recognize intangible assets or liabilities not recognized by their IFRS counterparts.

Acquiree is the lessor in an operating lease

US GAAP	IFRS
Property, plant, and equipment Underlying asset at FV **Asset or liability** for favorable/unfavorable terms in the lease contract	**Property, plant, and equipment** Underlying asset at FV[1]

Note 1:

The terms and conditions of the lease are taken into account when measuring the fair value of the underlying asset subject to an operating lease (IFRS only).

Comparison with current US GAAP – Acquisition accounting

Acquired operating leases where the acquiree is a lessee

11.1.380 Under current US GAAP, an asset or a liability is recognized in a business combination only to the extent that the operating lease is favorable or unfavorable to market terms. In contrast, under Topic 805 (as amended), the acquirer will recognize a lease liability and a right-of-use asset for acquired operating leases. The right-of-use asset is adjusted for favorable or unfavorable terms at the acquisition date. [805-20-25-12]

11.1.390 The acquirer's measurement of any favorable/unfavorable adjustment to the right-of-use asset under Topic 805 (as amended) will likely be similar to an acquirer's measurement of any favorable lease asset or unfavorable lease liability under current US GAAP. Consequently, the *net* effect of this change to US GAAP on the amount of goodwill (or bargain purchase gain) resulting from an acquisition may not be significant.

Acquired finance (capital) lease assets and lease liabilities no longer measured at fair value

11.1.400 Current US GAAP generally requires the recognition of lease assets and lease liabilities related to capital (sales-type/direct financing) leases at fair value, regardless of whether the acquiree is a lessee or a lessor. In contrast, as outlined in the KPMG observation at 11.1.260, Topic 805 (as amended) prescribes the measurement of lease assets and lease liabilities on a basis other than fair value. [805-20-30-1]

11.1.410 It is unclear how significant the financial statement effect of this difference in measurement will be; the basis for conclusions notes that the prescribed measurement will approximate fair value. However, eliminating the requirement to account for finance (sales-type/direct financing) lease assets and lease liabilities at fair value may simplify the acquisition accounting for such leases as compared to current US GAAP. [ASU 2016-02.BC416–BC417]

Consideration of lease terms and conditions in determining the fair value of lease assets in an acquired sales-type/direct financing lease

11.1.420 Current US GAAP, unlike Topic 805 (as amended), does not explicitly require consideration of the terms and conditions of the lease when measuring the lessor's lease receivable or unguaranteed residual asset. However, current *practice* has frequently concluded that measurement of the lease receivable and the unguaranteed residual asset at fair value under current US GAAP would take into consideration the terms and conditions of the lease.

Acquired operating leases where the acquiree is a lessor

11.1.430 An acquirer's accounting for an acquired operating lease as a lessor in acquisition accounting under Topic 805 (as amended) is substantially unchanged from current US GAAP.

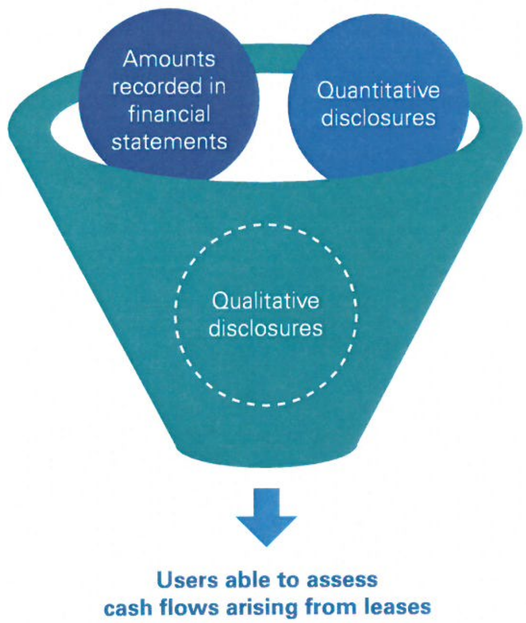
Acquired leasehold improvements

11.1.440 An acquirer's accounting for acquired leasehold improvements under Topic 805 (as amended) is substantially unchanged from current US GAAP.

12 Disclosures

How the standard works

The disclosure objective in Topic 842 is to provide financial statement users sufficient information to assess the amount, timing, and uncertainty of cash flows arising from leases. To achieve that objective, lessees and lessors will disclose qualitative and quantitative information about lease transactions.



This generally will result in increased information being disclosed compared to current US GAAP. Accordingly, entities will need to evaluate whether they have appropriate systems, processes, and internal controls to capture the complete and accurate lease data necessary to prepare the financial statement notes.

For a discussion of the transition disclosures, see chapter 13.

12.1 General disclosure requirements

12.1.10 The objective of the disclosure requirements for lessees and lessors is to enable financial statement users to assess the amount, timing, and uncertainty of cash flows arising from the entity's leases. To that effect, an entity discloses qualitative and quantitative information about:

- its leases;
- the significant judgments made in applying Topic 842; and
- the lease-related amounts recognized in the financial statements. [842-20-50-1, 842-30-50-1]

12.1.20 In preparing its notes to the financial statements, an entity considers the level of detail needed, how much emphasis to place on each disclosure requirement, and the appropriate level of aggregation. Useful information should not be obscured, for example by including a large amount of insignificant detail or by aggregating items with different characteristics. [842-20-50-2, 842-30-50-2]

12.1.30 In a sale-leaseback transaction for which the asset transfer qualifies as a sale (see chapter 9):

- the seller-lessee provides all applicable disclosures required by a lessee; and
- the buyer-lessor provides all applicable disclosures required by a lessor. [842-40-50-1]

KPMG observation – One size does not fit all

12.1.40 The Board included a disclosure objective in the standard so that entities understand the purpose of the disclosure requirements, and to assist entities in determining the extent of information to disclose about leases. Lessees and lessors will need to use judgment in determining how much to disclose, and what level of aggregation to use. While Topic 842 is silent on whether each disclosure requirement should be provided in *all* circumstances, the basis for conclusions highlights that it is implicit to the overall disclosure objective that the level of detail used in the notes should reflect the significance of the entity's leasing activity. As an entity's leasing activities become more significant, the disclosures will be more comprehensive. [ASU 2016-02.BC272–BC276]

KPMG observation – No specific guidance on disaggregation

12.1.50 While Topic 842 requires entities to consider the appropriate level of detail and aggregation for its lease disclosures, the Board decided not to provide specific disaggregation requirements such as those required of entities about their contracts with customers under Topic 606. [ASU 2016-02.BC274]

12.1.60 Topic 606 explicitly requires entities to disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors and provides implementation guidance to assist in selecting the categories for disaggregation. [606-10-50-5, 55-2 – 55-91]

US GAAP different from IFRS – Required qualitative disclosures for lessees and lessors

12.1.70 The objective of the disclosures in IFRS 16 is for entities to disclose information in the notes that, together with the information provided on the face of the financial statements, enables financial statement users to assess the effect that leases have on the entity's financial position, financial performance, and cash flows. [IFRS 16.51–60, 89–97]

12.1.80 While there are substantial similarities between IFRS 16 and Topic 842 for quantitative disclosures, IFRS 16 does not include a list of qualitative disclosure requirements. Instead, lessees and lessors reporting under IFRS 16 will disclose other information, in addition to the quantitative disclosures, in sufficient detail to satisfy the disclosure objective.

12.2 Lesseee disclosures

12.2.10 Qualitative information

☑ Nature of leases (and subleases), including:

- General description of those leases.
- Basis, and terms and conditions, of variable lease payments.
- Existence, and terms and conditions, of options to extend or terminate leases; this includes narrative disclosure of options recognized (and not recognized) as part of the right-of-use assets and lease liabilities.
- Existence, and terms and conditions, of lessee residual value guarantees.
- Restrictions or covenants imposed by leases (e.g. those relating to dividends or incurring additional financial obligations). [842-20-50-3]

☑ Leases that have not yet commenced, but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of an underlying asset. [842-20-50-3]

☑ Significant lease accounting judgments and assumptions, which might include determining:

- whether a contract contains a lease;
- the allocation of consideration between lease and non-lease components; and
- the discount rate for the entity's leases. [842-20-50-3]

☑ Main terms and conditions of any sale-leaseback transactions. [842-40-50-2]

☑ Lease transactions between related parties in accordance with Topic 850. [842-20-50-7, 850-10-50-1 – 50-6]

Short-term lease exemption

☑ The fact that the short-term lease exemption has been applied (see section 6.3.1). We believe that this would include disclosing to which class(es) of underlying assets the exemption is being applied. [842-20-50-8]

☑ To the extent that the periodic short-term lease cost does not reasonably reflect the lessee's short-term lease commitments as of the reporting date, that fact and the amount of its short-term lease commitments (see Example 12.4). [842-20-50-8]

Practical expedient: Combining lease and non-lease components

☑ The fact that the practical expedient has been applied (see 4.4.30–40). [842-20-50-9]

☑ The class(es) of underlying assets for which the practical expedient was elected. [842-20-50-9]

12.2.20 Quantitative information

- ☑ For finance leases, amortization of right-of-use assets and interest on lease liabilities (including capitalized costs). [842-20-50-4(a)]
- ☑ Operating lease cost (including capitalized costs). [842-20-50-4(b)]
- ☑ Short-term lease cost (when the lease term is greater than one month). [842-20-50-4(c)]
- ☑ Variable lease cost. [842-20-50-4(d)]
- ☑ Sublease income. [842-20-50-4(e)]
- ☑ Net gains (losses) on sale-leaseback transactions. [842-20-50-4(f)]
- ☑ Cash paid for amounts included in the measurement of lease liabilities, segregated between finance and operating leases, and between operating and financing cash flows. [842-20-50-4(g)]
- ☑ Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets, separately for finance and operating leases. [842-20-50-4(g)]
- ☑ Weighted-average remaining lease term (see Example 12.2), presented separately for finance and operating leases. [842-20-50-4(g), 50-5]
- ☑ Weighted-average discount rate (see Example 12.3), presented separately for finance and operating leases. [842-20-50-4(g), 50-5]
- ☑ Maturity analysis of lease liabilities, presented separately for finance and operating leases, for each of the first five years after the balance sheet date and in total thereafter, including a reconciliation of the undiscounted cash flows to the lease liabilities recognized in the balance sheet.[1] [842-20-50-6]

Note 1:

Finance and operating lease liabilities are either presented separately in the balance sheet or disclosed separately in the notes to the financial statements. [842-20-45-1]

Example 12.1
Selected lessee quantitative disclosures in a tabular format

12.2.30 While the Board did not specify a format that must be used to make the required quantitative disclosures, Topic 842 includes an illustration presenting the lessee quantitative disclosures in a tabular format. The following example is based on the example in the standard, and illustrates a lessee's quantitative disclosures. [842-20-55-53]

For the years ended December 31, 20X9 and 20X8 (in thousands)	20X9	20X8
Lease cost		
Finance lease cost (cost resulting from lease payments):		
Amortization of right-of-use assets	$ 600	$ 525
Interest on lease liabilities	150	110
Operating lease cost (cost resulting from lease payments)	1,000	900
Short-term lease cost	50	40
Variable lease cost (cost from amounts excluded from lease payments)	75	60
Sublease income	(10)	(8)
Total lease cost	**$1,865**	**$1,627**

Other information		
(Gains) losses on sale-leaseback transactions, net	$ (8)	$ 5
Cash paid for amounts included in the measurement of lease liabilities for finance leases:		
Operating cash flows	1,400	1,300
Financing cash flows	200	170
Cash paid for amounts included in the measurement of lease liabilities for operating leases:		
Operating cash flows	800	635
Right-of-use assets obtained in exchange for new finance lease liabilities	475	515
Right-of-use assets obtained in exchange for new operating lease liabilities	150	175
Weighted-average remaining lease term (in years):		
Finance leases	9.7	2.9
Operating leases	5.2	5.4
Weighted-average discount rate:		
Finance leases	5.8%	6.0%
Operating leases	6.1%	6.3%

Example 12.2
Weighted-average remaining lease term disclosure

12.2.40 A lessee calculates the weighted-average remaining lease term based on the remaining lease term and the lease liability balance for each lease at the reporting date. [842-20-55-11]

12.2.50 For the year ended December 31, 20X9, Lessee LE discloses a weighted-average remaining lease term of 4.96 years for its finance leases, and 2.73 years for its operating leases. LE calculated the weighted-average remaining lease terms as follows.

Lease ID	Lease liab. 12/31/20X9 (A)	Remain. lease term at 12/31/20X9 (B)	(A x B)	Weight. avg. lease term at 12/31/20X9
Finance leases				
FL1	$ 52,936	4.00	$211,744	
FL2	94,499	5.50	519,745	**D/C**
	C = $147,435		**D =** $731,489	**4.96**
Operating leases				
OL1	$ 14,104	2.00	$ 28,208	
OL2	21,654	2.25	48,722	
OL3	33,570	2.54	85,268	
OL4	24,365	4.00	97,460	
OL5	12,847	2.42	31,090	**F/E**
	E = $106,540		**F =** $290,748	**2.73**

Example 12.3
Weighted-average discount rate disclosure

12.2.60 A lessee calculates the weighted-average discount rate based on:

- the discount rate for the lease – i.e. used to calculate the lease liability balance for each lease at the reporting date; and
- the remaining balance of the lease payments for each lease at the reporting date. [842-20-55-12]

12.2.70 For the year ended December 31, 20X9, Lessee LE discloses a weighted-average discount rate of 5.72% for its finance leases, and 4.29% for its operating leases. The leases described are the same as in Example 12.2. LE calculated the weighted-average discount rates as follows.

Lease ID	Remain. pmts. 12/31/20X9 (A)	Rate to calc. liabs. (B)	(A x B)	Weighted avg. discount rate 12/31/20X9
Finance leases				
FL1	$ 60,000	5.20%	$3,120	
FL2	112,500	6.00%	6,750	**D/C**
	C = $172,500		**D =** $9,870	**5.72%**
Operating leases				
OL1	$ 15,000	4.20%	$ 630	
OL2	22,800	4.20%	958	
OL3	36,000	4.70%	1,692	
OL4	27,000	4.20%	1,134	
OL5	13,500	3.60%	486	**F/E**
	E = $114,300		**F =** $4,900	**4.29%**

Example 12.4

Periodic short-term lease cost does not reasonably reflect lessee's short-term lease commitments

12.2.80 Lessee LE has elected to apply the short-term lease exemption to one of its classes of underlying assets: office equipment (e.g. copiers and printers). During 20X8, LE only has a small number of leases within this class of underlying asset that qualify for the exemption. The short-term lease cost recognized and disclosed for those leases during 20X8 is $200,000. The remaining lease payments due in 20X9 are $40,000.

12.2.90 On December 31, 20X8, LE enters into a master lease agreement for a number of new items of office equipment. The leases subject to that master lease agreement qualify as short-term leases because the non-cancellable period of the leases is one year, and LE is not reasonably certain to exercise its right to renew those leases at the end of the non-cancellable period – i.e. the lease term is one year or less.

12.2.100 Because LE has elected the short-term lease exemption for its leases of office equipment, the short-term lease exemption applies to these new office equipment leases. The total lease payments that will be paid during 20X9 for the additional items of office equipment is $2,400,000.

12.2.110 In accordance with the lessee disclosure requirements in Topic 842, LE discloses the following in its financial statements:

- the fact that it elected to apply the short-term lease exemption for its leases of office equipment;
- short-term lease cost for 20X8 of $200,000; and
- because the periodic short-term lease cost of $200,000 disclosed does not reasonably reflect the lessee's short-term lease commitments as of December 31, 20X8, it discloses that fact and the amount of its short-term lease commitments of $2,440,000 ($2,400,000 + $40,000).

KPMG observation – Disclosure requirements not meant to be exhaustive

12.2.120 Although the Board provided a list of qualitative and quantitative disclosures, a lessee may need to provide additional information about its leases to achieve the disclosure objective at 12.1. For example, a lessee will need to consider whether to disclose information about reassessments or modifications that occurred during the reporting period, such as the following.

Disclosure	Required for:	
	Reassessments	Modifications
Lessee action(s) that triggered a reassessment of the lease term or exercise of purchase option(s)	✔	
The existence, and terms and conditions, of contract modifications		✔
Whether a contract modification was accounted for as a separate contract and any significant judgments made in that determination		✔
Reallocation of the remaining contract consideration to the lease components and non-lease components	✔	✔[1]
If the lease classification changes, that fact and how it impacts the comparative periods presented (e.g. amounts recognized in profit or loss, and in the statement of cash flows)	✔	✔[1]
The effect on the measurement of the lease liability, right-of-use asset, and any amounts recognized in profit or loss	✔	✔[1]

Note 1:

When the lease modification is not accounted for as a separate contract.

KPMG observation – No reconciliation of lease liabilities

12.2.130 The Board decided not to require a reconciliation of the opening and closing balances of lease liabilities due to preparers' concerns about the costs and complexity of implementation. Some preparers cited the need for more robust IT systems and/or process capabilities to track and accumulate reconciling items that are not identified for disclosure today. Instead, the Board decided to require lessees to disclose key components of the reconciliation, including total lease cost and cash paid for amounts included in the measurement of lease liabilities. This decision is consistent with current US GAAP for other financial liabilities, which does not require a reconciliation. [ASU 2016-02.BC284–BC286]

US GAAP different from IFRS – Lessee disclosures

Required tabular presentation of lessee quantitative disclosures

12.2.140 IFRS 16 requires provision of the lessee quantitative disclosures in a tabular format, unless the lessee can substantiate that another format is more appropriate. In contrast, Topic 842 only provides a tabular format for the quantitative disclosures as an example of one way a lessee could meet the disclosure requirements. [IFRS 16.54]

Some differences in lessee quantitative disclosure requirements

12.2.150 The following are differences between the lessee quantitative disclosure requirements in IFRS 16 and those in Topic 842.

- *Maturity analysis of lease liabilities* – IFRS 16 requires that lessees disclose a maturity analysis of its lease liabilities in accordance with the IFRS 7 (financial instruments disclosures) disclosure requirements for other financial liabilities. The maturity analysis requirements of IFRS 7 are less prescriptive than the requirements under Topic 842. [IFRS 16.58]
- *Total cash outflow for leases* – IFRS 16 requires disclosure of total cash paid for leases during the reporting period. Topic 842 only requires cash paid in satisfaction of amounts that comprise the lessee's lease liabilities. [IFRS 16.53(g)]
- *Total expense for leases of low-value assets* – IFRS 16 requires disclosure of the lease expense for the period related to leases of low-value assets. There is no equivalent exemption (and consequential disclosure) under Topic 842. [IFRS 16.53(d)]
- *Additions to right-of-use assets* – IFRS 16 requires disclosure of all additions of right-of-use assets by the lessee during the period. Topic 842 only requires the amount of right-of-use assets obtained in exchange for lease liabilities. Therefore, IFRS 16 requires disclosure of right-of-use assets in exchange for cash (i.e. prepaid leases), while Topic 842 only requires disclosure of amounts that equal the lease liability at lease commencement. [IFRS 16.53(h)]
- *Carrying amount of right-of-use assets by class of underlying asset* – IFRS 16 requires a lessee to disclose its right-of-use assets by underlying asset class (e.g. office space, computer equipment, vehicles). Topic 842 does not require a similar disclosure. [IFRS 16.53(j)]
- *Weighted-average remaining lease term* – IFRS 16 does not include a requirement like that in Topic 842 to disclose the weighted-average remaining lease term for a lessee's leases.
- *Weighted-average discount rate* – IFRS 16 does not include a requirement like that in Topic 842 to disclose the weighted-average discount rate used in accounting for the lessee's leases.

12.2.160 In addition, most of the required lessee quantitative disclosures in Topic 842 require separate disclosure for finance and operating leases. Under IFRS 16, there is only one type of lease for lessees; therefore, this is also a difference in how the disclosures will be prepared and presented between IFRS 16 and Topic 842.

Comparison with current US GAAP – Increased qualitative and quantitative disclosures

12.2.170 Lessee disclosures under Topic 842 are more extensive than current US GAAP. [840-10-50, 840-20-50, 840-30-50, 840-40-50]

- Examples of new qualitative disclosures include (1) information about leases that have not yet commenced at the balance sheet date that create significant rights and obligations to the lessee, and (2) significant judgments made such as determining whether a contract contains a lease, determining the discount rate for the lease, and allocating the consideration in the contract to lease and non-lease components.
- Examples of new quantitative disclosures include cash paid for amounts included in the measurement of lease liabilities, supplemental non-cash information on lease liabilities arising from obtaining right-of-use assets for operating leases, weighted-average remaining lease terms, and weighted-average discount rate information.

12.3 Lessor disclosures

12.3.10 Qualitative information

☑ Information about the nature of its leases, including:

- General description of those leases.
- Basis, and terms and conditions, on which variable lease payments are determined.
- Existence, and terms and conditions, of lease extension and termination options.
- Existence, and terms and conditions, of lessee purchase options. [842-30-50-3(a)]

☑ Information about the significant assumptions and judgments, which *may* include:

- Determining whether a contract contains a lease.
- Determining the allocation of consideration to the lease and non-lease components in a contract.
- Initially measuring the residual asset. [842-30-50-3(b)]

☑ Lease transactions between related parties in accordance with the related party guidance. [842-30-50-4]

☑ Explanation of significant changes in the carrying amount of the lessor's unguaranteed residual assets and deferred selling profit for net investments in sales-type and direct financing leases. [842-30-50-9]

☑ Information about how a lessor manages residual value risk of its leased assets, including:

- Carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor). [842-30-50-7(b)]
- Risk management strategy for residual assets. [842-30-50-7(a)]
- Any other means used by the lessor to reduce its residual asset risk (e.g. buyback agreements or variable lease payments for use in excess of specified limits). [842-30-50-7(c)]

12.3.20 Quantitative information

☑ Table of lease income received during each annual and interim reporting period, including:

- For sales-type leases and direct finance leases:
  - » Profit or loss recognized at commencement date; presented gross or net depending on lessor's business model – i.e. as a manufacturer/dealer or a financial lessor.
  - » Interest income either in aggregate or separated by the components of the net investment in the lease.
- For operating leases, lease income relating to lease payments.
- Lease income relating to variable lease payments not included in the lease receivable. [842-30-50-5]

☑ The carrying amounts of the components of the aggregate net investment in sales-type and direct financing leases:

- Lease receivables.
- Unguaranteed residual assets.
- Any deferred selling profit on direct financing leases. [842-30-50-6]

☑ For finance leases, a maturity analysis of the undiscounted cash flows comprising the lessor's lease receivables for each of the first five years and a total of the amounts thereafter, reconciled to the balance of lease receivables. [842-30-50-10]

☑ For operating leases, a maturity analysis of the undiscounted future lease payments for each of the first five years and a total of the amounts thereafter. A lessor presents the operating lease maturity analysis separately from the maturity analysis required for sales-type and direct financing leases. [842-30-50-12]

☑ The general property, plant, and equipment disclosures for assets subject to operating leases, provided by significant class of underlying asset, separately from those disclosures for the lessor's other owned assets. [842-30-50-13, 360-10-50]

Example 12.5
Table of lease income for the reporting period

12.3.30 The following table is an example of the lease income disclosure by a Lessor LR, which is required to be in tabular format.

For the years ended December 31, 20X9 and 20X8 (in thousands)	20X9	20X8
Lease income – sales-type and direct financing leases		
Profit at lease commencement[1]	$ 17	$ 5
Interest income on lease receivables[2]	345	320
Interest income from accretion of unguaranteed residual assets[2]	105	97
Subtotal	**467**	**422**
Lease income – operating leases	510	495
Variable lease income	25	22
Total lease income	**$1,002**	**$939**

Notes:

1. Presentation is based on LR's business model in accordance with paragraph 842-30-45-4. In this example, LR uses leases for the purpose of providing finance and therefore profit is presented net.
2. Interest income on LR's net investment in leases may be disclosed either in aggregate or separately (as shown) for each component of the net investment in the lease.

KPMG observation – Assets subject to operating leases are a separate major class of depreciable assets

12.3.40 In the Board's view, leased assets are often subject to risks different from owned assets that are held and used by the entity, and providing separate disclosures benefits users. Accordingly, a lessor should treat assets subject to operating leases as a separate major class of depreciable assets, which should be further disaggregated by significant class of underlying assets (e.g. airplanes versus buildings). In addition, the risks related to one class of leased asset may be very different from another. [ASU 2016-02.BC341]

Comparison with current US GAAP – More information on risks to which a lessor is exposed and lease income

12.3.50 Although the Board decided not to substantially change lessor accounting and to retain most of the existing disclosure requirements, its decision to expand the lessor disclosure requirements is intended to provide financial statement users (e.g. investors and analysts) with:

- more information about the risks to which a lessor is exposed; for example, collectibility of lease receivables (i.e. credit risk), and risks related to the lessor's residual interest in its leased assets; and
- additional information about the lessor's lease income (as illustrated in Example 12.5). [840-10-50, 840-20-50, 840-30-50, 840-40-50]

13 Effective dates and transition

How the standard works

Effective date:	**Public business entities:**[1] Annual and interim periods in fiscal years beginning after December 15, 2018.	**Other entities:** – Annual periods beginning after December 15, 2019. – Interim periods in fiscal years beginning after December 15, 2020.
Early adoption:	All entities can adopt Topic 842 immediately.	
Transition method:	Modified retrospective, which requires application of the new guidance for all periods presented.	
Transition date:	As referred to in this chapter, the date on which an entity applies the transition requirements to a lease, which is the later of: (1) the beginning of the earliest period presented in the financial statements, or (2) the 'commencement date' for the lease (see section 5.1).	
Package of practical expedients (all or nothing):	An entity may elect not to reassess: – whether expired or existing contracts contain leases under the new definition of a lease; – lease classification for expired or existing leases; and – whether previously capitalized initial direct costs would qualify for capitalization under Topic 842.	
Use of hindsight:	– Hindsight allowed when considering the likelihood that lessee options to extend or terminate a lease or purchase the underlying asset will be exercised, and in assessing the impairment of right-of-use assets. – Elect on its own or with the package of practical expedients.	

Note 1:

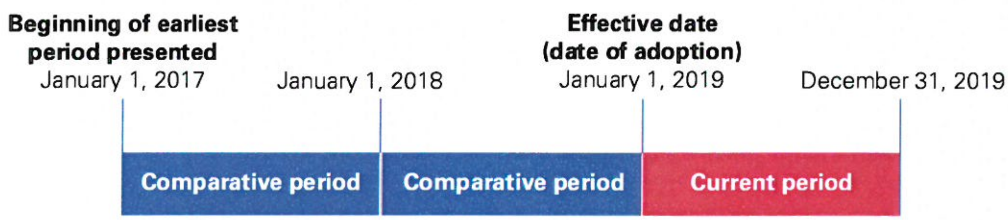
This includes (1) not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and (2) employee benefit plans that file or furnish financial statements with or to the SEC.

13.1 Effective dates

13.1.10 Public business entities apply Topic 842 for interim and annual periods in fiscal years beginning after December 15, 2018. All other entities apply Topic 842 for fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning one year later. [842-10-65-1(a) – 65-1(b)]

13.1.20 If a calendar year-end public business entity adopts Topic 842 in accordance with the mandatory effective date, then the following are the relevant dates.

13.1.30 An entity can early adopt Topic 842 at any time after issuance. [842-10-65-1(a) – 65-1(b)]



KPMG observation – Early adoption considerations

Lessors may want to align implementation with Topic 606

13.1.40 Most of the changes applicable to lessors transitioning from current US GAAP to Topic 842 were designed to substantially align key aspects of the lessor accounting model with the new revenue recognition guidance in Topic 606. For example, the separation and allocation guidance for lease and non-lease components, the lease modifications guidance, the guidance on initial direct costs, and the contract combinations guidance. [ASU 2016-02.BC8(d)]

13.1.50 Those aspects of Topic 606 and Topic 842 that are substantially aligned are designed to work together. The Board's decision to align these aspects of the two standards explicitly considered that many lessors have contracts that contain lease *and* non-lease (e.g. services or supplies) components and that those lessors in particular would benefit from the alignment. Consequently, many lessors may find it preferable to early adopt Topic 842 at the same time as they adopt Topic 606.

Minimize disruption

13.1.60 Most entities will likely be affected by the implementation of both Topic 606 and Topic 842. Some entities might view it as advantageous to adopt both standards concurrently, in a big bang approach, to minimize the extent of ongoing systems and process changes, get past the disruption, and revert to a steady state accounting environment more quickly.

Seller-lessees in real estate sale-leaseback transactions

13.1.70 As discussed in section 9.1, it will generally be easier to achieve sale accounting for real estate sale-leaseback transactions than under current US GAAP. A seller-lessee that has, or is contemplating, a significant real estate sale-leaseback transaction that is, or is expected to be, a failed sale under current US GAAP might want to early adopt Topic 842 if the transaction would be accounted for as a sale and a leaseback. For further discussion, see section 13.7.

Lessees with existing build-to-suit lease arrangements

13.1.80 Because of the existing build-to-suit lease accounting guidance in current US GAAP, there are many lessees that have assets and liabilities recognized for assets that they do not legally own, but were deemed to own for accounting purposes during the construction period. In some of those cases, the construction period ended many years ago but, because of the restrictive sale-leaseback requirements applicable to real estate under current US GAAP, the entity has been unable to derecognize those assets and liabilities. Because the transition provisions in Topic 842 applicable to build-to-suit leases and sale-leaseback transactions may permit the entity to derecognize those assets and liabilities (see section 13.8), some entities in this situation may choose to early adopt Topic 842.

KPMG observation – Reporting requirements for SEC registrants

SEC requirements on adoption of a new standard

SEC regulations require registrants to present selected financial data for the five most recent fiscal years. SEC registrants adopting a standard on a retrospective basis (including the use of one or more practical expedients) are required to update the other areas of their filings, including the MD&A, to reflect the retrospective application of the new standard. Additionally, the SEC Staff Financial Reporting Manual states that, if a registrant adopts a new accounting standard retrospectively, the staff will expect all five years to be presented on the same basis. [SEC Reg S-K Item 301, SEC FRM 1610]

13.1.90 We believe that SEC registrants would not restate previously reported information in their Selected Financial Data table that precedes the beginning of the earliest comparative period presented in the registrant's financial statements. For example, if a calendar year-end SEC registrant adopts Topic 842 in accordance with the mandatory effective date (i.e. for calendar 2019), we believe that the registrant would not restate the selected financial data in its 2019 annual report on Form 10-K for 2015 and 2016; it would, however, restate 2017 and 2018 information in the selected financial data table.

13.1.100 Topic 842 mandates only a *modified* retrospective transition approach (which is not the same as a retrospective transition approach), that does not provide guidance on applying its requirements to periods before the beginning of the earliest period presented. Therefore, it is unclear on what basis, for example, a lessee would measure its operating lease right-of-use assets and lease liabilities. In addition, such measurement (e.g. that uses a discount rate for the lease determined as of a date before the beginning of the earliest period presented) would affect subsequent periods so that those periods would not be in accordance with Topic 842's transition requirements.

US GAAP different from IFRS – Early adoption

13.1.110 IFRS 16 is effective for annual periods beginning on or after January 1, 2019. Early adoption is permitted, but *only* if the entity is concurrently adopting or has already adopted the new revenue recognition standard (IFRS 15). [IFRS 16.C1]

13.1.120 Because current IFRS does not have the same restrictive real estate sale-leaseback guidance as current US GAAP, and does not have specific requirements for build-to-suit lease arrangements, there are likely to be less incentives for IFRS preparers to early adopt IFRS 16 than there will be for US GAAP preparers to early adopt Topic 842.

13.2 Transition principles – Lessees and lessors

Transition approach – general

13.2.10 In the financial statements in which an entity first applies Topic 842, the entity recognizes and measures all leases that exist at the beginning of the earliest comparative period presented using a modified retrospective transition approach. As an exception, a lessee electing the exemption for short-term leases (see section 6.3.1) does not apply the transition requirements to those leases. [842-10-65-1(c) – 65-1(e)]

13.2.20 Topic 842 does not specify what to do instead for those leases in transition. However, we believe that:

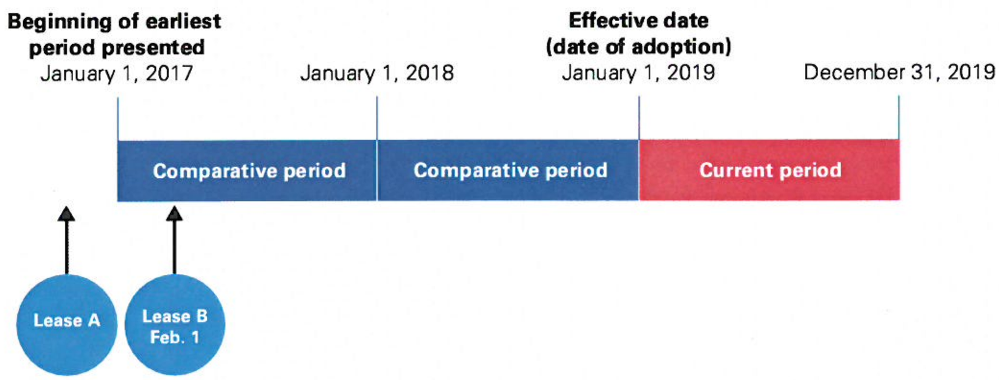
- the lessee will recognize the minimum rental payments (as defined in current US GAAP) as lease cost, generally on a straight-line basis over the lease term consistent with the lessee's accounting for those leases under current US GAAP; and
- consistent with all other lessee leases that exist at the effective date, will apply the new requirements in Topic 842 to that lease if, on or after the effective date, it is modified (and that modification is not accounted for as a separate contract) – see section 6.7 – or there is an event that would require remeasurement of the lease liability (e.g. a change in the lease term or change in the assessment of a lessee purchase option) – see section 6.6.

13.2.30 An entity adjusts equity at the beginning of the earliest comparative period presented, and the other comparative amounts disclosed for each prior period presented, as if Topic 842 had always been applied, subject to the transition requirements described in this chapter. [842-10-65-1(d)]

13.2.40 An entity applies the transition requirements at the later of: (1) the beginning of the earliest period presented in the financial statements, or (2) the commencement date (see section 5.1). For ease of reference, this date is referred to as the 'transition date' in this chapter. [842-10-65-1(k), 65-1(r)(1), 65-1(s)(1), 65-1(v)(1), 65-1(w)(1), 65-1(x)(1)]

13.2.50 The following diagram is based on a calendar year-end public business entity that adopts Topic 842 on the mandatory effective date. The transition requirements apply to:

- Lease A at the beginning of the earliest period presented – i.e. January 1, 2017 is the transition date; and
- Lease B at the commencement date of – i.e. February 1, 2017 is the transition date.



Transition approach – modifications

13.2.60 The following transition requirements apply to modifications that are not accounted for as a separate contract, for both lessees and lessors. [842-10-65-1(q), 65-1(t), 65-1(x)(4)]

Modification occurs...	
Before effective date:	**On or after effective date:**
– Apply current GAAP, Topic 840.	– Apply the requirements of Topic 842 in accounting for the modification and in accounting for the lease on and after the effective date of the modification. See section 6.7 (lessees) and section 7.7 (lessors).

13.2.70 The same requirements apply to lessees in respect of remeasurements that occur on or after the effective date[1] – i.e. Topic 842 applies in:

- determining whether there is a remeasurement (see section 6.6.1);
- accounting for the remeasurement (see section 6.6.2); and
- accounting for the lease after the remeasurement (see section 6.6.2). [842-10-65-1(q), 65-1(t)]

Note 1:

Current US GAAP does not include a lessee remeasurement requirement; therefore, remeasurements will not occur before the effective date.

13.2.80 In the diagram in 13.2.50, if Lease B is modified on March 15, 2019, the modification will be accounted for under Topic 842.

Practical expedients

13.2.90 The following table summarizes the two types of practical expedients in Topic 842. [842-10-65-1(f) – 65-1(g)]

Package of practical expedients	Use of hindsight
On transition, an entity may elect *not* to reassess: – whether expired or existing contracts contain leases under the new definition of a lease (see chapter 3); – lease classification for expired or existing leases – see sections 6.2 (lessees) and 7.2 (lessors); and – whether previously capitalized initial direct costs would qualify for capitalization under Topic 842 (see section 5.5).	An entity may use hindsight: – in determining the lease term, assessing the likelihood that a lessee purchase option will be exercised (see section 5.3); and – for lessees, in assessing the impairment of right-of-use assets (see section 6.5).
Must be elected as a package, but can be elected separately from the use of the hindsight expedient.	May be elected separately or together with the package of practical expedients.
Practical expedients are applied consistently to all leases – i.e. all leases for which the entity is a lessee or a lessor – for leases that commence *before* the effective date.	

13.2.100 In effect, the transition relief provides four possible transition combinations for entities to choose from for leases entered into before the effective date.

Combination	Package of practical expedients	Use of hindsight
1	✘	✘
2	✔	✔
3	✔	✘
4	✘	✔

13.2.110 Lease modifications that occur before the effective date do not affect the availability of the practical expedients. If the entity modifies its contracts that are leases under current US GAAP but would not be leases under Topic 842 during the transition period – between January 1, 2017 and December 31, 2018 in the diagram in 13.1.20 – and has elected the package of practical expedients, the entity would apply the current US GAAP definition of a lease to the modified contracts. In addition, unless there are additional modifications on or after January 1, 2019 (the effective date in the diagram in 13.1.20), the entity will not evaluate whether those contracts are leases under Topic 842. [842-10-65-1(f), ASU 2016-02.BC390, BC393]

13.2.120 The overall effect of the transition requirements is that an entity that elects to apply all of the practical expedients will, in effect, continue to account for existing leases – i.e. leases for which the commencement date is before the effective date – in accordance with current US GAAP throughout the entire lease term, including periods after the effective date, with the following exceptions. [ASU 2016-02.BC390]

Lessees only	Lessees and lessors
– Recognize a right-of-use asset and a lease liability for all operating leases at each reporting date (see section 13.3). – Apply the reassessment requirements beginning on the effective date and, if the lease liability is remeasured on or after the effective date, account for the lease under Topic 842 beginning on the remeasurement date (see 13.2.70).	– If the lease is modified (and not accounted for as a separate contract) on or after the effective date, account for the lease under Topic 842 beginning on the effective date of the modification (see 13.2.60).

Disclosures

13.2.130 An entity generally provides the transition disclosures required on accounting changes and error corrections. As an exception, an entity is not required to disclose the effect of the change on income from continuing operations, net income, and per-share amounts for the current period and any prior periods retrospectively adjusted. [842-10-65-1(i), 250-10-50-1(b)(2)]

13.2.140 If an entity elects the package of practical expedients and/or the practical expedient to use hindsight, it discloses that fact. [842-10-65-1(j)]

KPMG observation – Impact on initial direct costs for entities not electing the package of practical expedients

13.2.150 An entity's decision not to elect the package of practical expedients for lease definition, lease classification, and initial direct costs may not have a significant effect on the entity unless it has previously incurred a significant amount of initial direct costs. This is because the new definition of a lease and the new lease classification guidance will likely yield similar outcomes to the related guidance in current US GAAP in most cases. However, because substantially fewer costs qualify as initial direct costs under Topic 842 (see section 5.5), the effect of electing (or not electing) the package of practical expedients may be significant for entities that incur significant lease origination costs. [ASU 2016-02.BC393]

KPMG observation – Errors not grandfathered

13.2.160 The practical expedient not to reassess whether expired or existing contracts contain a lease grandfathers the guidance on identifying a lease under current US GAAP. However, it does not grandfather an incorrect assessment determined under current US GAAP. For example, an entity may have incorrectly determined that a contract does not contain a lease under current US GAAP; the practical expedient does not grandfather this incorrect assessment. [ASU 2016-02.BC393(a)]

KPMG observation – Arrangements committed or agreed to before reporting periods beginning after May 28, 2003

13.2.170 Under current US GAAP, arrangements not accounted for as leases that were committed or agreed to before reporting periods beginning after May 28, 2003 (and not subsequently modified or acquired in a business combination), were grandfathered from determining whether the arrangement is or contains a lease. While Topic 842 does not carry forward that grandfathering provision, the package of practical expedients grandfathers the current US GAAP lease identification guidance for all leases that have commenced prior to the effective date of Topic 842.

13.2.180 We believe that this includes the grandfathering provision. Therefore, if an entity elects the package of practical expedients, leases previously subject to this grandfathering provision would remain eligible for that provision.

13.2.190 However, entities will need to have a process in place to monitor contracts in place before the effective date for modifications that occur on or after the effective date. If a contract previously subject to this grandfathering provision is modified on or after the effective date, the entity will have to consider whether the contract is or contains a lease under Topic 842.

KPMG observation – Modified retrospective transition approach a middle-ground for preparers and users

13.2.200 The modified retrospective transition approach represents a compromise between providing all of the information that would likely be useful to financial statement users and limiting unnecessary costs to financial statement preparers to implement Topic 842. [ASU 2016-02.BC389]

Financial statement users

13.2.210 The decision to require a modified retrospective approach, rather than a prospective or cumulative effect approach, was made to ensure that, in particular, the principal financial statement changes resulting from Topic 842 – i.e. the recognition of operating leases on the balance sheet by lessees, and enhanced disclosures for lessees *and* lessors – were presented on a comparative basis for all periods presented in entities' first set of financial statements applying Topic 842. [ASU 2016-02.BC389]

13.2.220 The Board also expects financial statement users to benefit from the relatively limited number of transition options (see table in 13.2.90). It was this desire to limit the transition options that drove the Board's decision to require entities to adopt the package of practical expedients on an all-or-nothing basis. Given the options available, we believe that most entities will choose to use hindsight when considering lessee options to extend or terminate a lease or purchase the underlying asset, and in considering the possible impairment of right-of-use assets.

13.2.230 In contrast, financial statement users will not receive completely comparable information because of those aspects of the modified retrospective transition approach that are intended to reduce the burden on preparers. For example, the difference in what comprises *minimum lease payments* and *minimum rental payments* under current US GAAP compared to *lease payments* under Topic 842, which entities do not generally have to revisit for leases that commence prior to the effective date of Topic 842, will reduce comparability between those leases and leases that commence on or after the effective date.

13.2.240 Comparability will be more significantly affected in some cases for entities that elect the package of practical expedients. This might be most pronounced for entities that incur significant lease origination costs that qualify as initial direct costs under current US GAAP but will not qualify as initial direct costs under Topic 842 (see KPMG observation at 13.2.150).

13.2.250 For example, a lessor has two identical operating leases: Lease #1 that commenced just prior to the effective date, and Lease #2 that commenced just after the effective date. The lessor incurred significant lease origination costs on both leases that meet the definition of initial direct costs under current US GAAP (which are then deferred and recognized over the lease term in proportion to the recognition of lease income), but do not meet the new definition of initial direct costs (and therefore are expensed as incurred). Lease #1 may have a substantively lower margin throughout the lease term compared with Lease #2, while the lessor will have some earnings volatility resulting from Lease #2 because it must recognize those one-time origination costs for that lease as incurred.

Financial statement preparers

13.2.260 Financial statement preparers will generally benefit from not being required to apply Topic 842 on a full retrospective basis, and even more so if they elect the practical expedients that are available to them. Even without the practical expedients, entities will benefit from applying the transition requirements at the transition date and not having to look back to lease commencement for measurement purposes.

13.2.270 In addition, if an entity elects the practical expedients, there will likely be significant cost/effort savings from not having to go back and reassess previous accounting conclusions, identify which initial direct costs previously deferred would have been ineligible for deferral under Topic 842, or consider the impairment of right-of-use assets not previously recognized (lessees only).

13.2.280 The modified retrospective approach, particularly if the practical expedients are elected, may provide more significant benefits to entities that have older leases.

13.2.290 However, the modified retrospective transition approach also represents a compromise from a preparer's perspective because it is not the simplest approach that the Board could have selected. It will require more effort than, for example, a purely prospective transition approach.

US GAAP different from IFRS – IFRS 16 transition significantly different

13.2.300 The transition approaches and options under IFRS 16 are significantly different from Topic 842. In addition, the considerations for preparers when selecting a transition approach will often be different under IFRS and US GAAP. This guidance and the preparer considerations differ significantly because the Topic 842 and IFRS 16 lessee accounting models differ so significantly (see chapter 6).

13.2.310 The IASB has sought to reduce transition costs by introducing a series of practical expedients. Some expedients are accounting policy choices, some apply by class of underlying asset, and some can be elected on a lease-by-lease basis. Therefore, unlike the limited number of transition choices that are available in Topic 842 (see 13.2.100), many entities applying IFRS will have a myriad of transition choices that can result in a dizzying number of combinations and permutations.

13.2.320 **IFRS transition**

Lessees

- Full retrospective approach or cumulative effect approach:
  - Under the cumulative effect approach, a lessee does not restate comparative information.
  - At the date of initial application (i.e. the beginning of the annual reporting period in which an entity first applies IFRS 16), recognize the cumulative effect of application as an adjustment to the opening balance of retained earnings (or other equity component as appropriate). [IFRS 16.C5–C13]

$ Lessors

- Lessors continue to apply existing accounting for any leases that are existing at the date of initial application, except for intermediate lessors in a sublease. [IFRS 16.C14]
- Intermediate lessors in subleases reassess each existing operating sublease at the date of initial application to determine whether it is classified as an operating lease or a finance lease under IFRS 16, based on the remaining contractual terms of the head lease and the sublease. [IFRS 16.C15(a)]
- For subleases that were classified as operating leases under current IFRS guidance on leases, but finance leases under IFRS 16, account for the sublease as a new finance lease entered into at the date of initial application. [IFRS 16.C15(b)]

13.2.330 IFRS practical expedients

- Entities may elect not to reassess whether a contract is or contains a lease at the date of initial application; the election must be applied to all of the entity's contracts. [IFRS 16.C3]
- Lessees may use one or more of the following practical expedients when applying the modified retrospective approach to leases previously classified as operating leases under current IFRS, which can be elected on a lease-by-lease basis.
  - » Use hindsight, such as in determining the lease term.
  - » Rely on their assessment of whether leases are onerous under IAS 37 (provisions and contingencies) immediately before the date of initial application instead of performing an impairment review.
  - » Apply a single discount rate to a portfolio of leases with reasonably similar characteristics.
  - » Elect not to apply the transition requirements to leases for which the lease term ends within 12 months of date of initial application.
  - » Exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application. [IFRS 16.C10]

13.3 Transition for lessees

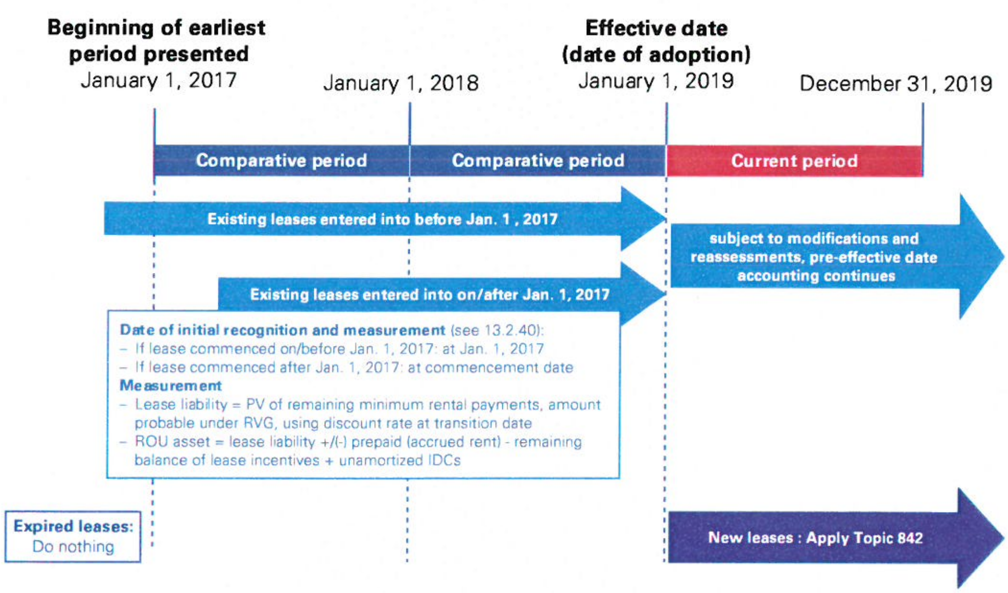
13.3.1 Lessee elects package of practical expedients

13.3.10 The following are the transition requirements applicable to a lessee that elects both of the transition practical expedients (i.e. the package and use of the hindsight). Because lease classification is not reassessed in applying the package of practical expedients:

- all existing leases classified as operating leases under current US GAAP will be classified as operating leases under Topic 842; and
- all existing leases classified as capital leases under current US GAAP will be classified as finance leases under Topic 842. [842-10-65-1(f)(2)]

Operating leases under current US GAAP

13.3.20 The following diagram gives an overview of the transition requirements for an operating lease, which are explained in this section, assuming a public business entity with a calendar year-end.



Lease liability – initial and subsequent measurement

13.3.30 Absent lease modifications or remeasurements, the lease liability is measured as follows, both at the transition date (see 13.2.30) and subsequently – i.e. for the remainder of the lease term. [842-10-65-1(l)]

Lease liability = **PV of unpaid minimum rental payments[1]** + **PV of amount probable of being owed under RVG**

Note 1:

Minimum rental payments (as defined in current US GAAP).

13.3.40 The discount rate for the lease is measured as follows at the transition date.

- For public business entities, it is the rate implicit in the lease; if the implicit rate is not readily determinable, it is the lessee's incremental borrowing rate.
- For all other entities, a risk-free discount rate may be used if the lessee elects to do so for all of its leases. [842-10-65-1(l)]

Right-of-use asset – initial measurement

13.3.50 The right-of-use asset is measured as follows at the transition date (see 13.2.30). [842-10-65-1(m) – 65-1(n)]

Lease liability + **Unamortized IDCs** +/(–) **Prepaid/(accrued) lease payments** – **Unamortized balance of lease incentives received** – **Any Topic 420 lease liability**

13.3.60 Under current US GAAP, lessees are sometimes required to recognize a liability under Topic 420 (exit or disposal cost obligations) for (1) costs to terminate an operating lease before the end of its term, and/or (2) other costs associated with the operating lease that will continue to be incurred without economic benefit to the entity.

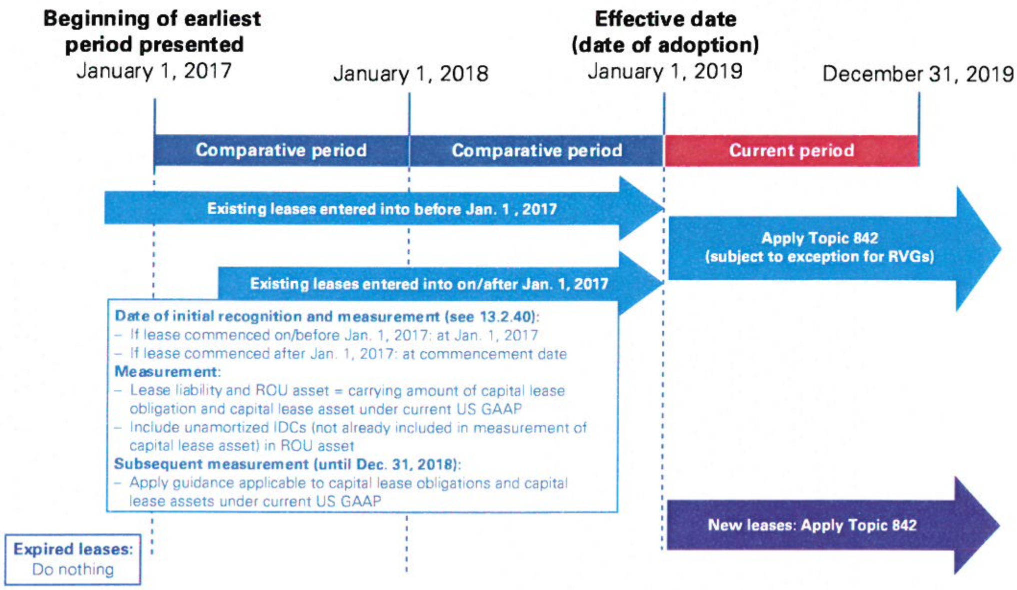
13.3.70 At the transition date, any existing Topic 420 liability reduces the initial measurement of the right-of-use asset recognized for the lease – regardless of whether the lease is classified as an operating lease or as a finance lease under Topic 842. If the lease is an operating lease, the accounting after the transition date is different from other operating leases. The right-of-use asset is amortized generally on a straight-line basis. The combined straight-line amortization of the right-of-use asset and the accretion of the lease liability on an effective interest basis each period is recognized as the single operating lease cost for the lease. [842-10-65-1(m), 65-1(o)]

Right-of-use asset – subsequent measurement

13.3.80 After initial recognition, the right-of-use asset is measured using the same lessee subsequent measurement guidance applicable to new operating leases entered into on or after the effective date (see section 6.4.2). [842-10-65-1(n)]

Capital leases under current US GAAP

13.3.90 The following diagram gives an overview of the transition requirements for a capital lease, which is explained in this section, assuming a public business entity with a calendar year-end.



Initial recognition and measurement

13.3.100 The lease liability and right-of-use asset are initially measured as follows at the transition date (see 13.2.30). [842-10-65-1(r)(1)]

Topic 842 item	Measurement
Lease liability	– Carrying amount of capital lease obligation under current US GAAP immediately before the transition date.
Right-of-use asset	– Carrying amount of the capital lease asset under current US GAAP immediately before the transition date. – Plus any unamortized initial direct costs not included in the capital lease asset under current US GAAP.

Subsequent measurement for periods before the effective date

13.3.110 A lessee subsequently measures the right-of-use asset and the lease liability in accordance with the subsequent measurement guidance in current US GAAP. [842-10-65-1(r)(4)]

Subsequent measurement beginning on the effective date

13.3.120 A lessee measures the right-of-use asset and the lease liability in accordance with the subsequent measurement guidance applicable to new finance leases under Topic 842. As an exception, a lessee does *not* remeasure the lease payments for changes in amounts probable of being owed under residual value guarantees unless the lease liability is remeasured for other reasons (e.g. because of a change in the lease term or in the assessment of a lessee purchase option). [842-10-65-1(r)(5)]

Presentation and disclosure

13.3.130 A lessee presents the assets and liabilities under capital leases as right-of-use assets and lease liabilities arising from finance leases for presentation and disclosure purposes in all periods presented in the financial statements. [842-10-65-1(r)(6)]

Example 13.1

Lessee transition for an existing capital lease with practical expedients elected

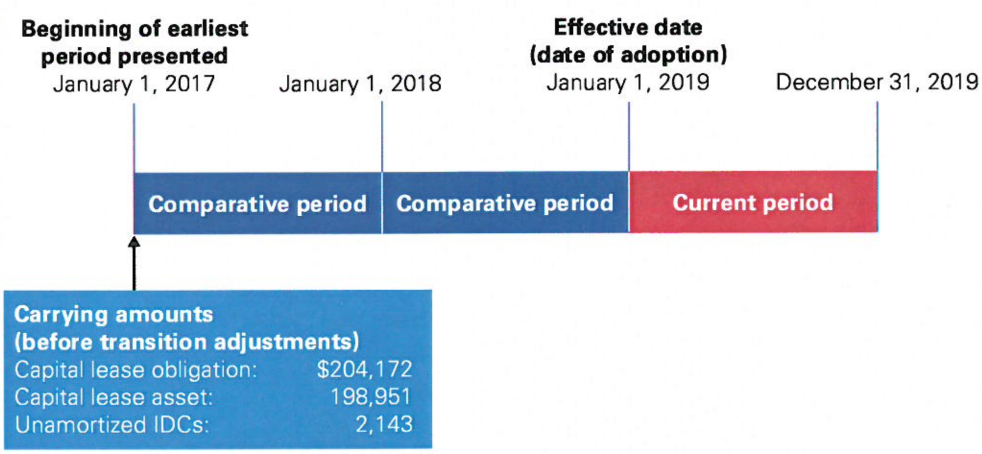
Scenario 1: Lease is not modified or remeasured on or after the effective date

About the lease

13.3.140 The following table summarizes relevant information about Lessee LE's lease of equipment.

Commencement date of the lease:	January 1, 2016
Lease term:	7 years
Lease payments (annual, paid in arrears):	$40,000
Residual value guarantee (lessee):	$6,000
Amount probable of being owed under the residual value guarantee (no change throughout lease term):	$2,000
Lease classification at inception under current US GAAP:	Capital lease
LE's incremental borrowing rate at lease inception:	5.5%
Initial direct costs, amortized on a straight-line basis over the lease term:	$2,500

Effective date and transition



13.3.150 LE elects the package of practical expedients. Therefore, LE does not reassess whether the contract is or contains a lease, whether classification of the lease would be different under Topic 842, or whether the unamortized initial direct costs at January 1, 2017 would meet the definition of initial direct costs under Topic 842.

Worksheet at January 1, 2017 (beginning of earliest period presented)

Step	Amounts Debit/(credit)	Notes
Recognize lease liability	$(204,172)	Equal to existing capital lease obligation
Recognize right-of-use asset	201,094	Equal to existing capital lease asset ($198,951) + existing unamortized IDCs ($2,143)
Adjustment to equity	$ –	N/A – replacing existing assets and liabilities at the same amounts

Subsequent accounting for the lease

13.3.160 LE will account for the lease liability and right-of-use asset in accordance with the subsequent measurement guidance:

- in current US GAAP through December 31, 2018; and
- in Topic 842 from January 1, 2019 through the end of the lease term; as an exception, because the entire amount of the $6,000 residual value guarantee is already included in the lease liability, LE will not make any adjustments for changes in the amount that it is probable of owing under the residual value guarantee.

13.3.170 LE does not modify the lease or have to remeasure the lease liability (e.g. for a change in the lease term) subsequent to the effective date. The following tables show the effect of the lease accounting on the financial statements.

Balance sheet

13.3.180 LE recognizes the following amounts in its balance sheet through the end of the lease term.

Year ended	ROU asset arising from finance lease	Lease liability arising from finance lease
Dec. 31, 2018[1]	$135,396	$145,048
Dec. 31, 2019	102,547	113,026
Dec. 31, 2020	69,698	79,242
Dec. 31, 2021	36,849	43,601
Dec. 31, 2022	4,000	6,000

Note:

December 31, 2017 balance sheet is not shown because it is expected that LE will present only one comparative balance sheet (i.e. as of December 31, 2018) in its first set of financial statements issued after the effective date of Topic 842.

13.3.190 At the end of the lease term, LE makes a payment under the residual value guarantee and credits cash for $2,000, debits the lease liability balance of $6,000, and credits the right-of-use asset of $4,000.

Income statement[1]

13.3.200 LE recognizes the following amounts in its income statement through the end of the lease term.

Year ended	Interest expense	Amortization of ROU asset
Dec. 31, 2017	$11,229	$32,849
Dec. 31, 2018	9,647	32,849
Dec. 31, 2019	7,978	32,849
Dec. 31, 2020	6,216	32,849
Dec. 31, 2021	4,359	32,849
Dec. 31, 2022	2,399	32,849

Note 1:

The interest expense on the lease liability and amortization of the right-of-use asset are not required to be presented as separate line items; rather each is presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets (see section 6.8).

Scenario 2: Lease liability is remeasured after the effective date

13.3.210 Changing the facts of Scenario 1, on January 1, 2020, LE remeasures the lease liability. The lease included a renewal option and LE now determines that it is reasonably certain to exercise the option based on the occurrence of a significant event that is within its control (see section 6.6.1).

13.3.220 As a result, LE applies the lease accounting guidance under Topic 842 beginning on the remeasurement date (January 1, 2020). The following table summarizes relevant information for the remeasurement of the lease liability.

Renewal period:	3 years
Remaining lease term:	6 years
Lease payments for the renewal period (annual, paid in arrears):	$43,000
Lease payments for the remainder of the original lease term (annual, paid in arrears):	$40,000
Amount probable of being owed under the residual value guarantee at the end of the revised lease term:	$1,500
LE's incremental borrowing rate at January 1, 2020:	6.0%

Lease liability remeasurement

13.3.230 In this example, LE identifies one difference between current US GAAP and Topic 842 that affects the measurement of the lease liability and the right-of-use asset: under Topic 840, *minimum lease payments* include the full amount of a lessee residual value guarantee (and therefore the capital lease obligation and the capital lease asset reflect the full amount of such guarantee) while the definition of *lease payments* under Topic 842 includes only amounts probable of being owed by the lessee to satisfy the guarantee.

13.3.240 LE remeasures the lease liability based on:

- three remaining payments of $40,000 (the remainder of the original lease term);
- three additional payments of $43,000 to reflect the renewal period; and
- a final payment of $1,500 to satisfy the residual value guarantee.

13.3.250 LE discounts the stream of lease payments at its incremental borrowing rate of 6.0% at January 1, 2020. This results in a remeasured lease liability of $204,483, or an increase of $91,457 compared to the lease liability balance immediately prior to the remeasurement date.

Journal entry

13.3.260 LE records the following journal entry at January 1, 2020.

	Debit	Credit
Right-of-use asset	91,457	
Lease liability		91,457
To remeasure the ROU asset and lease liability following reassessment of lease term		

Lease classification

13.3.270 LE also reassesses lease classification and determines that the lease is still a finance lease.

Subsequent accounting for the lease

13.3.280 LE prospectively accounts for the lease liability and the right-of-use asset using the guidance in Topic 842 for a finance lease (see section 6.4.1).

- The lease liability carrying amount is increased each period of the remaining lease term to reflect interest on the lease liability, and reduced to reflect the lease payments made during the period.
- The right-of-use asset is measured at cost less any accumulated amortization (and any accumulated impairment losses).

Balance sheet

13.3.290 LE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term.

Year ended	ROU asset arising from finance lease	Lease liability arising from finance lease
Dec. 31, 2020	$161,670	$176,752
Dec. 31, 2021	129,336	147,357
Dec. 31, 2022	97,002	116,198
Dec. 31, 2023	64,668	80,170
Dec. 31, 2024	32,334	41,980
Dec. 31, 2025	–	1,500

13.3.300 At the end of the lease term, LE makes a payment under the residual value guarantee, debits the lease liability balance of $1,500, and credits cash for $1,500.

Income statement[1]

13.3.310 LE recognizes the following amounts in its income statement for its lease of equipment through the end of the revised lease term.

Year ended	Interest expense	Amortization of ROU asset
Dec. 31, 2020	$12,269	$32,334
Dec. 31, 2021	10,605	32,334
Dec. 31, 2022	8,841	32,334
Dec. 31, 2023	6,972	32,334
Dec. 31, 2024	4,810	32,334
Dec. 31, 2025	2,520	32,334

Note: 1

The interest expense on the lease liability and amortization of the right-of-use asset are not required to be presented as separate line items; rather each is presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets (see section 6.8).

Example 13.2
Lessee transition for an existing operating lease with practical expedients elected

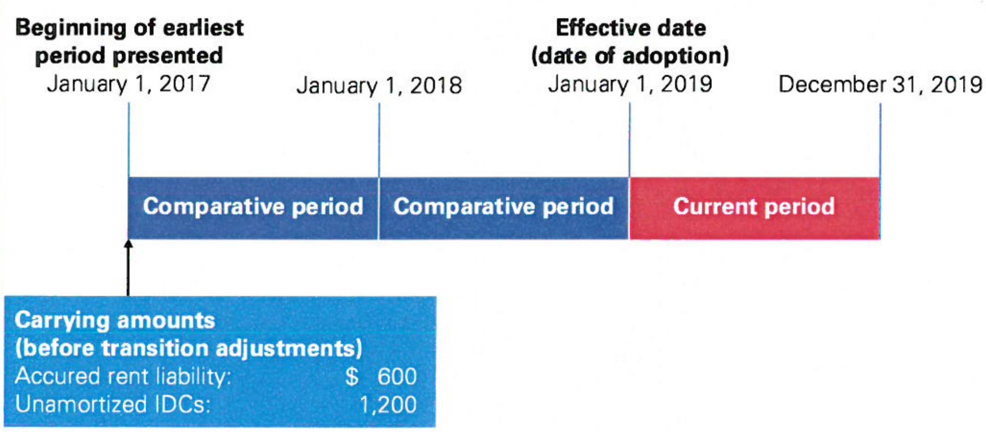
Scenario 1: Lease is not modified or remeasured on or after the effective date

About the lease

13.3.320 The following table summarizes relevant information about Lessee LE's lease of office space.

Commencement date of the lease:	January 1, 2016
Lease term:	5 years
Rental payments (annual, paid in arrears):	$28,000 first two years, $29,000 thereafter
Estimated amount of annual payment related to reimbursing the lessor's costs of property taxes and insurance:	$3,000
Minimum rental payments under current US GAAP:	$25,000 first two years, $26,000 thereafter
Lease classification at inception under current US GAAP:	Operating lease
Initial direct costs, amortized on a straight-line basis over the lease term:	$1,500

Effective date and transition



13.3.330 Because LE elected the package of practical expedients, it does not reassess whether the contract is or contains a lease, whether classification of the lease would be different under Topic 842, or whether the unamortized initial direct costs at January 1, 2017 would meet the definition of initial direct costs under Topic 842.

Worksheet at January 1, 2017 (beginning of earliest period presented)

13.3.340 At January 1, 2017, LE's incremental borrowing rate is 5.0%.

Step	Amounts Debit/(credit)	Notes
Recognize lease liability	$(91,242)	Remaining minimum rental payments ($25,000 for Year 2 and $26,000 for each of Years 3–5) discounted at 5.0%
Recognize right-of-use asset	91,842	Sum of lease liability recognized, ($600) accrued rent liability, and $1,200 of unamortized IDCs
Derecognize accrued rent	600	Balance at transition under current US GAAP
Derecognize unamortized IDCs	(1,200)	Balance at transition under current US GAAP
Adjustment to equity	$ –	N/A

Subsequent accounting for the lease

13.3.350 LE subsequently measures the lease liability and right-of-use asset through the end of the lease term in a manner similar to how it determined the lease liability and right-of-use asset at January 1, 2017; unless the lease is modified or there is a remeasurement of the lease liability.

13.3.360 LE does not modify the lease and does not have to remeasure the lease liability on or after the effective date. There is also no impairment of the right-of-use through the remainder of the lease term.

Balance sheet

13.3.370 LE recognizes the following amounts in its balance sheet for its lease of office space through the end of the lease term.

Year ended	ROU asset arising from operating lease	Lease liability arising from operating lease
Dec. 31, 2018[1]	$48,144	$48,344
Dec. 31, 2019	24,661	24,761
Dec. 31, 2020	–	–

Note 1:

December 31, 2017 balance sheet is not shown because it is expected that LE will present only one comparative balance sheet (i.e. as of December 31, 2018) in its first set of financial statements issued after the effective date of Topic 842.

Income statement[1]

13.3.380 LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

Year ended	Operating lease cost
Dec. 31, 2017	$25,900
Dec. 31, 2018	25,900
Dec. 31, 2019	25,900
Dec. 31, 2020	25,900

Note 1:

A lessee continues to present lease cost in a manner consistent with its presentation under current GAAP (e.g. SG&A expenses).

Scenario 2: Lease is modified after the effective date

13.3.390 Changing the facts of Scenario 1, on January 1, 2020 LE modifies the lease to extend the lease term for two additional years. The original lease agreement did not include any renewal options.

13.3.400 As a result, LE applies the lease accounting guidance under Topic 842 beginning on the effective date of the modification (January 1, 2020). Because the modification increases the lease term only, it does not grant LE an additional right of use, and therefore the modification cannot be accounted for as a separate contract. Accordingly, LE adjusts the original lease liability and records an equal and offsetting change to the existing right-of-use asset. The following table summarizes relevant information for the remeasurement of the lease liability.

Extension period:	2 years
Remaining lease term, including the extension:	3 years
Lease payments during extension period of 2 years (annual, paid in arrears):	$30,000
Lease payments for the remaining 1 year of the original lease term (paid in arrears):	$29,000
Estimated amount of the remaining annual payments related to reimbursing the lessor's costs of property taxes and insurance:	$3,000
Additional initial direct costs associated with the lease modification:	None

13.3.410 At the effective date of the modification, $300 of the initial direct costs remain unamortized, and they meet the definition of initial direct costs under Topic 842.

Lease liability remeasurement

13.3.420 In this example, LE identifies only one difference between current US GAAP and Topic 842 that affects the remeasurement of the lease liability and the right-of-use asset: under Topic 840, minimum lease payments *exclude* payments related to reimbursing the lessor's costs of property taxes and insurance while the definition of lease payments under Topic 842 *includes* such amounts (see section 4.6).

13.3.430 Another difference would have existed if all or a portion of the $300 in unamortized initial direct costs at the effective date of the modification did not meet the definition of initial direct costs under Topic 842. If that were the case, those unamortized costs would be written off as an adjustment to equity.

13.3.440 LE remeasures the lease liability based on:

- one remaining lease payment of $29,000 (for the remainder of the original lease term), which includes the amounts estimated to relate to the lessor's property taxes and insurance; and
- two additional lease payments of $30,000 for the extension period.

13.3.450 LE discounts the stream of lease payments at its January 1, 2020 incremental borrowing rate of 5.5%. This results in a remeasured lease liability of $79,990, or an increase of $55,229 compared to the lease liability balance immediately prior to the effective date of the modification.

Journal entry

13.3.460 LE records the following journal entry at the effective date of the modification.

	Debit	Credit
Right-of-use asset	55,229	
Lease liability		55,229
To remeasure the ROU asset and lease liability following lease modification		

Lease classification

13.3.470 LE reassesses lease classification and determines that the modified lease is still classified as an operating lease.

Subsequent accounting for the lease

13.3.480 LE calculates the remaining lease cost for the lease as follows.

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the lease modification 12/31/2016 $28,000; 12/31/2017 $28,000; 12/31/2018 $29,000; 12/31/2019 $29,000; 12/31/2020 $29,000; 12/31/2021 $30,000; 12/31/2022 $30,000	$ 203,000
Plus: Total initial direct costs attributable to the lease	1,500
Less: Periodic lease cost recognized in prior periods	
calculated as (straight-line rent of $25,600 x 4 periods) plus (amortization of initial direct costs of $1,200) plus (reimbursement of lessor's costs of $3,000 x 4 periods)	(115,600)
Remaining lease cost for the lease	**$ 88,900**

13.3.490 LE recognizes a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (i.e. $29,633 per year for the remaining three years).

13.3.500 LE prospectively accounts for the lease liability and right-of-use asset from the effective date of the modification using the guidance in Topic 842 for an operating lease.

Balance sheet

13.3.510 LE recognizes the following amounts in its balance sheet for its lease of office space through the end of the lease term.

Year ended	ROU asset arising from operating lease	Lease liability arising from operating lease
Dec. 31, 2020	$54,656	$55,389
Dec. 31, 2021	28,069	28,435
Dec. 31, 2022	–	–

Income statement[1]

13.3.520 LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

Year ended	Operating lease cost
Dec. 31, 2020	$29,633
Dec. 31, 2021	29,633
Dec. 31, 2022	29,634

Note 1:

A lessee continues to present lease cost in a manner consistent with its presentation under current GAAP (e.g. SG&A expenses).

13.3.2 Lessee does not elect package of practical expedients

Leases previously classified as operating leases under current US GAAP

Leases classified as operating leases under Topic 842

13.3.530 In general, the recognition, initial measurement, and subsequent measurement of the lease liability and right-of-use asset are the same as for a lessee that elects the package of practical expedients for its leases (see 13.3.30–80). As an exception, at the transition date, a lessee writes off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842. This means that the initial and subsequent measurement of the lessee's right-of-use asset will differ for the effect of initial direct costs written off at the transition date. [842-10-65-1(k) – 65-1(n), 65-1(p)]

Leases classified as finance leases under Topic 842

Initial recognition and measurement

13.3.540 The lease liability is recognized and measured the same as for an existing operating lease that remains classified as an operating lease (see 13.3.530). [842-10-65-1(o)]

13.3.550 The right-of-use asset is recognized and measured using the formula in 13.3.50, except that the starting point is a *proportion of the original lease liability* – i.e. the lease liability as of the original commencement date – that is calculated as follows.

Proportion of original lease liability = **Original lease liability at commencement date[1]** X **Remaining lease term at transition date ÷ total lease term**

Note 1:

Topic 842 states that this amount can be 'imputed' from the remaining lease liability, rather than directly calculated. Example 13.3 demonstrates imputing the original lease liability and this is further discussed in the KPMG observation at 13.3.680–710. [842-10-65-1(o)]

Subsequent measurement

13.3.560 Subsequent to initial recognition and measurement, there is no difference in accounting for the finance lease in transition solely because it was previously classified as an operating lease under current US GAAP. Example 13.3 illustrates the accounting for an existing lease classified as an operating lease under current US GAAP but classified as a finance lease under Topic 842.

Leases previously classified as capital leases under current US GAAP

Leases classified as finance leases under Topic 842

13.3.570 In general, the recognition, initial measurement, and subsequent measurement of the lease liability and right-of-use asset are the same as for a lessee that elects the package of practical expedients for its leases. However, as an exception, at the transition date, a lessee writes off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 *and* that are not included in the measurement of the capital lease asset under current US GAAP. This means that the initial and subsequent measurement of the lessee's right-of-use assets will differ for the effect of initial direct costs written off at the transition date. [842-10-65-1(r), 65-1(t)]

Leases classified as operating leases under Topic 842

Transition adjustments

13.3.580 At the transition date, a lessee:

- derecognizes the carrying amount of the capital lease asset and capital lease obligation determined under current US GAAP; the difference is accounted for as prepaid or accrued rent; and
- writes off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842. [842-10-65-1(s)]

Initial recognition and measurement

13.3.590 The lessee initially measures the operating lease liability and operating right-of-use asset in the same manner as for a new lease that commences on or after the effective date, using the transition date instead of the commencement date. [842-10-65-1(s)(2) – 65-1(s)(3)]

Subsequent recognition and measurement

13.3.600 Subsequent to the transition date, the lessee accounts for the operating lease in the same manner as it accounts for any other operating lease under Topic 842. [842-10-65-1(s)(4)]

Example 13.3

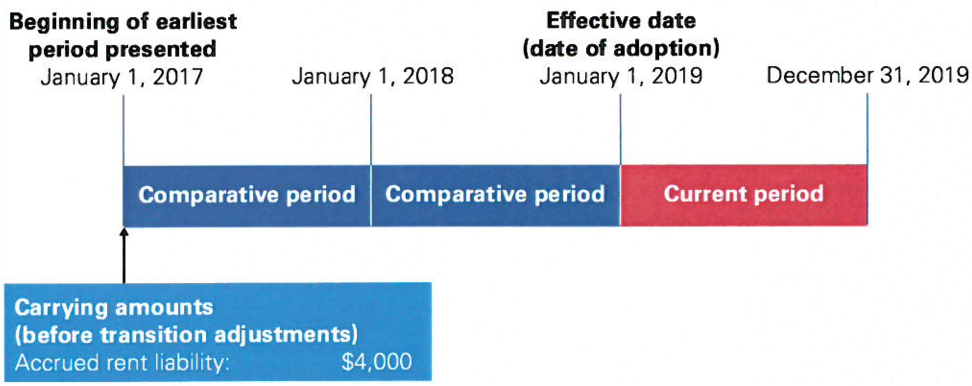
Lessee transition for operating lease under current US GAAP classified as a finance lease under Topic 842 (i.e. package of practical expedients not elected)

About the lease

13.3.610 The following table summarizes relevant information about Lessee LE's lease of a machine.

Commencement date of the lease:	January 1, 2015
Lease term:	6 years
Minimum rental payments determined under Topic 840 (annual, paid in arrears):	\$51,000 first 3 years \$55,000 last 3 years
Lease classification at inception under current US GAAP:	Operating lease
Initial direct costs:	None

Effective date and transition



13.3.620 LE does not elect the package of practical expedients.

Worksheet at January 1, 2017 (beginning of earliest period presented)

13.3.630 Assume that the lease would have been classified as a finance lease under Topic 842 at lease commencement. At January 1, 2017, LE's incremental borrowing rate is 6%.

Lease liability measurement

13.3.640 On January 1, 2017, LE measures the finance lease liability as $186,807, which is the present value of one payment of $51,000, and three payments of $55,000, discounted at 6%.

Right-of-use asset measurement

13.3.650 LE determines the carrying amount of the right-of-use asset at January 1, 2017 using the formula described in Topic 842 as follows.

Step 1:	Determine the minimum rental payments over the remaining lease term as of the transition date: $51,000 + ($55,000 × 3) = $216,000
Step 2:	Determine the lease term at lease commencement: 6 years
Step 3:	Determine the remaining lease term as of the transition date: 4 years
Step 4:	Divide the amount determined in Step 1 by the amount determined in Step 3: $216,000 ÷ 4 years = $54,000 per year
Step 5:	Determine the present value of the periodic payment calculated in Step 4 over the lease term identified in Step 2 using the lessee's incremental borrowing rate at the transition date: $54,000 per year in arrears for 6 years discounted at 6% = $265,536
Step 6:	Multiply the amount in Step 5 by the ratio of the remaining lease term calculated in Step 3 divided by the lease term identified in Step 2: $265,536 × (4 ÷ 6) = $177,024
Step 7:	Add to the amount calculated in Step 6 the amount of any previously recognized prepaid rental payments (and subtract from that amount any accrued rental payments): $177,024 - $4,000 = $173,024

Journal entry

13.3.660 The difference between the right-of-use asset and the lease liability on January 1, 2017 is an adjustment to opening retained earnings at that date. Lessee recognizes the following entry to reflect the transition of the operating lease to a finance lease.

	Debit	Credit
Right-of-use asset	173,024	
Accrued rent	4,000	
Retained earnings	9,783	
Lease liability		186,807
To recognize finance lease on transition		

Subsequent accounting for the lease

13.3.670 Subsequent to January 1, 2017, the lessee's accounting is no different from that illustrated in Example 13.1, Scenario 1.

KPMG observation – Imputing the commencement date lease liability for a lease classified as an operating lease under current US GAAP and a finance lease under Topic 842

13.3.680 In specifying measurement of the right-of-use asset as a proportion of the *original* lease liability ("the lease liability at the commencement date"), Topic 842 states that the original lease liability "can be imputed from the lease liability" determined at the transition date. There is no additional guidance or an example of how to impute the original lease liability from the transition date lease liability. [842-10-65-1(o)]

13.3.690 This specific guidance is unchanged from the 2013 Exposure Draft, which included an illustrative example of how to impute the original lease liability from the transition date lease liability. Example 13.3 above imputes the original lease liability in the same manner as in the exposure draft. However, because the example was not carried forward to Topic 842, there may be other ways an entity could meet the requirements. In addition, in the exposure draft, the lease liability was not calculated based on the remaining minimum rental payments as required by paragraph 842-10-65-1(l).

13.3.700 For example, the guidance would not appear to prohibit the lessee in Example 13.3 from calculating the 'original lease liability' based on the *actual* minimum rental payments ($51,000 for the first three years; $55,000 for the final three years), rather than the derived lease payments of $54,000 illustrated. In that case:

- The original lease liability, using the discount rate determined in Example 13.3 (i.e. there is no mechanism in the transition guidance for using a discount rate for the lease established before the transition date), would be $259,761 (rather than $265,536).
- The lessee would then multiply that amount ($259,761) by the ratio of the remaining lease term calculated in Step 3 divided by the lease term identified in Step 2 ($259,751 × [4 ÷ 6] = $173,174).
- As in the example above, the lessee would reduce this amount ($173,174) by the amount of the accrued rent ($173,174 - $4,000 = $169,174).

13.3.710 Under this approach, at January 1, 2017 LE would record a slightly different journal entry than that recorded in Example 13.3.

	Debit	**Credit**
Right-of-use asset	169,174	
Accrued rent	4,000	
Retained earnings	13,633	
Lease liability		186,807
To recognize finance lease on transition		

KPMG observation – No examples where the package of practical expedients is not elected

13.3.720 Topic 842 does not include an example of a lessee not electing the package of practical expedients. We believe that this may have been partially a function of limiting the number of examples overall, but also because the Board may believe that most entities will elect the package of practical expedients (see KPMG observation at 13.2.200–290).

KPMG observation – Changes in lease classification in transition

13.3.730 In general, we believe that it would be relatively infrequent that a lease classified as an operating lease under current US GAAP would be classified as a finance lease under Topic 842 or vice versa. However, the following are a few examples of changes in the lease classification guidance that could result in different outcomes.

- Four of the five classification tests in Topic 842 for determining if a lease is a finance lease are substantially similar to those in current US GAAP for determining if a lease is a capital lease. However, Topic 842 includes a fifth test (the 'alternative use' test – see section 6.2) that has no equivalent in current US GAAP. The introduction of this test *could* result in some leases being classified as finance leases if reassessed under Topic 842.
- Lessees under current US GAAP do not consider *either* the lease term or present value classification tests (see section 6.2) when the lease term falls within the last 25 percent of the total estimated economic life of the underlying asset. Topic 842 only includes a similar exemption for the lease term test (see section 6.2). Consequently, some leases for which the present value test in current US GAAP was not even considered would have to consider the similar present value test in Topic 842 and some of those leases *might* therefore be classified as finance leases.
- While Topic 842 *permits* entities to continue to use 75 and 90 percent as bright-line thresholds when evaluating the lease term compared to the remaining economic life of underlying asset and lease payments (and any lessee residual value guarantee) compared to the fair value of the underlying asset lease classification tests, respectively, it does not *require* use of those thresholds. Consequently, an entity not utilizing those thresholds could reach a different conclusion about the classification of some of its existing leases if it reassesses lease classification under Topic 842 (see section 6.2).

13.3.740 In the first two examples in 13.3.730, the result of the changes to the lease classification guidance from current US GAAP to Topic 842 is that a previously classified operating lease might be classified as a finance lease. In the third example, in theory, the effect *could* be that a previously classified operating lease is classified as a finance lease *or* vice versa; however, it appears less likely that an entity could reasonably conclude that a lease term *greater than* 75 percent is not a 'major part' of the remaining economic life of the underlying asset or a present value of lease payments *greater than* 90 percent of the fair value of the underlying asset is not 'substantially all' of the fair value of the underlying asset than the opposite. See KPMG observation at 6.2.350–410.

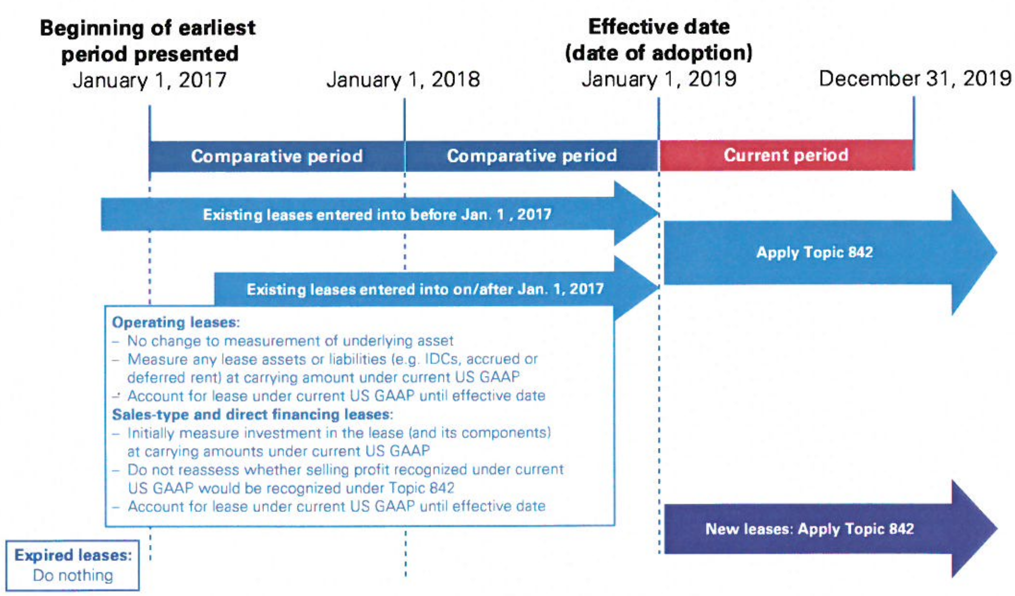
13.3.750 Based on our initial evaluation of the guidance, we believe that, to the extent some changes in lease classification would occur if a lessee were not to elect the package of practical expedients, most of those differences would be in the direction of previously classified operating leases becoming finance leases, rather than vice versa.

13.4 Transition for lessors

13.4.1 Lessor elects package of practical expedients

13.4.10 The following are the transition requirements applicable to a lessor that elects the transition practical expedients. Because lease classification is not reassessed in applying the package of practical expedients:

- all existing leases classified as operating leases under current US GAAP will be classified as operating leases under Topic 842; and
- all existing leases classified as sales-type or direct financing leases under current US GAAP will be classified as sales-type or direct financing leases under Topic 842. [842-10-65-1(f)(2)]



Leases classified as operating leases under current US GAAP

13.4.20 At the transition date, a lessor:

- continues to recognize the underlying asset and any lease assets or liabilities (e.g. accrued or deferred rent income or initial direct cost assets) at their carrying amounts recognized in accordance with current US GAAP immediately prior to the transition date; and
- accounts for previously recognized securitized receivables as secured borrowings in accordance with other GAAP, if applicable. [842-10-65-1(v)]

13.4.30 After the transition date, the lessor accounts for the operating lease in accordance with Topic 840 for periods prior to the effective date; and starting on the effective date, in accordance with the operating lease guidance in Topic 842.

Leases previously classified as sales-type or direct financing leases under current US GAAP

13.4.40 A lessor:

- continues to recognize, at the transition date, a net investment in the lease at the carrying amount of the net investment at that date; this includes any unamortized initial direct costs capitalized as part of the net investment in the lease in accordance with current US GAAP; and
- after the transition date, accounts for the net investment in the lease under current US GAAP for periods prior to the effective date; and starting on the effective date, under the recognition, subsequent measurement, presentation, and disclosure guidance under Topic 842. [842-10-65-1(x)(1) – 65-1(x)(3)]

13.4.50 If the lease is modified (and that modification is not accounted for as a separate contract) on or after the effective date, a lessor applies Topic 842 beginning at the modification date and accounts for the modification under the lessor modifications guidance in Topic 842. A lessor does not remeasure the net investment in the lease after the effective date unless the lease is modified (and that modification is not accounted for as a separate contract). [842-10-65-1(x)(4)]

13.4.2 Lessor does not elect package of practical expedients

Leases previously classified as operating leases under current US GAAP

Leases classified as operating leases under Topic 842

13.4.60 The accounting at, and subsequent to the transition date, is the same as that for a lessor that elects the package of practical expedients for its leases. As an exception, at the transition date, a lessor writes off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842. [842-10-65-1(v)]

Leases classified as direct financing or sales-type leases under Topic 842

13.4.70 The objective is to account for the lease, beginning on the transition date, as if it had always been accounted for as a direct financing lease or a sales-type lease in accordance with Topic 842. Therefore, at the transition date a lessor:

- derecognizes the carrying amount of the underlying asset;
- recognizes a net investment in the lease as if the lease had been accounted for as a direct financing lease or a sales-type lease under Topic 842 since lease commencement; and
- records the difference between the carrying amount of the underlying asset derecognized and the net investment in the lease recognized as an adjustment to equity. [842-10-65-1(w)]

13.4.80 After the transition date, the lessor accounts for the lease in accordance with Topic 842. [842-10-65-1(w)(4)]

Leases previously classified as direct financing or sales-type leases under current US GAAP

Leases classified as direct financing or sales-type leases under Topic 842

13.4.90 The accounting at, and subsequent to the transition date, is the same as that for a lessor that elects the package of practical expedients for its leases (see section 13.4.1). [842-10-65-1(x)]

13.4.100 Initial direct costs included in the measurement of the net investment in the lease are *not* written off even if they do not meet the definition of initial direct costs under Topic 842. [842-10-65-1(x)(1)]

Leases classified as operating leases under Topic 842

13.4.110 The objective is to account for the lease, beginning at the transition date, as if it had always been accounted for as an operating lease in accordance with Topic 842. Therefore, at the transition date, a lessor:

- derecognizes the carrying amount of the net investment in the lease;
- recognizes the underlying asset at what the carrying amount would have been had the lease been classified as an operating lease under current US GAAP; and
- records any difference between the carrying amount of the underlying asset recognized and the net investment in the lease derecognized as an adjustment to equity. [842-10-65-1(y)(4)]

13.4.120 A lessor subsequently accounts for the operating lease in accordance with Topic 842 and the underlying asset in accordance with other GAAP. [842-10-65-1(y)(4)]

Example 13.4

Lessor transition for operating lease under current US GAAP classified as sales-type lease under Topic 842 (i.e. package of practical expedients not elected)

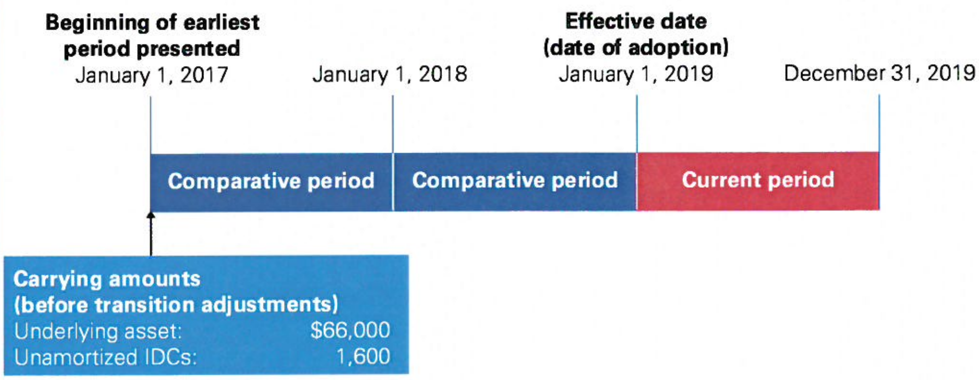
About the lease

13.4.130 The following table summarizes relevant information about Lessor LR's lease of equipment.

Commencement date of the lease:	January 1, 2016
Lease term:	5 years
Renewal, termination, or purchase options:	None
Lease payments (annual, paid in arrears):	$17,000
Estimated residual value of the equipment at the end of the lease term:	$18,000
Residual value guarantee (provided by either lessee or third-party):	None
Fair value at January 1, 2016:	$77,000
Carrying amount at January 1, 2016:	$77,000
Remaining (and original) economic life of the equipment:	7 years
Useful life of the equipment:	7 years
Initial direct costs incurred by lessor under current US GAAP (only $800 would meet the definition of initial direct costs under Topic 842):	$2,000
Rate implicit in the lease under current US GAAP, which does not factor in initial direct costs:	9.368%
Rate implicit in the lease under Topic 842 (i.e. the rate that causes the sum of the present value of the lease payments and the present value of the expected residual value to equal the sum of the fair value of the underlying asset and capitalizable initial direct costs):	9.010%
Lease classification at inception under current US GAAP:	Operating lease

13.4.140 The lease is not modified on or after the effective date.

Effective date and transition



13.4.150 LR does not elect the package of practical expedients. Therefore it reassesses whether the arrangement is or contains a lease, whether classification of the lease would be different under Topic 842, and whether the unamortized initial direct costs of $1,600 at January 1, 2017 would have qualified for capitalization under Topic 842.

13.4.160 LR determines that the arrangement is still a lease. However, assume that the lease is classified as a sales-type lease under Topic 842 (see KPMG observation at 13.4.200–220). Only $800 of the $2,000 in initial direct costs under current US GAAP meet the definition of initial direct costs under Topic 842, but that $800 would also have been capitalized because the fair value of the underlying asset equaled its carrying amount at lease commencement.

Worksheet at January 1, 2017 (beginning of earliest period presented)

13.4.170 The objective of the transition guidance in this case is to account for the lease, beginning on January 1, 2017 (i.e. the transition date), as if it had always been a sales-type lease accounted for in accordance with Topic 842.

Step	Amounts Debit/(credit)	Notes
Derecognize the carrying amount of the underlying asset	$(66,000)	$77,000 original carrying amount - 1 year of depreciation ($77,000 ÷ 7-year useful life = $11,000)
Derecognize entire unamortized portion of originally capitalized IDCs	(1,600)	$2,000 original amount of IDCs capitalized - 1 year of IDCs amortization ($2,000 ÷ 5 year lease term = $400) *The portion capitalizable under Topic 842 will be included in the net investment in the sales-type lease*
Recognize a net investment in the lease as if the lease had been accounted for as a sales-type lease under Topic 842 since lease commencement	67,810	Commencement date net investment in the lease of $77,800 ($77,000 fair value of the underlying asset + $800 in capitalizable IDCs) - Year 1 lease payment of $17,000 + Year 1 interest on the net investment in the lease of $7,010 ($77,800 × 9.010%)
Adjustment to equity	**$ (210)**	

13.4.180 Accordingly, LR records the following journal entry.

	Debit	Credit
Net investment in equipment lease	67,810	
Equipment		66,000
Unamortized initial direct costs		1,600
Retained earnings		210
To recognize sales-type lease on transition		

13.4.190 After January 1, 2017, LR accounts for the lease in accordance with Topic 842.

KPMG observation – Changes in lease classification on transition

13.4.200 Consistent with the KPMG observation at 13.3.730–750, we believe that it would be relatively infrequent that a lease classified as an operating lease under current US GAAP would have been classified as a sales-type or direct financing lease under Topic 842 or vice versa. The same examples outlined in 13.3.730 could result in a different classification of an existing lease for lessors if reassessed under the classification criteria in Topic 842, most likely from classification as an operating lease under current US GAAP to classification as a sales-type lease (or less frequently, to a direct financing lease).

13.4.210 In addition to the examples in 13.3.730, a lease classified as an operating lease under current US GAAP solely because either (1) collectibility of the minimum lease payments was not reasonably predictable, or (2) there were uncertainties surrounding the amount of unreimbursable costs yet to be incurred by the lessor under the lease would be classified as a sales-type lease under Topic 842. Topic 842 does not preclude sales-type lease classification when there are collectibility uncertainties or when there are significant uncertainties surrounding unreimburseable costs.

13.4.220 Consistent with our earlier lessee observations, it appears to us that, where lease classification might change for lessors if reassessed under Topic 842, it is most likely to involve operating leases being reassessed as sales-type or direct financing leases rather than the opposite.

KPMG observation – Initial direct costs included in the net investment in a sales-type or direct financing lease

13.4.230 If a lessor does not elect the package of practical expedients, it is required to reassess only whether those unamortized initial direct costs at the transition date capitalized in connection with an *operating* lease under current US GAAP would meet the definition of initial direct costs under Topic 842.

13.4.240 Initial direct costs capitalized in connection with a *direct financing* lease under current US GAAP[1] are included in the lessor's net investment in the lease. Unamortized amounts are not reassessed even if the lessor does not elect the package of practical expedients. Those amounts are not reassessed because the Board decided that sales-type/direct financing lessors should carry forward the same net investment in the lease it had under current US GAAP to Topic 842 at the transition date. Reassessing unamortized initial direct costs for those leases would have rendered that impossible in most cases given the substantially different definitions of initial direct costs between current US GAAP and Topic 842. [842-10-65-1(x)(1)]

Note 1:

Initial direct costs are not capitalized in connection with a sales-type lease under current US GAAP.

13.5 Applying the guidance on components of a contract on transition

13.5.10 Neither the transition guidance in Topic 842, nor the basis for conclusions, explicitly discuss the effect of the new guidance on identifying, separating, and allocating the 'consideration in the contract' to components of a contract (see chapter 4) on transition. Therefore, it is unclear whether the Board expressly considered the effect of this guidance, which is significantly changed in some respects from the comparable guidance in current US GAAP, on entities' transition efforts.

13.5.20 However, we believe that the requirements with respect to the new components guidance in transition can be derived from other requirements in the transition guidance. The following table describes what we believe the effect (or non-effect) of this guidance is on the various transition scenarios presented.

13.5.30 Each of these scenarios assumes that the lease is *not* modified or remeasured (lessees only) on or after the effective date. If a lease is modified (and that modification is not accounted for as a separate contract) or remeasured on or after the effective date, all of the requirements of Topic 842 become applicable to that lease, including the guidance on accounting for components of a contract.

Lessee

Operating → Operating

13.5.40 Lessees will not re-evaluate their previous allocations to lease and non-lease elements of a lease. This is because, absent a post-effective date modification or remeasurement, the transition guidance requires lessees to use the minimum rental payments determined in accordance with current US GAAP to account for the lease. Revising previous decisions with respect to identification, separation, and allocation of contract consideration would change the amounts used to account for the lease, directly contradicting the explicit requirement to account for the lease based on the minimum rental payments as determined under current US GAAP.

Lessee

Operating → Finance

13.5.50 The transition guidance applicable to this scenario requires the lessee to recognize and measure a new finance lease liability in the same way as for an operating lease that remains classified as an operating lease, and to derive the new finance lease right-of-use asset from the finance lease liability at the commencement date. Measurement of the lease liability is based on the minimum rental payments (as defined in current US GAAP). Revising previous decisions with respect to identification, separation, and allocation of contract consideration would change the amounts used to account for the lease, directly contradicting the explicit requirement to account for the lease based on the minimum rental payments as determined under current US GAAP.

Lessee

Finance → Finance

13.5.60 Lessees will not re-evaluate their previous allocations to lease and non-lease elements of a lease. This is because the transition guidance requires lessees to measure the initial finance lease right-of-use asset and initial finance lease liability at the same amounts recognized immediately before the transition date for the capital lease asset and the capital lease obligation, respectively. In addition, absent a post-effective date modification or remeasurement, lessees will not remeasure those amounts; they will simply complete the accounting for the lease based on those initially-measured amounts. Similar to the operating lease to operating lease scenario in 13.5.40, revisions to decisions made about components of the contract would require the lessee *not* to follow the explicit measurement requirements for this scenario.

Lessee

Finance → Operating

13.5.70 The transition guidance applicable to this scenario requires the lessee to derecognize its existing capital lease asset and capital lease obligation and, at the transition date, recognize and measure a new operating lease liability in accordance with Topic 842 and derive the new operating lease right-of-use asset from that lease liability. Measurement of the lease liability in accordance with Topic 842 is based on the lease payments. Because the lease payments are a function of the separation and allocation guidance in Topic 842 if there are either (1) multiple separate lease components or (2) lease and non-lease components of the contract, lessees will need to apply the multiple-component separation and allocation guidance to comply with the transition measurement requirements.

Lessor

Operating → Operating

13.5.80 The transition guidance requires lessors in this scenario to continue to recognize the underlying asset, as well as any other lease assets and liabilities (e.g. accrued rent assets or deferred rent liabilities), at the same amounts as immediately prior to the transition date under current US GAAP. If a contract that contains an operating lease includes multiple lease components and/or lease and non-lease components, revising the units of account and revising the allocation of the consideration in the contract (which might be different from the total contract consideration under current US GAAP if there are variable payments that specifically relate to non-lease components of the contract) would likely result in adjustments to any recognized lease assets or liabilities – i.e. a change would have resulted in a change to the lease payments, and therefore the accrued/deferred rent amount would typically be measured differently from that which resulted under current US GAAP.

Lessor

Sales-type/direct financing → Sales-type/direct financing

13.5.90 Lessors will not re-evaluate their previous allocations to lease and non-lease elements of a contract. This is because the transition guidance requires lessors to measure their initial lease assets under Topic 842 at the same amount recognized immediately before the transition date under current US GAAP. In addition, absent a post-effective date modification, lessors in this scenario will not remeasure their lease assets; they will simply complete the accounting for the lease based on the initially measured amount for the net investment in the lease.

$ Lessor

Operating → Sales-type/direct financing; or Sales-type/direct financing → Operating

13.5.100 The transition guidance states for either of these scenarios that "the objective is to account for the lease, beginning on the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, as if it had always been accounted for as an operating [a sales-type or direct financing] lease in accordance with this Topic." It therefore seems clear that this would include reassessing the lessor's accounting with respect to the components of the contract.

13.5.110 Taken as a whole, we believe that entities will only reassess their identification and accounting for components of a contract when the lease classification changes as a result of applying Topic 842 to the lease. If lease classification does not change or the entity elects the package of practical expedients, which means the entity will not reassess classification of its leases under Topic 842, entities will not reassess their identification of or accounting for multiple components of a contract. Avoiding the effort to reassess the accounting for components of a contract and avoiding the operational complexities that could arise from that exercise is another reason many entities will likely consider electing the package of practical expedients.

13.5.120 *However*, consistent with the discussion in the KPMG observation at 13.2.160 about identifying leases, the ability to not reassess identification of or accounting for multiple components of a contract presumes the entity applied the guidance in current US GAAP completely and accurately. For example, if an entity did not appropriately identify lease and non-lease components, or did not appropriately separate 'minimum rental payments' or 'minimum lease payments' from payments for non-lease components (e.g. services), the transition guidance does not excuse those errors.

13.6 Leveraged leases under current US GAAP

13.6.10 For leases classified as leveraged leases under Topic 840 and for which the commencement date is before the effective date, a lessor continues its existing leveraged lease accounting. However, if a leveraged lease is modified on or after the effective date, it is accounted for as a new lease at the modification date in accordance with Topic 842. [842-10-65-1(z)]

13.6.20 If a lessee exercises an option to extend a leveraged lease that commenced before the effective date of Topic 842 that it was not previously reasonably assured of exercising, the exercise of that option is considered a lease modification. [842-50-15-1]

13.6.30 For further discussion of leveraged leases, including KPMG's observation and a comparison to IFRS, see section 7.5.

13.7 Sale-leaseback transactions

13.7.10 If a sale-leaseback transaction was previously accounted for as a sale and a leaseback under current US GAAP, an entity does not reassess whether the transaction would have qualified as a sale (or purchase) under Topic 842. This means that buyer-lessors will not revisit whether a purchase of the underlying asset occurred for any sale-leaseback transactions entered into before the effective date. [842-10-65-1(aa)]

13.7.20 If a previous sale-leaseback transaction was, and continues to be at the effective date, accounted for as a failed sale under current US GAAP, the entity reassesses whether a sale would have occurred at any point on or after the beginning of the earliest period presented in the financial statements in accordance with Topic 842. If so, the sale-leaseback transaction is accounted for on a modified retrospective basis – i.e. in accordance with the transition guidance applicable to sale and operating leasebacks – from the date a sale is determined to have occurred. [842-10-65-1(bb)]

13.7.30 An entity accounts for the leaseback in accordance with the lessee and lessor transition requirements outlined in sections 13.2–13.5. [842-10-65-1(cc)]

13.7.40 If a transaction was previously accounted for as a sale and capital (finance) leaseback under current US GAAP, a seller-lessee continues to amortize any deferred gain or loss existing at the later of the beginning of the earliest period presented or the date of sale of the underlying asset as follows.

- If the asset is land only, over the remaining lease term on a straight-line basis.
- If the asset is not land only:
  - in proportion to the amortization of the right-of-use asset if the leaseback is a finance lease; and
  - in proportion to total lease cost recognized in profit or loss if the leaseback is an operating lease. [842-10-65-1(dd)]

13.7.50 If a transaction was previously accounted for as a sale and operating leaseback under current US GAAP, a seller-lessee:

- recognizes the portion of any deferred gain or loss not resulting from off-market terms as a cumulative-effect adjustment to equity at the later of the beginning of the earliest period presented (to equity) or the date of sale (to earnings of the comparative period presented).
- recognizes the portion of any deferred gain or loss that resulted from off-market terms as an adjustment to the leaseback right-of-use asset (if the sale price was below market) or as a remaining financial liability (if the sale price was above market) at the transition date. [842-10-65-1(ee)]

Example 13.5

Sale-leaseback transaction previously accounted for as a sale and an operating leaseback under current US GAAP

About the sale-leaseback transaction

13.7.60 The following table summarizes relevant information about Seller-Lessee SL's equipment sale-leaseback transaction with Buyer-Lessor BL. The transaction qualified as a sale and a leaseback – i.e. there was no failed sale.

Sale-leaseback transaction date:	January 1, 2018
Beginning of earliest period presented:	January 1, 2017
Leaseback term:	5 years
Leaseback payments (annual, paid in arrears):	$15,000
Sale price and fair value of equipment at transaction date:	$115,000
Carrying amount of equipment at transaction date:	$80,000
Remaining economic life of the equipment at transaction date:	9 years
Leaseback classification:	Operating lease
Initial direct costs:	None
Lessee residual value guarantee:	None

13.7.70 There is no automatic reversion of ownership to SL, nor does SL have an option to repurchase the equipment. SL retains more than a minor portion, but less than substantially all, of the remaining use of the equipment. Therefore, because the profit on the sale does not exceed the present value of the minimum lease payments under current US GAAP, the entire gain of $35,000 is deferred and will be recognized over the five-year leaseback term.

Effective date and transition

13.7.80 SL and BL are calendar year-end public business entities that adopt Topic 842 on January 1, 2019.

13.7.90 SL and BL do not reassess whether the transaction would have qualified for sale/purchase accounting under Topic 842. BL does not adjust its previous accounting for the purchase of the asset in any manner. Upon adoption of Topic 842 SL will record the following journal entry to (1) recognize the full amount of the profit on the sale-leaseback transaction as of the sale date (January 1, 2018), which is later than the beginning of the earliest period presented, and (2) reverse the journal entry recorded under current US GAAP to recognize one-fifth of the deferred gain during calendar 2018 (the first year of the leaseback term):

	Debit	Credit
Deferred profit on sale-leaseback transaction	35,000	
Gain on sale-leaseback transaction		35,000
Amortization of sale-leaseback transaction gain	7,000	
Deferred profit on sale-leaseback transaction		7,000

Subsequent accounting for the leaseback

13.7.100 SL and BL account for the leaseback in the same manner as any other lease that commenced during the transition period.

KPMG observation – Limited adjustments to retained earnings for existing sale-leaseback transactions

13.7.110 Consistent with the transition requirements for lessees and lessors, the sale-leaseback transition requirements generally limit the implementation cost and complexity for preparers. A seller-lessee will recognize an adjustment to equity in transition only for sale and operating leasebacks for which there is a deferred gain or loss not resulting from off-market terms.

US GAAP different from IFRS – Transition for sale-leaseback transactions

13.7.120 Like Topic 842, entities do not assess whether an existing sale and leaseback transaction meets the 'sale' criteria under the new revenue recognition standard (IFRS 15). Also like Topic 842, entities will, in effect, continue pre-adoption accounting for existing sale and finance leasebacks. [IFRS 16.C16–C18]

13.7.130 However, there are differences in the transition requirements applicable to sale and operating leasebacks and failed sale-leaseback transactions. The differences with respect to the former stem principally from differences between current US GAAP and IFRS; for example, while current US GAAP generally requires deferral of the gain on a sale and operating leaseback transaction, current IFRS generally requires recognition of the gain at the time of sale. With respect to the latter, Topic 842 includes specific transition guidance for failed sale-leaseback transactions, which are common under current US GAAP for real estate sale-leaseback transactions. IFRS 16 does not include similar guidance because current IFRS does not generally result in failed sale-leaseback transactions.

13.8 Build-to-suit lease arrangements

13.8.10 Current US GAAP addresses a lessee's involvement with the construction of an asset that the lessee will lease when construction is complete (i.e. build-to-suit lease accounting). Under that guidance, the transaction is subject to the sale-leaseback guidance if the lessee is deemed to be the accounting owner of the asset during the construction period because it has substantially all of the construction period risks (or meets other specified criteria).

13.8.20 Topic 842 supersedes the current build-to-suit lease accounting guidance and stipulates that a lessee is the accounting owner of an asset under construction when it *controls* that asset before the commencement date (see section 9.4). The new guidance about when a lessee controls an asset under construction that it will lease is similar to the guidance in Topic 606 about when a customer controls an asset under construction (or that is being modified) that it will purchase.

13.8.30 We believe that the new guidance will result in fewer instances where a lessee will be deemed the accounting owner of an asset under construction, but those instances will still occur.

13.8.40 A lessee applies a modified retrospective transition approach for leases accounted for as build-to-suit lease arrangements under current US GAAP that exist at, or are entered into after, the beginning of the earliest period presented. This approach does not require any transition accounting for build-to-suit leases that expired prior to the beginning of the earliest period presented.

- A lessee that recognized assets and liabilities solely as a result of a transaction's build-to-suit designation derecognizes those assets and liabilities at the later of (a) the beginning of the earliest period presented and (b) the date the lessee is determined to be the accounting owner of the asset under the current build-to-suit guidance. Any difference is recorded as an adjustment to equity at that date. A lessee then follows the general lessee transition guidance for the lease itself (see sections 13.2–13.3, and 13.5).
- For build-to-suit leases for which the construction period ended prior to the beginning of the earliest period presented and the transaction qualified for sale and leaseback accounting under existing guidance prior to that date, the entity applies the lessee transition requirements for the lease. [842-10-65-1(u)]

KPMG observation – No transition provisions provided when lessee is deemed the accounting owner under Topic 842 but not under current US GAAP

13.8.50 Because an entity can still be the accounting owner of an asset under construction under Topic 842, there may be cases where a lessee would have reached the same conclusion that it was the accounting owner of an asset under construction based on the current US GAAP guidance and the new guidance in Topic 842. In addition, because the underlying principle for when a lessee is the accounting owner of an asset under construction is different from that in current US GAAP, there may be instances where a lessee is the accounting owner of an asset under construction under Topic 842 for which would *not* have been deemed the accounting owner under current US GAAP.

13.8.60 It does not appear that the Board considered either of these possibilities when providing transition guidance for build-to-suit leases. The transition guidance appears to contemplate only situations in which the lessee was deemed the accounting owner of the asset under construction under current US GAAP but would not be deemed the accounting owner under Topic 842.

13.8.70 In the absence of specific transition guidance, we believe that an entity may consider the following modified retrospective transition approach.

If the lessee was previously deemed the accounting owner under current US GAAP and would also be considered the accounting owner under Topic 842

- Continue to recognize the assets and liabilities arising as a result of the lessee being deemed the accounting owner of the asset under construction until they qualify for derecognition (i.e. a sale of the asset occurs) in accordance with the sale-leaseback requirements in Topic 842:
  - If that occurs after the effective date of Topic 842, apply the sale-leaseback guidance in Subtopic 842-40.
  - If a sale of the asset would have occurred after the beginning of the earliest period presented in the financial statements, but before the effective date, apply the sale-leaseback transition guidance in Topic 842 applicable to previously failed sales. [842-10-65-1(bb)]
  - If a sale of the asset would have occurred before the beginning of the earliest period presented, follow the build-to-suit transition requirements in Topic 842. Derecognize the assets and liabilities as of the beginning of the earliest period presented in the financial statements and account for the lease in accordance with the lessee transition requirements.
- If, between the beginning of the earliest period presented in the financial statements and the effective date, the entity had completed a sale-leaseback transaction in accordance with current US GAAP (i.e. a sale had been completed under Subtopic 840-40), the entity would not reassess whether a sale also would have occurred under Topic 842 (or whether that sale would have occurred at a different date – earlier or later).

If the lessee was *not* previously deemed the accounting owner under current US GAAP but would be considered the accounting owner under Topic 842

- We believe that the Board did not contemplate an entity looking back to periods prior to the effective date to determine if it would have been the accounting owner of (i.e. controlled) an asset under construction, or that it would be the Board's intent for entities to do so. This would appear inconsistent with much of the Board's rationale for the transition approach in Topic 842 as a whole, and seemingly at odds with the guidance on sale-leaseback transactions under which an entity does not revisit whether a sale would have occurred prior to the effective date. Consequently, we believe that an entity is not *required* to undertake this evaluation. However, we believe that an entity generally would be required to evaluate, as of the effective date, any arrangement in which it is presently involved in the construction or design of an asset it will subsequently lease to determine whether it controls that asset.
- In contrast, we believe that the transition guidance applicable to build-to-suit leases does not *prohibit* an entity from evaluating whether it was the accounting owner of an asset under construction before the effective date. While we would expect it to be rare that an entity would choose to undertake this evaluation if not required to do so, if an entity chooses to do so, we believe that it would recognize the assets and liabilities arising as a result of the lessee being deemed the accounting owner of the asset under construction at the later of (1) the beginning of the earliest period presented, and (2) the date the lessee is determined to be the accounting owner of the asset under construction in accordance with Topic 842. From the date that the asset is recognized, the entity would account for the transaction in accordance with the sale-leaseback guidance in Topic 842.

13.9 Previous business combinations

13.9.10 If an entity previously recognized an asset (liability) relating to favorable (unfavorable) terms of an operating lease acquired as part of a business combination:

- a **lessee** derecognizes that asset (liability), and adjusts the carrying amount of the right-of-use asset recognized on transition by a corresponding amount.
- a **lessor** derecognizes that asset (liability) only if it arises from a sales-type or direct financing lease, and makes a corresponding adjustment to equity at the beginning of the earliest period presented in the financial statements. [842-10-65-1(h)]

13.9.20 A favorable operating lease asset or unfavorable operating lease liability is not written off in transition by operating lessors. Lessors will continue to recognize such favorable lease assets or unfavorable lease liabilities even after the adoption of the amendments to Topic 805 included in ASU 2016-02; for a discussion about leases acquired in a business combination, see chapter 11. [842-10-65-1(h)(1)]

KPMG observation – Effect of previously recognized favorable lease asset or unfavorable lease liability on lessee's subsequent accounting

13.9.30 Topic 842 does not prescribe or illustrate the subsequent accounting for a lease of a lessee that, at the transition date, is affected by a previously recognized favorable lease asset or unfavorable lease liability, other than to say that the asset or liability is written-off as an adjustment to the transition date right-of-use asset. However, we believe that:

- a favorable lease asset would affect the accounting for the lease on and after the transition date in the same manner as initial direct costs – i.e. it would increase the lessee's right-of-use asset recognized at the transition date; and
- an unfavorable lease liability would affect the accounting for the lease after the transition date in the same manner as a lease incentive – i.e. it would decrease the lessee's right-of-use asset recognized at the transition date.

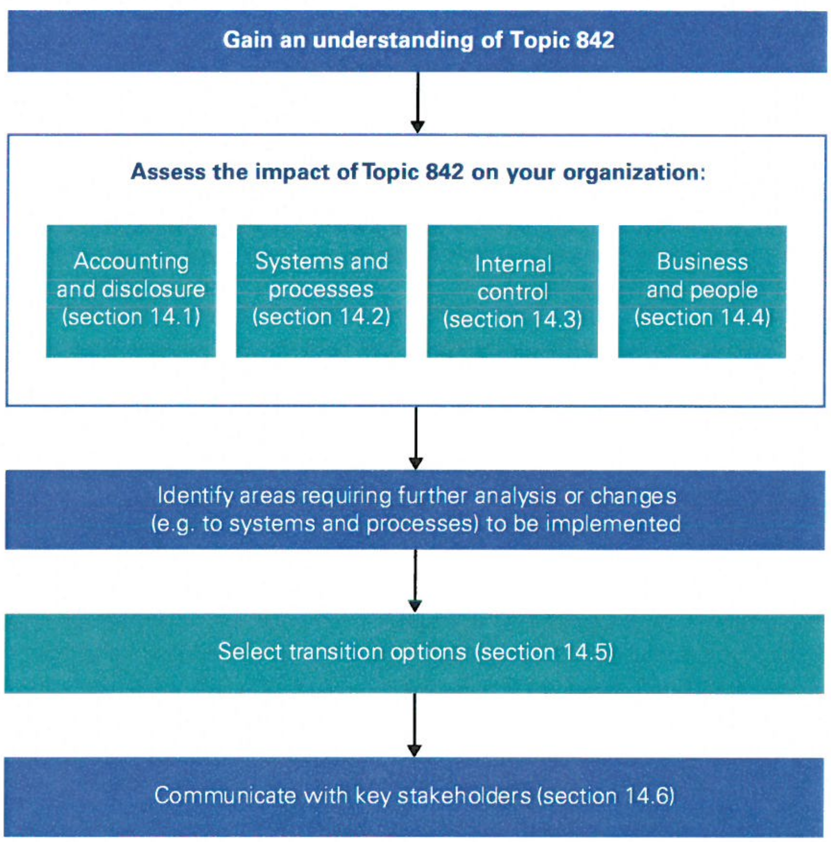
14 Next steps

An overview

The adoption of Topic 842 could have significant impacts – not just on the accounting and financial reporting, but also requiring changes in systems and processes used to account for lease transactions.

Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, and estimates. The change in accounting resulting from implementing Topic 842 could also impact entities' business decisions and the responsibilities of personnel and their training.

This chapter highlights the initial steps that an entity should take as a starting point to thinking about what kind of implementation process will be required.



14.1 Accounting and disclosure

14.1.10 Topic 842 will require new judgments, estimates, and calculations. For example, entities may need to make new/different judgments about:

- whether a contract meets the definition of a lease,
- identifying components within lease agreements, and
- determining the lease term.

As changes in accounting policies and data availability are identified in the gap analysis, the areas that will require new policies, judgments, estimates, and/or calculations will need to be identified.

14.1.20 After gaining an understanding of Topic 842, entities should perform an analysis to identify accounting differences that will arise from changes from current US GAAP, accounting policies that may need to change or be implemented, and additional disclosures that will be required.

14.1.30 The following are some of the key factors to consider.

Definition of a lease

14.1.40 In many cases, lease identification based on the definition of a lease will be obvious, and a transaction that is a lease today will be a lease under Topic 842. However, there are significant changes in the definition of a lease that will need to be considered as to their effect on more complex types of arrangements – e.g. some outsourcing, power purchase, and transport agreements.

→ See chapter 3.

Practical expedients

14.1.50 Entities have to decide whether to elect the exemption for short-term leases, and whether they can (and want to) apply portfolio-level accounting to any of their leases.

→ See sections 6.3.1 and 5.8.

Transition options

14.1.60 Entities have to decide whether to elect the transition practical expedients, weighing the potential benefits against the effect on the entity's reported financial information both in the comparative periods in the first set of financial statements issued after the effective date of Topic 842 and for a period of time after the effective date.

→ See section 14.5.

Lease classification

14.1.70 While Topic 842 mostly retains the current US GAAP lease classification regime, there are some changes that may significantly affect some entities. For example, lessors that enter into longer-term arrangements with significant variable lease payments, or enter into leases with lower credit quality customers, may reach lease classification conclusions different from those reached under current US GAAP, and both lessees and lessors will have to consider changes resulting from a new lease classification test (i.e. the alternative use test – see section 6.2).

→ See chapter 6 (lessees) and 7 (lessors).

14.1.80 Entities will need to develop accounting policies and procedures for lease classification and, if the transition practical expedients are not elected for existing leases, an approach for lease classification reassessment at transition.

Sale-leaseback transactions

14.1.90 Changes to the sale-leaseback guidance will require entities to first determine whether the transaction is a sale under Topic 606; the guidance in Topic 606 is indicator-based and markedly different from that applicable to sale-leaseback transactions under current US GAAP, requiring entities to make new judgments and determinations.

14.1.100 Entities will also need to assess whether the transaction includes specific provisions that would prevent accounting for the transaction as a sale – i.e. a purchase option at a strike price different from the underlying asset's fair value on the exercise date, a put option that the buyer-lessor has a significant economic incentive to exercise, or terms that would classify the leaseback as a finance lease.

14.1.110 Although the transaction may result in derecognizing the underlying asset – and, depending on the facts and circumstances, financing associated with the asset – seller-lessees will still recognize a right-of-use asset and lease liability for the leaseback unless the leaseback is a short-term lease.

→ See chapter 9.

Disclosure requirements

14.1.120 In addition to recognizing leases on-balance sheet, lessees will have to provide significant additional qualitative and quantitative disclosures compared to current US GAAP.

→ See chapter 12.

14.1.130 Entities will need to develop new processes and procedures for accumulating the relevant data and information necessary to meet those disclosure requirements.

Multi-jurisdictional financial reporting requirements

14.1.140 Because Topic 842 and the new International leasing standard, IFRS 16, are significantly different in a number of key areas (e.g. the accounting for lessee operating leases under Topic 842 and accounting for sale-leaseback transactions), entities that have to report under both US GAAP and IFRS will need to consider the impact that significantly different lease accounting requirements will have on their systems, process, and control needs.

→ See Appendix for a summary.

SEC registrants

14.1.150 Early on, SEC registrants will also need to consider their requirement to disclose the expected effect of Topic 842 on their financial statements. Generally, we would not expect entities, in particular lessees, to simply provide only boilerplate disclosure that they are "evaluating the effect of the new standard," without providing any more detailed information for very long after the issuance of ASU 2016-02. [SAB Topic 11-M]

14.2 Systems and processes

14.2.10 Complying with the requirements of Topic 842 will require most entities to both:

- gather or acquire information that has not been historically required to account for leases under current US GAAP – e.g. incremental borrowing rates for operating leases; and
- utilize information, some of which may not already be obtained for financial reporting purposes, for new purposes; for example, to recognize and measure operating lease liabilities and operating lease right-of-use assets, or to prepare new disclosures such as the weighted-average remaining lease term and weighted-average discount rate as of the balance sheet date.

14.2.20 Preparing an inventory of the information needed to apply Topic 842, mapping those needs to existing sources, and identifying gaps between the information needed and the information currently captured by existing sources will be critical steps early on in the implementation process. It is likely that, for most entities, additional information will need to be captured that is not already captured by entities' existing systems or processes. Entities should consider what new IT reporting packages, if any, need to be developed or acquired to meet the requirements of Topic 842.

14.2.30 To achieve a cost-effective solution, entities could evaluate the best way to source incremental information by:

- establishing the level of effort required to obtain new information from existing feeder systems and/or existing processes; and
- determining additional systems and/or process requirements that might be necessary.

14.2.40 Incremental IT systems capabilities *may* be needed for one or more of the following reasons:

- Existing leasing solutions are principally administrative in nature, rather than designed to meet accounting or financial reporting objectives, such that they do not accumulate or maintain information that will be necessary to meet the accounting and/or disclosure requirements in Topic 842. Even more sophisticated entities' lease administration systems likely were not designed to capture all of the information that will be needed.

- Entities often use a spreadsheet-based solution either as their primary leasing tool or as a significant supplemental tool. Those entities may conclude that their spreadsheet lease administration is not well enough controlled to rely upon in applying Topic 842.
- The entity has significant US GAAP and IFRS reporting requirements and needs incremental system capabilities to help it report under the different US GAAP and IFRS lease accounting requirements.

14.2.50 Even if new IT systems capabilities are not necessary, new *processes* will still be necessary to capture, and ensure the completeness and accuracy of, the additional information needed to meet the requirements in Topic 842 from existing systems, and to provide the incremental disclosures about the entity's leasing activities required by Topic 842.

14.2.60 Entities should also assess how applying Topic 842 will affect *existing processes,* including how new contracts or modifications to existing contracts are reviewed and/or approved and accounted for, and how information is compiled for financial reporting purposes.

14.2.70 Processes may also need to be reconsidered to ensure that information is captured for financial reporting purposes on a timely basis (e.g. accounting personnel learn of new leases or lease modifications in a timely manner) and management judgment is properly exercised at key points as financial information is prepared, and internal controls are in place and functioning effectively around key information and key judgments. Some existing processes that are decentralized may need to be made more centralized to ensure that accounting effects are appropriately considered and identified on a timely basis.

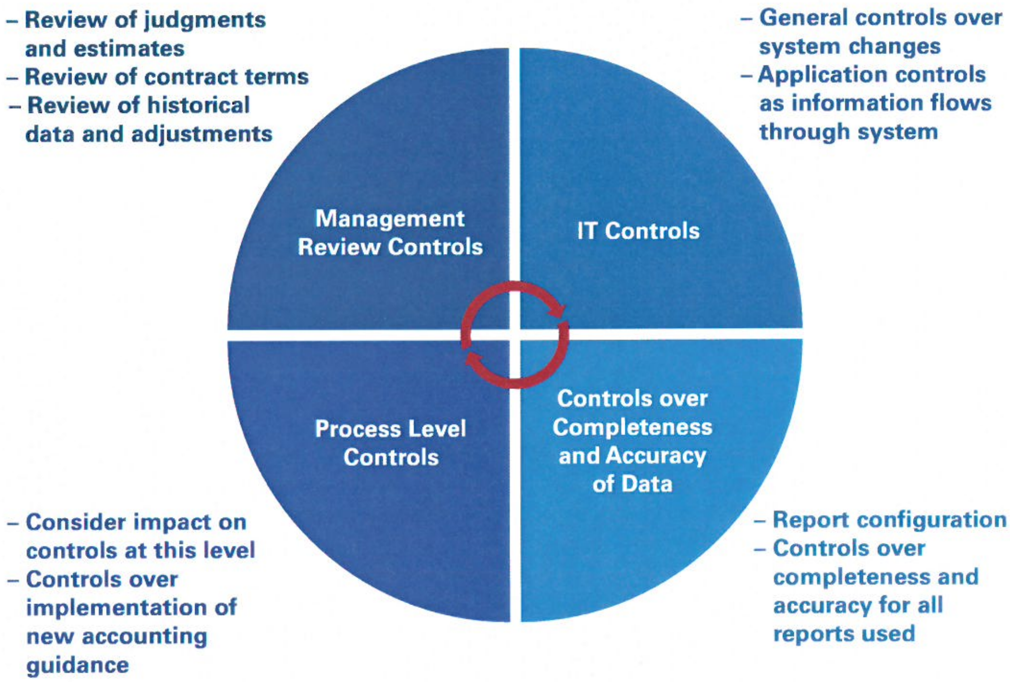
14.3 Internal control

14.3.10 Entities will need to consider the potential effect of required changes or additions to their systems and processes on their internal control environment, including internal controls over financial reporting. Many entities will need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, and estimates.

14.3.20 New risk points may arise from changes to IT systems and reports that provide data inputs used to support new estimates and judgments. To the extent that data is needed to comply with the accounting or disclosure requirements of Topic 842, entities will need to consider the internal controls necessary to ensure the completeness and accuracy of this information – especially if it was not previously collected, or was collected outside of the financial reporting environment (e.g. only for HR or legal purposes).

14.3.30 Because Topic 842 may require new judgments and perhaps different analyses, entities should consider the skill level, resource capacity, and training needs of employees who will be responsible for performing the new or modified controls; as well as the need for new management review controls if new processes and/or judgments will be performed by lower-level employees.

14.3.40 The following chart provides examples of different internal controls that may be affected.



14.3.50 Early in planning implementation, entities should also consider what processes and related internal controls should be designed and implemented to assess the impact of, and record accounting adjustments arising on, application of Topic 842. For example, new internal controls may be required relating to:

- identifying changes to existing accounting policies;
- reviewing contracts for accounting adjustments on application of Topic 842;
- recording accounting adjustments that have been identified; and
- preparing new qualitative and quantitative disclosures.

14.3.60 SEC registrants will need to consider the potential effect of any changes in internal controls on management's requirement to make its quarterly and annual disclosures, and certifications about disclosure controls, procedures, and internal controls.

14.4 Business and people

14.4.10 Entities should evaluate how Topic 842 will affect their organization and the users of their financial statements. Among other things, management should consider:

- the training that will be required for both finance and non-finance personnel, including the board, audit committee, senior management, and investor relations;
- the potential need to renegotiate current business contracts that include financial covenants linked to the current accounting for leases;
- the potential need to reassess buy-versus-lease decisions;
- what changes may be required to forecasting and budgeting processes;
- the need to set up a project management team and develop an efficient implementation plan early in the process; and
- communication plans to stakeholders, such as investors, creditors, board members, the audit committee, and some employees (see section 14.6).

14.4.20 Lessors will also likely need to consider the effect of Topic 842 on their customers, and therefore what that may mean for their businesses and their contracting practices. For example, a lessor's sales personnel should be aware that some lessees might want shorter lease terms or a more variable payment structure to limit recognized lease liabilities going forward; or might want to modify existing leases to limit the effect that Topic 842 will have on their financial statements.

14.4.30 When Topic 842 will have a significant effect on the entity (e.g. the entity is a lessee with a significant amount of leasing activity), effective governance will be a key element of a successful implementation. This includes input from and involvement of the audit committee, a steering committee, and a project management team.

14.5 Select transition and accounting policy options

14.5.10 As discussed in section 13.2, in the financial statements in which an entity first applies Topic 842, the entity recognizes and measures all leases that exist at the beginning of the earliest comparative period presented using a modified retrospective transition approach. In addition, there are two optional practical expedients.

- A package of practical expedients that provides relief in respect of the definition of a lease, the classification of leases, and initial direct costs. This package must be elected on an all or nothing basis.
- A practical expedient that allows the use of hindsight in assessing the likelihood that a lessee will exercise extension, termination, and purchase options and in assessing right-of-use assets for impairment.

14.5.20 An entity's decisions about which, if any, transition practical expedients to adopt will have a significant effect on its implementation efforts. Therefore, determining the transition options that the entity intends to apply should be an early step in the implementation process. The trade-off is between the cost of implementation and comparability between periods.

Select the transitional relief that is available?	Impact on cost:	Impact on comparability:
No:	↑	↑
Yes:	↓	↓

14.5.30 In addition, entities should weigh the benefit in terms of implementation effort that electing the practical expedients generally will provide against the financial reporting effect of that election – both the quantitative effects of each transition option and relevant qualitative factors. The following are a few examples of circumstances in which the practical expedients might have a significant effect on the entity's financial reporting.

- While most leases under current US GAAP will be leases under Topic 842, that will not universally be the case. If an entity enters into contracts that were leases under current US GAAP, but will not be leases under Topic 842, a decision to apply the transition practical expedients could significantly affect comparability going forward – i.e. as similar arrangements are entered into on or after the effective date and determined not to be leases – and could result in significantly different balance sheet reporting (e.g. the recognition of significant lease assets and lease liabilities, including after the effective date of Topic 842, that would not be recognized under Topic 842).

- An entity that today structures its leases to avoid capital lease classification (e.g. structuring lease terms to ensure that minimum lease payments are 89.9% of the fair value of the underlying asset) may decide, given that all of its leases will be on-balance sheet, that its investors and analysts would prefer finance lease accounting going forward. A decision to apply the transition practical expedients would affect comparability for a significant period of time if the entity continued to account for all of its existing leases as operating leases, but accounted for its leases entered into on or after the effective date as finance leases.
- If an entity has significant unamortized initial direct costs that would not qualify as initial direct costs under Topic 842 (see section 5.5), *not* electing the transition practical expedients would improve comparability between the accounting for existing leases and those leases entered into on or after the effective date. In addition, not electing the transition practical expedients would permit an entity to write off those unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 to equity, and therefore improve their performance going forward.

14.5.40 Accounting policy elections not specific to transition will also affect an entity's implementation process. For example:

- A lessee that elects the short-term lease exemption for a class of underlying assets (see section 6.3.1), does not apply the lessee transition guidance applicable to other leases to those leases that meet the definition of a short-term lease within that class of underlying assets.
- An entity's decision about whether to use the bright-line thresholds for lease classification (see sections 6.2 and 7.2 for lessees and lessors, respectively) will affect the entity's transition accounting if the entity does not elect the package of practical expedients.

14.5.50 Advanced planning with respect to selecting transition and related accounting policy options will allow time to address unanticipated complexities and will offer greater flexibility in maximizing the use of internal resources by spreading the implementation effort over a longer period.

14.5.60 Entities should therefore take steps to understand Topic 842 and then to evaluate the effects of applying the transition expedients and other accounting policy alternatives (e.g. the short-term lease exemption) on their financial reporting. If the expected effects of Topic 842 and/or the effects of selecting or not selecting transition practical expedients and accounting policy options are limited, it may be appropriate to wait longer to make these decisions.

14.5.70 The following diagram highlights the decisions to be made about transition in the broader context of implementation.

1. Perform a high-level gap analysis to identify potential drivers of accounting change
2. Determine the population of contracts that would need to be reassessed
3. Begin assessing the information that will be needed to apply Topic 842, both ongoing and in transition, and compare this to currently available information to identify potential data gaps
4. Identify the qualitative factors that may influence the choice of transition options, and consider engaging key stakeholders to understand which factors are most valued
5. Ensure that the transition approach is evaluated with the broader implementation effort for Topic 842
6. Monitor the activities of standard-setters and regulators related to the new standard(if any)

14.6 Communication with key stakeholders

14.6.10 Communication between management, the audit committee, and the external auditor is key to a successful implementation. Management may want to discuss key transition issues with the audit committee, including:

- whether there is a significant change expected to current accounting policies and disclosures;
- historical data availability and the importance of showing a consistent story about financing trends;
- investors' needs on lease-related financial information;
- the entity's readiness for change, including IT systems and accounting, legal, business, and tax knowledge of Topic 842; and
- whether the entity has long-term contracts, including their volume, duration, uniqueness, and significance.

14.6.20 As entities proceed with implementing Topic 842, they will also need to consider the timing and detail of communications to investors, analysts, and other key stakeholders, including:

- the expected impact of Topic 842 on the entity;
- the transition approach that will be applied; and
- when Topic 842 will be adopted.

Appendix

Summary of similarities and differences between US GAAP and IFRS

On January 13, 2016, the IASB issued IFRS 16, *Leases*, which requires lessees to present right-of-use assets and lease liabilities on-balance sheet for most leases of assets that are not of low value when new (e.g. $5,000 or less). IFRS 16 introduces a single, on-balance sheet accounting model that is similar to the current accounting under IFRS for finance leases (and US GAAP for capital leases). Lessor accounting will remain similar to current practice.

IFRS 16 is effective for entities that apply IFRS for annual periods beginning on or after January 1, 2019. Earlier application is permitted for entities that apply IFRS 15, *Revenue from Contracts with Customers*, on or before the date of initial application of IFRS 16.

The following table provides a summary comparison between the requirements of Topic 842 and IFRS 16. Differences between the two standards are discussed in more detail throughout this Issues In-Depth. For more information about the requirements of IFRS 16, visit the leases topic page at kpmg.com/ifrs.

<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td colspan="2">Definition of a lease (see chapter 3)</td></tr>
<tr><td colspan="2">– A contract contains a lease if:
» There is an identified asset; and
» The contract conveys the right to control the use of that asset for a period of time</td></tr>
<tr><td colspan="2">– A customer controls the use of an identified asset if it has the right, throughout the period of use, to:
» Direct the use of the asset; and
» Obtain substantially all of the economic benefits from use of the asset</td></tr>
<tr><td colspan="2">Practical expedients and targeted reliefs (see sections 5.8 and 6.3.1)</td></tr>
<tr><td colspan="2">– Optional lessee recognition and measurement exemption for short-term leases – i.e. leases with a lease term of ≤ 12 months (elected by class of underlying asset)</td></tr>
<tr><td>– If a lease includes a purchase option that the lessee is reasonably certain to exercise, it is not a short-term lease</td><td>– If a lease includes a purchase option, it is not a short-term lease</td></tr>
<tr><td colspan="2">– Portfolio-level accounting permitted if it does not differ materially from applying the requirements to individual leases (e.g. discount rate or lease term)</td></tr>
<tr><td>– No exemption for leases of low-value assets.</td><td>– Optional lessee recognition and measurement exemption for leases of low-value assets (e.g. $5,000 or less when new), even if material in aggregate</td></tr>
<tr><td colspan="2">Lessee accounting model (see chapter 6)</td></tr>
<tr><td>– Dual-lease accounting model</td><td>– Single lease accounting model</td></tr>
<tr><td>– Lease classification test based on current US GAAP classification criteria</td><td>– No lease classification test</td></tr>
<tr><td>– All leases on balance sheet: lessees recognize a right-of-use (ROU) asset and lease liability
» Finance leases treated as the purchase of an asset on a financed basis
» Operating leases generally have straight-line recognition of total lease cost</td><td>– All leases on balance sheet: lessees recognize a right-of-use (ROU) asset and lease liability
» All leases treated as the purchase of an asset on a financed basis.</td></tr>
</table>

US GAAP versus IFRS	
Topic 842	**IFRS 16**
Lessor accounting model (see chapter 7)	
– Dual lease accounting model	
– Lease classification test based on current US GAAP/IFRS classification criteria	
– Operating lease accounting model based on current operating lease accounting under both US GAAP and IFRS	
– Sales-type and direct financing lease accounting model based on current US GAAP accounting for sales-type and direct financing leases with recognition of net investment in lease comprising lease receivable and unguaranteed residual asset » Selling profit not recognized on commencement of leases classified as direct financing leases, even if the carrying amount and fair value of the underlying asset are different; selling profit recognized over the lease term	– Finance lease accounting model based on current IFRS finance lease accounting with recognition of net investment in lease comprising lease receivable and unguaranteed residual asset » No restriction on recognizing selling profit on commencement for finance leases
– Leveraged leases that have commenced prior to the effective date are grandfathered and exempt from applying the new standard unless modified on or after the effective date	– N/A – leveraged lease accounting does not exist under IFRS
Related party leasing transactions (see section 9.2 and chapter 12)	
– Account for leases between related parties based on their contractual terms, even if those terms are different from the substance of the arrangement	– N/A – the IASB did not address related party leasing transactions
– Disclose lease transactions between related parties	– N/A
Lease term and purchase options (see sections 5.3 and 5.4.4)	
– Payments for optional (e.g. renewal) periods and purchase options included in lease accounting if it is *reasonably certain* that the lessee will exercise those options, consistent with the high threshold in current US GAAP and IFRS	
– Lessees reassess renewal and purchase options if there is a significant event or significant change in circumstances that is within the control of the lessee and directly affects the assessment of whether the lessee will exercise an option (e.g. construction of significant leasehold improvements)	
– No reassessment of renewal and purchase options by lessors	

US GAAP versus IFRS	
Topic 842	**IFRS 16**
Initial direct costs (see section 5.5)	
– IDCs include only incremental costs that an entity would not have incurred if it had not obtained the lease (e.g. commissions or payments made to existing tenants to obtain the lease)	
– Lessees include IDCs in the initial measurement of the ROU asset and amortize the costs over the lease term	
– Lessors capitalize IDCs for operating leases and amortize the costs over the lease term in the same pattern as lease income	
– Lessors capitalize IDCs as part of the net investment in the lease for sales-type leases when the fair value of the underlying asset equals its carrying amount at lease commencement, and for direct financing leases. Otherwise, IDCs are expensed at lease commencement	– Non-manufacturer/dealer lessors capitalize IDCs as part of the net investment in the lease for finance leases – Manufacturer/dealer lessors expense IDCs arising from finance leases at lease commencement
Discount rate (see section 5.6)	
– The lessee's discount rate is the rate implicit in the lease (implicit rate), if readily determinable; otherwise, it is the lessee's incremental borrowing rate	
» The incremental borrowing rate is the rate a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the *lease payments* in a similar economic environment	» The incremental borrowing rate is the rate a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the ROU asset in a similar economic environment
– Lessees reassess the discount rate when there is: » A change in the lease term or the assessment of whether the lessee is, or is not, reasonably certain to exercise a purchase option » A lease modification that is not accounted for as a separate contract	
» N/A	» A change in future lease payments as a result of a change in floating interest rates
– Nonpublic business entity lessees permitted to elect as an accounting policy to use a risk-free discount rate	– N/A – no unique guidance for nonpublic business entities

<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td colspan="2">– The lessor's discount rate is the rate implicit in the lease. The rate implicit in the lease is the rate of interest that causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset (US GAAP only: minus any related investment tax credit retained and expected to be realized by the lessor), and (2) any capitalizable initial direct costs of the lessor</td></tr>
<tr><td colspan="2">– Lessors reassess the discount rate for the modified lease when there is a lease modification not accounted for as a separate contract</td></tr>
<tr><th colspan="2">Variable lease payments (see section 5.4.1)</th></tr>
<tr><td colspan="2">– Lease payments used in the initial measurement of lease assets and lease liabilities include:
» Variable payments based on an index or rate using prevailing (spot) rates or indices at lease commencement; and
» Variable payments that represent in-substance fixed payments (consistent with current practice)</td></tr>
<tr><td colspan="2">– Variable payments that are not based on an index or rate and are not in-substance fixed payments are excluded from the measurement of lease assets and liabilities and recognized as an expense when incurred or income as earned</td></tr>
<tr><td colspan="2">– No reassessment of variable lease payments by lessors</td></tr>
<tr><td>– Lessees reassess variable lease payments based on an index or rate only when lease payments are remeasured for other reasons (e.g. a reassessment due to a change in the lease term)</td><td>– Lessees reassess variable lease payments based on an index or rate on the date that:
» lease payments are remeasured for other reasons (e.g. a reassessment due to a change in the lease term); or
» there is a contractual change in the cash flows (i.e. when an adjustment to the lease payments based on an index or rate takes effect under the lease's terms)</td></tr>
<tr><th colspan="2">Arrangements with lease and non-lease components (see chapter 4)</th></tr>
<tr><td colspan="2">– Activities (or costs of the lessor) that do not transfer a good or service to the lessee (e.g. taxes and insurance on the property) are not components of a contract and, therefore, do not receive an allocation of the consideration in the contract (i.e. all or a portion of these costs will be included in the lease payments)</td></tr>
<tr><td colspan="2">– Lessors always separate lease and non-lease components and allocate consideration in the contract using the new revenue recognition standard's transaction price allocation guidance (i.e. on a relative stand-alone selling price basis)
» Reallocate consideration when there is a contract modification that is not accounted for as a separate contract</td></tr>
</table>

<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td colspan="2">– Lessees elect an accounting policy by class of underlying asset to either:
» Separate lease from non-lease components and allocate consideration in the contract based on the relative stand-alone prices of the separate lease and non-lease components to maximize the use of observable information
– Reallocate consideration when: (a) there is a remeasurement of the lease liability (e.g. because of a change in the lease term); or (b) there is a contract modification that is not accounted for as a separate contract
» Account for non-lease components together with the separate lease component to which they relate as a single lease component</td></tr>
<tr><th colspan="2">Contract combinations (see section 4.7)</th></tr>
<tr><td colspan="2">– Two or more contracts entered into at or near the same time with the same counterparty (or related parties) are combined into a single transaction if:
» 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; or
» The rights to use underlying assets conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component</td></tr>
<tr><th colspan="2">Lease modifications (see sections 6.7 and 7.7)</th></tr>
<tr><td colspan="2">– Lease modifications are defined as a change to the terms and conditions of a contract that results in a change in the scope of, or the consideration for, a lease (e.g. a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term)</td></tr>
<tr><td colspan="2">– A modification is accounted for as a separate contract when it grants the lessee an additional ROU that was not included in the original lease and the lease payments increase commensurate with the stand-alone price for the additional ROU, adjusted for the circumstances of that particular contract (IFRS: except for lessor operating lease modifications)</td></tr>
<tr><td>» N/A</td><td>» A lessor accounts for an operating lease modification as a new lease at the effective date of the modification (i.e. does not account for the modification as a separate contract under any circumstances)</td></tr>
<tr><td colspan="2">– For lessees, when a modification is not considered a separate contract:
» If the modification does not fully or partially terminate the existing lease, the ROU asset is adjusted by the amount of the adjustment to the lease liability
» If the modification fully or partially terminates the lease (e.g. reduces the assets subject to the lease, such as reducing an office space lease from two floors to one floor), the ROU asset is decreased on a basis proportionate to the full or partial termination of the existing lease. Any difference between the adjustment to the lease liability and the adjustment to the ROU asset is recognized in the income statement.</td></tr>
</table>

<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td colspan="2">– For lessors, when a modification is not a separate contract (IFRS: N/A for operating leases; operating lease modifications can never be accounted for as a separate contract), lease classification is reassessed and:</td></tr>
<tr><td>– Operating lease modifications
» If the modified lease is a sales-type or direct financing lease, the lessor derecognizes prepaid or accrued rent as an adjustment to the selling profit or selling loss
» If the modified lease is an operating lease, the lessor considers prepaid or accrued rent as part of the lease payments for the new lease</td><td>– Operating lease modifications
» A lessor accounts for an operating lease modification as a new lease at the effective date of the modification (prepaid or accrued lease payments from the original lease are considered lease payments for the new lease)</td></tr>
<tr><td>– Direct financing lease modifications
» If the modified lease is a sales-type lease, the lessor accounts for the modified lease as other sales-type leases, commencing at the effective date of the modification
» If the modified lease is a direct financing lease, the lessor adjusts the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease
» If the modified lease is an operating lease, the lessor recognizes the underlying asset at the carrying amount of the net investment in the original lease
– Sales-type lease modifications
» If the modified lease is a sales-type lease or a direct financing lease, the lessor adjusts the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease
» If the modified lease is an operating lease, the lessor recognizes the underlying asset at the carrying amount of the remaining net investment in the original lease</td><td>– Finance lease modifications
» If the modified lease would have been classified as an operating lease at inception, the lessor accounts for the modified lease as a new lease and recognizes the underlying asset at the carrying amount of the net investment in the original lease
» If the modified lease would have been classified as a finance lease at inception, the lessor applies IFRS 9, Financial Instruments</td></tr>
</table>

<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td colspan="2">Subleases (see chapter 8)</td></tr>
<tr><td colspan="2">– A lessee-sublessor accounts for the head lease and the sublease as two separate contracts unless those contracts meet the criteria for combining
» The head lease is accounted for using the requirements for lessee accounting
» The sublease is accounted for using the requirements for lessor accounting</td></tr>
<tr><td colspan="2">– A lessee-sublessor does not offset lease liabilities and assets arising from a head lease and sublease unless they meet the financial instruments requirements for offsetting in US GAAP or IFRS</td></tr>
<tr><td colspan="2">– A lessee-sublessor does not offset lease income from a sublease and lease cost from a head lease unless it meets the requirements for offsetting in other US GAAP or IFRS (e.g. the new revenue recognition standard)</td></tr>
<tr><td>– A sublessor considers the underlying asset rather than the ROU asset to be the leased asset in determining the classification of the sublease</td><td>– A sublessor considers the ROU asset to be the leased asset in determining the classification of the sublease</td></tr>
<tr><td colspan="2">Sale-leaseback transactions (see chapter 9)</td></tr>
<tr><td colspan="2">Determining whether a sale has occurred</td></tr>
<tr><td colspan="2">– A sale-leaseback of the underlying asset is recognized if the buyer-lessor obtains control of the underlying asset using the requirements in the new revenue recognition standard. The existence of the leaseback does not, on its own, result in a conclusion that control of the asset has not been conveyed to the buyer-lessor</td></tr>
<tr><td>– If the leaseback would be classified as a finance lease or a sales-type lease, then sale recognition is precluded</td><td>– N/A – single model approach for lessee accounting</td></tr>
<tr><td>– A repurchase option held by the seller-lessee in a sale-leaseback transaction precludes sale recognition unless:
» The strike price to repurchase the asset is its fair market value at the date of option exercise; and
» Assets that are substantially the same as the underlying asset are readily available</td><td>– If the seller-lessee has a substantive repurchase option with respect to the underlying asset, sale recognition is precluded</td></tr>
<tr><td colspan="2">– Both the seller-lessee and the buyer-lessor account for a sale-leaseback transaction that does not qualify for sale accounting as a financing transaction</td></tr>
</table>

<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td colspan="2">Accounting for a sale/purchase</td></tr>
<tr><td colspan="2">– A buyer-lessor accounts for the purchase of an asset in a sale-leaseback transaction that qualifies for sale accounting consistent with the applicable US GAAP or IFRS for the purchase of a nonfinancial asset</td></tr>
<tr><td colspan="2">– A seller-lessee accounts for any loss on a sale-leaseback transaction that qualifies for sale accounting consistent with the guidance that applies to any other sale resulting in a loss</td></tr>
<tr><td colspan="2">– A seller-lessee recognizes any gain on the sale of the underlying asset (the amount of the gain is different under Topic 842 and IFRS 16) at the time the sale is completed</td></tr>
<tr><td>– The gain on the sale is measured consistent with the guidance that applies to any other sale (i.e. the difference between the sale price and the carrying amount of the asset), subject to any adjustment for off-market terms</td><td>– The gain on the sale is restricted to the amount of the difference between the sale price and the carrying amount of the asset, as adjusted for off-market terms, that relates to the buyer-lessor's residual interest in the underlying asset</td></tr>
<tr><td colspan="2">Accounting for the leaseback</td></tr>
<tr><td colspan="2">– If a sale-leaseback transaction qualifies for sale accounting, the leaseback is accounted for in the same manner as other leases</td></tr>
<tr><td colspan="2">Accounting for off-market terms</td></tr>
<tr><td colspan="2">– Any potential off-market adjustment is measured as the more readily determinable of:
» The difference between the fair value of the underlying asset and the sale price, or
» The difference between the present value of fair-market value lease payments and the present value of the contractual lease payments</td></tr>
<tr><td colspan="2">– A deficiency in the transaction terms versus market terms is accounted for as a prepayment of rent</td></tr>
<tr><td colspan="2">– An excess in the transaction terms versus market terms is accounted for as additional financing provided by the buyer-lessor to the seller-lessee</td></tr>
<tr><td colspan="2">Lessee presentation – balance sheet (see section 6.8)</td></tr>
<tr><td colspan="2">– Lessees present finance lease ROU assets and lease liabilities either as separate line items on the balance sheet or disclose them separately in the notes to the financial statements</td></tr>
<tr><td>– If not separately presented on the balance sheet, lessees disclose in the notes the line items on the balance sheet in which finance lease ROU assets and lease liabilities are included and their amounts</td><td>– If not separately presented on the balance sheet, lessees:
» Present ROU assets as if the underlying asset were owned
» Disclose in the notes the line items on the balance sheet in which ROU assets and lease liabilities are included and their amounts</td></tr>
</table>

<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td>– Lessees do not include operating lease ROU assets and lease liabilities in the same line items as finance lease ROU assets and lease liabilities on the balance sheet
» If not separately presented on the balance sheet, lessees disclose in the notes the line items on the balance sheet in which operating lease ROU assets and lease liabilities are included and their amounts</td><td>– N/A – no operating lease classification</td></tr>
<tr><th colspan="2">Lessee presentation – statement of cash flows (see section 6.8)</th></tr>
<tr><td>– Lessees classify cash paid for:
» Principal on finance lease liabilities as financing activities
» Interest on finance lease liabilities based on the requirements relating to interest paid under Topic 230
» Operating leases, variable lease payments, and leases that are not recognized on-balance sheet (e.g. some short-term leases) as operating activities</td><td>– Lessees present cash paid for:
» Principal on lease liabilities as financing activities
» Interest on lease liabilities as either operating or financing activities based on the lessee's accounting policy choice under IAS 7
» Variable lease payments and leases that are not recognized on-balance sheet (e.g. some short-term leases) as operating activities</td></tr>
<tr><th colspan="2">Lessee disclosures (see chapter 12)</th></tr>
<tr><td>– Objective: Enable financial statement users to assess the amount, timing, and uncertainty of cash flows arising from leases</td><td>– Objective: Disclose information that, together with the information in the balance sheet, income statement, and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the lessee's financial position, financial performance, and cash flows</td></tr>
</table>

<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td>– Lessees disclose the following qualitative information:
» Nature of leases (and subleases)
» Leases that have not yet commenced, but that create significant rights/obligations, including involvement in construction or design of the underlying asset
» Significant lease accounting judgments and assumptions
» Main terms and conditions of sale-leaseback transactions
» If applicable, that the lessee elected the short-term lease exemption and the class(es) of underlying asset(s) for which it made that election. If short-term lease expense is not representative of lessee's short-term lease commitments, disclose that fact and amount.
» If applicable, that the lessee elected the practical expedient not to separate lease from non-lease components and the class(es) of underlying asset(s) for which it made that election</td><td>– Lessees disclose additional information, in addition to the required quantitative disclosures, in sufficient detail to satisfy the lessee disclosure objective. This may include, but is not limited to:
» Nature of leases (and subleases)
» Information about future cash flows to which the lessee is exposed (e.g. from variable lease)
» Payments or residual value guarantees)
» Main terms and conditions of sale-leaseback transactions
» Restrictions or covenants imposed by leases
» If applicable, that the lessee elected the short-term lease exemption. If short-term lease expense is not representative of lessee's short-term lease commitments, disclose the amount.
» If applicable, that the lessee elected the low-value assets lease exemption</td></tr>
<tr><td>– Lessees disclose the following quantitative information (in any format the lessee considers appropriate):</td><td>– Lessees disclose the following quantitative information (in a tabular format, unless another format is more appropriate):</td></tr>
<tr><td colspan="2">» Amortization of ROU assets and interest on lease liabilities (including amounts capitalized)</td></tr>
<tr><td>– For finance leases only
» N/A
» N/A</td><td>– Amortization split by class of underlying asset
» Additions to ROU assets
» Carrying amount of ROU assets, split by class of underlying asset</td></tr>
<tr><td colspan="2">» Short-term lease cost (when the lease term is > one month)
» Variable lease cost
» Sublease income (on gross basis)
» Gains (losses) from sale-leaseback transactions, net</td></tr>
</table>

US GAAP versus IFRS	
Topic 842	**IFRS 16**
» Operating lease cost	» N/A
» N/A	» Expense relating to leases of low-value assets
» Cash paid for lease payments, separately for finance and operating leases and segregated between operating and financing cash flows	» Total cash outflow for leases
» Supplemental noncash information on lease liabilities exchanged for ROU assets, separately for finance and operating leases	» N/A
» Weighted-average remaining lease term, separately for finance and operating leases	» N/A
» Weighted-average discount rate as of the balance sheet date, separately for finance and operating leases	» N/A
» A maturity analysis of lease liabilities for each of the first five years after the balance sheet date and in total thereafter, including a reconciliation of undiscounted cash flows to lease liabilities on the balance sheet, separately for finance leases and operating leases	» A maturity analysis of lease liabilities using IFRS 7, separate from the maturity analysis for other financial liabilities
– N/A	– If ROU assets meet the definition of investment property under IAS 40, provide applicable disclosures. In this case, the lessee is not required to disclose quantitative information about ROU assets and sublease income in IFRS 16.
– N/A	– If the lessee measures ROU assets at revalued amounts under IAS 16, provide applicable disclosures

US GAAP versus IFRS	
Topic 842	**IFRS 16**
Lessor presentation – balance sheet (see section 7.8)	
– Lessors present assets from sales-type and direct financing leases as an aggregate net investment in the lease. The net investment is presented separately from other assets. » Lease assets are subject to the same current/non-current classification requirements as other assets	– Lessors present assets held under a finance lease as a net investment in the lease
– Lessors present underlying assets subject to an operating lease in accordance with other GAAP (e.g. Topic 360)	– Lessors present underlying assets subject to operating leases according to the nature of the underlying asset
Lessor presentation – income statement (see section 7.8)	
– Lessors either present in the income statement, or in the notes, income arising from leases (and if disclosing in the notes, which line item(s) include lease income) – Lessors present selling profit or loss recognized at lease commencement in a manner that best reflects the lessor's business model	– Manufacturer and dealer lessors present selling profit or loss in accordance with their policy for outright sales under the new revenue recognition standard
Lessor presentation – statement of cash flows (see section 7.8)	
– Lessors classify all cash inflows from all leases (i.e. operating, sales-type and direct financing leases) as operating activities in the statement of cash flows	– N/A
Lessor disclosures (see chapter 12)	
– *Objective*: Enable financial statement users to assess the amount, timing, and uncertainty of cash flows arising from leases	– *Objective*: Disclose information that, together with the information in the balance sheet, income statement, and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the lessor's financial position, financial performance, and cash flows

<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><td>– Lessors disclose the following qualitative information:
» Nature of leases
» Information about managing the risk associated with the residual asset
» Significant lease accounting judgments and assumptions</td><td>– Lessors disclose qualitative and quantitative information, in addition to the required quantitative disclosures, in sufficient detail to satisfy the lessor disclosure objective. This may include, but is not limited to:
» Nature of leases
» Information about managing the risk associated with the residual asset</td></tr>
<tr><td colspan="2">– Lessors disclose the following quantitative information:
» A table of lease income recognized during the reporting period
– For finance leases, disclose:
• Profit or loss recognized at lease commencement
• Interest income on net investment in leases
• Lease income related to variable lease payments not included in net investment in leases
– For operating leases, disclose lease income related to lease payments, separately disclosing income on variable lease payments not based on an index or rate
» A maturity analysis of (a) the undiscounted cash flows comprising a lessor's lease receivables (for finance leases), and (b) the undiscounted future lease payments (for operating leases) for each of the first five years and a total thereafter
– For finance leases, the amounts included in the maturity analysis are reconciled to the balance of lease receivables presented separately in the balance sheet or disclosed separately in the notes
– A lessor presents the operating lease maturity analysis separately from the maturity analysis required for finance leases</td></tr>
<tr><td colspan="2">Operating leases
– General property, plant, and equipment disclosures by significant class of underlying asset separately from those disclosures for the lessor's other owned assets</td></tr>
<tr><td>Direct financing leases</td><td>Finance leases</td></tr>
<tr><td>– An explanation of the significant changes in the balance of unguaranteed residual assets and deferred selling profit</td><td>– A qualitative and quantitative explanation of the significant changes in the net investment in finance leases during the reporting period</td></tr>
</table>

<table>
<tr><th colspan="2">US GAAP versus IFRS</th></tr>
<tr><th>Topic 842</th><th>IFRS 16</th></tr>
<tr><th colspan="2">Lessee transition (see section 13.3)</th></tr>
<tr><td>– Modified retrospective transition:
» Required for all leases existing at, or entered into on or after, the beginning of the earliest comparative period presented in the financial statements
» Does not require transition accounting for leases that expired prior to the date of initial application</td><td>– Full retrospective approach or modified retrospective approach:
» Under the modified retrospective approach, a lessee does not restate comparative information
» At initial application date, recognize the cumulative effect of application as an adjustment to the opening balance of retained earnings (or other equity component as appropriate)</td></tr>
<tr><td>– Lessees may elect specified reliefs, which must be elected as a package and applied to all of the entity's leases (including those for which the entity is a lessor):
» Not to reassess whether expired or existing contracts contain leases
» Not to reassess lease classification for expired or existing leases
» Not to reassess initial direct costs for existing leases</td><td>– Lessees may elect not to reassess whether contracts contain leases at the date of initial application, which must be elected and applied to all of the lessee's contracts</td></tr>
<tr><td>– Lessees may use hindsight in evaluating whether payments for lease renewals and purchase options should be included in lease payments, and in assessing impairment of the entity's right-of-use assets, when accounting for existing leases. This practical expedient may be elected separately or in conjunction with the package of specified reliefs, and must be applied to all leases.</td><td>– Lessees may use one or more of the following practical expedients when applying the modified retrospective approach to leases previously classified as operating leases under current IFRS, which can be elected on a lease-by-lease basis:
» Use hindsight, such as in determining the lease term
» Rely on their assessment of whether leases are onerous under IAS 37 immediately before the date of initial application instead of performing an impairment review
» Apply a single discount rate to a portfolio of leases with reasonably similar characteristics
» Elect not to apply the transition requirements to leases for which the lease term ends within 12 months of the date of initial application
» Exclude initial direct costs from the ROU asset at the date of initial application</td></tr>
</table>

US GAAP versus IFRS	
Topic 842	**IFRS 16**
Lessor transition (see section 13.4)	
– Modified retrospective transition » Required for all leases existing at, or entered into on or after, the beginning of the earliest comparative period presented in the financial statements » Does not require any transition accounting for leases that expired prior to the date of initial application – Lessors may elect specified reliefs, which must be elected as a package and applied to all of the entity's leases (including those for which the entity is a lessee) » Not to reassess whether expired or existing contracts are or contain leases » Not to reassess lease classification for expired or existing leases » Not to reassess initial direct costs for existing leases	– Continue to apply existing accounting for any leases that are ongoing at the date of initial application, except for intermediate lessors in a sublease – Intermediate lessors in subleases reassess each ongoing operating sublease at the date of initial application to determine whether under the new standard it is classified as an operating lease or a finance lease, based on the remaining contractual terms of the head lease and the sublease – For subleases that were classified as operating leases under current IFRS guidance on leases, but finance leases under the new standard, account for the sublease as a new finance lease entered into on the date of initial application – Lessors may elect not to reassess whether contracts are or contain leases at the date of initial application, which must be elected and applied to all of the lessor's contracts
– Lessors may use hindsight in evaluating whether payments for lease renewals and purchase options should be included in lease payments when accounting for existing leases. This practical expedient may be elected separately or in conjunction with the package of specified reliefs, and must be applied to all leases.	– N/A

Detailed contents

Detailed contents

Index of examples

Keep informed

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The Financial Reporting Network (FRN) provides a single source for the latest, executive-level financial reporting information, as well as news and activity from standard setters and industry sources – all organized by topic. It has been designed to help keep executives in front of critical issues in today's evolving financial reporting environment. We not only keep a close watch on the latest financial reporting developments, we report on them and interpret what they might mean for you.

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JD Edwards Lease Accounting

2017 Statement of Direction

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Lease Accounting
FASB ASC 842 and IASB 15 Leases

- **What's Happening**
  - Standards changing effective 2019 – Carry Leases on the Balance Sheet
  - Property and non-property leases
- **Who Does this Impact**
  - Most all Companies
    - Do you rent/lease printers, laptops, Trucks, heavy equipment, buildings, office space?
  - Lessor's and Lessee's

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Statement of Direction

JD Edwards Lease Accounting Plans

High Level Solution

- Support For lessors **and** lessees
- For property **and** non-property leases
- For single and multi-asset leases
- Integrated with Fixed Assets
- Integrated with AP for automatic lease payments and balance sheet updates
- Support for Revenue recognition for lessors

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Statement of Direction

JD Edwards Lease Accounting

Considerations

- **Customers are asking questions now**
  ….yes, JDE will support them
- **Think 9.2 by 2019**
- **Benefits**
  - **Increase productivity** with auto-generated balance sheet entries for leased assets
  - **Minimize time and cost of audits** through a central source to manage leases and leased assets
  - **Reduce financial close process** with integrated lease management, fixed asset, and lease payments solution
  - **Accurately recognize revenue** through configured rules for lessors

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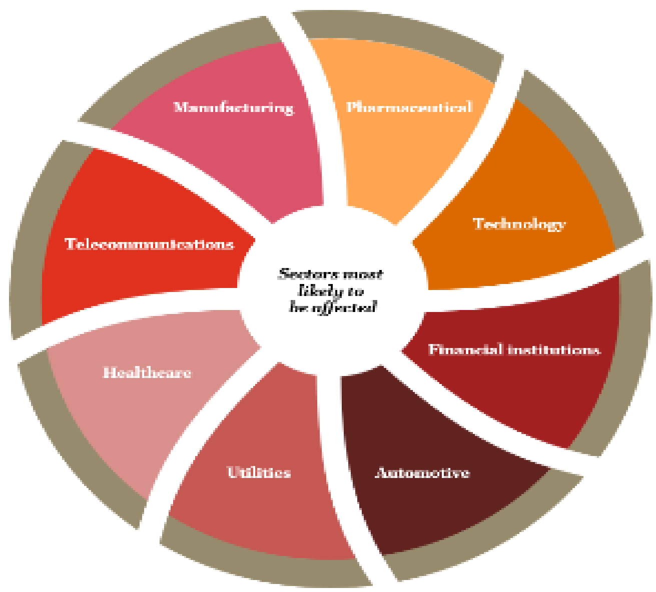
Are leases embedded in your contracts?

What you need to know

- The FASB's new lease accounting standard requires lessees to record an asset and liability on the balance sheet for nearly all leases.
- Identifying embedded leases is important to avoid misstating the balance sheet.
- As a general rule, an embedded lease exists if there is an explicit or implicit asset in the contract and the customer controls use of the asset.
- If you identify an embedded lease, you need to separate the contract into its lease and nonlease components and allocate consideration to each. Then, you need to classify each embedded lease as an operating or finance lease. Reassessment of these conclusions may be required.
- Changing certain contract terms may change the conclusion regarding whether an arrangement contains an embedded lease.

Does your company outsource its manufacturing? Do your supply arrangements bundle services and a device? Does your company rely on suppliers for products? Do you have data center arrangements?



The FASB recently issued its new lease accounting standard. Under the new guidance, lessees will recognize an asset and liability for nearly all of their leases. This requirement also applies to any leases embedded in other arrangements, like supply contracts, data center agreements, and outsourcing agreements.

While current leasing guidance requires that embedded leases be identified and accounted for separately, most lessees were not always diligent in doing so because typically, they were off-balance-sheet and did not have a material impact on the income statement. But under the new guidance, balance sheet amounts will be misstated if embedded leases are not identified and accounted for appropriately.

The requirement in the new leases standard to identify and account for embedded leases could have a significant impact on companies that rely heavily on outsourcing, data centers, bundled goods and services contracts, or other similar arrangements.

Identifying an embedded lease

There is judgment involved in assessing if an arrangement contains an embedded lease. The general rule under the new model is that an arrangement contains a lease if (1) there is an explicit or implicit asset in the contract, and (2) the customer controls use of the asset.

There is an embedded lease - what's next?

Once you identify an embedded lease, the contract needs to be separated into its lease and nonlease components. A component is an item or activity that transfers goods or services to the lessee. Under the new guidance, items such as property taxes and insurance that the lessee pays to the owner are not separate components because the lessee does not obtain a separate good or service for them. Instead, they are considered as part of the lease payment.

The next step is to allocate the contract consideration among the identified components based on their relative, observable standalone prices. The standalone prices for the lease versus nonlease components might not be readily apparent, and you may have to get the information from the lessor, or make an estimate if the lessor is not willing to share such information. Finally, each embedded lease component needs to be classified as an operating or finance lease. The classification will determine the specific balance sheet presentation and the expense recognition model (straight-line rent expense for an operating lease and front-loaded expense for a finance lease).

Reassessment

The new guidance adds more circumstances that require reassessment, and if necessary, reallocation and reclassification. The reassessment requirements in the new standard - which go well beyond actual modifications - are a significant change from today. Lessees will need new processes to monitor changes in circumstances that require revisions to lease accounting.

What lessees should consider

How an arrangement is structured can impact whether it contains an embedded lease. For example, contracts that specify particular assets may be accounted for differently than those in which the supplier can substitute the assets. Similarly, different provisions may influence the conclusion regarding whether the lessee controls the use of the asset.

Join our webcast and take our lease accounting survey

Webcasts on March 3 (replay available) and March 17

Survey: How will the new standards impact you?

In the loop

Executive-level insight into today's top financial reporting and regulatory issues

How PwC can help

To have a deeper discussion about embedded leases, please contact:

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You may also want to see

In brief: Lease accounting: The long-awaited FASB standard has arrived

In depth: The leasing standard - A comprehensive look at the new model and its impact

In the loop: Lessor accounting: how the new lease and revenue standards interact

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The overhaul of lease accounting

Catalyst for change in corporate real estate

The US GAAP edition

April 2016

pwc

Dear friends,

The newly-released lease accounting standard effects all leased assets, from airplanes to copiers, and changes the reporting characteristics of such obligations. For companies that are heavy users of real estate, the rules related to the new standard may be an incentive to reconsider their real estate strategy. Implementation of the new rules may have a significant impact on the company's financial statements and require substantial changes to processes and systems.

Many companies, especially those that utilize significant real estate as part of their operations, are already reconsidering their real estate strategies. In many cases, this reconsideration is part of an effort to unlock shareholder value in existing assets or to provide growth capital for the continued expansion of capital-intensive industries. Increasingly, activist investors are driving these pressures, who are not likely to go away any time soon. The new lease accounting standard may serve to further increase the focus on real estate in general, and leasehold interests in particular.

Management at companies of all sizes and in all industries needs to be prepared to provide shareholders and investors with a well-articulated real estate strategy that is supported by a proactive assessment of the company's existing property portfolio, including both owned and leased assets. By telling a clear story and openly communicating with shareholders and investors, companies both minimize the risk of becoming an activist target and help to build shareholder value.

When you are evaluating your real estate strategy, for whatever reason, PwC can help. We can help you understand the new standards and the implications to your business, as well as help you consider the implications to your broader real estate strategy. Through our specialists' global presence and extensive knowledge of capital markets, PwC can also provide you with the insight you need to achieve increased organizational transparency for investors and shareholders. PwC offers a powerful combination of personal service, specialized experience, and global reach that sets us apart and helps you achieve your goals.

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Table of contents

Executive summary

In preparation for the new GAAP leases requirements, or to be more nimble in the current economic climate, senior management at many companies are targeting their corporate real estate strategy and operations for major renovation and update. The existing corporate real estate function may have originally been designed to support a very different operational structure compared to what exists today, or may even have been originally motivated by financing or tax considerations that are no longer applicable. The changes to lease accounting may provide a catalyst for change to these operations that goes beyond adapting to the technical requirements of the accounting, and may include reconsideration of strategy and the potential engagement in real estate monetization transactions.

The coming changes

The FASB and IASB have both recently issued new accounting standards that radically transform lease accounting. Unfortunately, while the boards worked together on the project and were previously largely aligned, they reached very different conclusions in certain areas, most significantly relating to the income statement treatment of many leases. This divergence will cause complications for multi-national companies dealing with the different models in different jurisdictions. This publication deals predominately with the application of the FASB model and its implications on US reporting entities.

The changes in the new standard will affect almost every company. Under the new model, a lessee's rights and obligations under all leases (except short-term leases)— existing and new—will be recognized on its balance sheet. The income statement treatment will be based on the classification of the lease as either an operating lease or a finance lease, which are differentiated using rules largely similar to those applied today for classifying capital leases.

The effective date for calendar year end public business entities is 2019, with some relief on transition under several practical expedients. Upon adoption, prior comparative periods will need to be recast. For public business entities, this means 2017 and 2018 will need to be recast to reflect the impact of the new standard–which is right around the corner.

Overview of the new leases standard

- The biggest changes were made to lessee accounting. Generally, pre-existing leases will not be grandfathered. Lessor accounting is substantially the same under the new standard compared to today's accounting.
- Essentially all assets leased under operating leases (except short term leases that are less than 12 months at lease commencement) will be brought on balance sheet. The lease liability will be equal to the present value of lease payments. A corresponding right-of-use asset will be based on the liability, subject to certain adjustments, such as for initial direct costs.
- For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Operating leases will result in straight-line expense (similar to current operating leases), while finance leases will result in a front-loaded expense pattern (similar to current capital leases). Classification is based on criteria that are largely similar to those applied in current lease accounting, but without explicit "bright lines." While bright lines no longer exist, we believe that a reasonable approach may be to consider the previous percentages when determining lease classification (i.e., 75% of the economic life of the underlying asset and 90% or more of the fair value of the underlying asset).
- Lease accounting will continue to require significant judgment, including estimates related to the lease term, lease payments, and the discount rate. Similar to today, the term of the lease will include the noncancellable lease term plus renewal periods that are reasonably certain of exercise by the lessee or within the control of the lessor and periods covered by an option to terminate the lease that the lessee is reasonably certain not to exercise.
- Variable rent payments are generally excluded when assessing classification and when measuring the lease liability, except those based on an index or rate, which are included based on the index or rate at lease commencement. Subsequent changes to the index or rate (e.g., changes in CPI) and other variable payments will be treated similar to contingent rent today. A lessee will only reassess variable lease payments that depend on an index or rate when the lease liability is remeasured for another reason independent of a change in a reference index or rate. Lease incentives should be included in lease payments when classifying the lease and measuring the lease liability.
- When calculating present value, the applicable discount rate will be determined similar to existing leasing literature, except that lessors will be required to include deferred initial direct costs in their calculation of the rate implicit in the lease.
- Lessees will need to monitor for the occurrence of certain triggering events on an ongoing basis. For example, upon certain events under the lessee's control or an option that is exercised or not exercised as planned, the lessee must reassess the lease term. A change to the lease term may lead to reclassification of the lease and remeasurement of the right-of-use asset and lease liability. In such cases, assumptions related to variable rents based on an index or rate and the discount rate will be updated as of the remeasurement date.
- A lease modification may be accounted for as a modification to the original lease or as the creation of a separate lease. A lessor should not reassess the lease term or a lessee option to purchase the asset unless the lease is modified and that modification is not accounted for as a separate lease.
- Existing sale and leaseback guidance, including guidance applicable to real estate, is replaced with a new model applicable to both lessees and lessors. Existing sale and leasebacks will need to be addressed in transition – which may include recognizing previously deferred gains as an adjustment through opening equity as of the earliest period presented upon adoption.
- Financial performance ratios may be impacted and other new operating metrics may evolve as a result of the adoption of the new standard.
- For some companies, the new standard will require significant system and process changes prior to the adoption date.
- Companies with international operations many need to consider the impact of the new lease standard under IFRS. There are significant differences between the US GAAP and IFRS standards in that IFRS requires a single model in which all leases are treated as financing transactions.

At a minimum, compliance with the new standard may drive companies to consider significant upgrades, replacements, or overhauls of their legacy accounting systems, processes, and controls. Importantly, the new standard may also have a significant impact on a company's operating results, financial ratios, and debt covenants. The scope of areas impacted by adoption goes well beyond just financial accounting. Many companies are already starting to plan for the coming changes, which may have operational, legal, tax, and IT implications.

For some companies, the new lease accounting standard will represent just another compliance exercise, but one that is likely to entail significant cost and complexity. The cost of adoption is likely to include the education of all key stakeholders, robust systems upgrades, new processes, and implementation of new controls.

For others, the compliance exercise will serve as a much-needed catalyst for change in their overall corporate real estate strategies. Because the new model will eliminate the off-balance sheet accounting for existing operating leases, it may also eliminate some of the perceived accounting advantages of leasing. Thus, the new standard may be an impetus for many to overhaul their real estate strategies. Changes to strategy may include re-evaluating lease versus buy decisions and considering the accounting ramifications of alternate lease structures. Such alternative structures could be different lease terms, variable rent (e.g., net lease structures over gross/modified gross leases for CAM/insurance/real estate taxes, leases based on CPI) or considering contingent rent over leases with increasing fixed rent payments.

For significant users of real estate (e.g., retail, healthcare, and hospitality companies), it will be critical to manage stakeholder relations during the transition to the new standard. Board members, analysts, and shareholders will have many questions about the potential financial reporting impact and necessary investments in new systems, processes, and controls. In addition, the significant changes to the financial statements, and the related changes in financial metrics, will require thoughtful investor/analyst communication and possible changes to compensation arrangements and debt covenants.

But it's not just the new leases standard that has management reconsidering their real estate strategies. The real estate industry has recently seen a variety of economic, tax, and business issues. In addition, activist investors are becoming much more aggressive in their advocacy for dramatic operational changes and alternate means of monetizing real estate assets.

Regardless of whether narrow changes are made to real estate strategies purely as a result of the new standard or more pervasive changes are made to be responsive to other macroeconomic and governance developments, management needs to begin the process now. Decisions made now, including leases being negotiated today, can have long-term implications. It's important for management to take decisive action after careful consideration and analysis.

Aside from the direct impact on financial statement presentation, the following section details some of the more pervasive ancillary business implications that may result from adoption of the new leases standard.

Significant impacts

- **Stakeholder education.** Lessees will recognize a lease liability measured at the present value of future lease payments. This amount may differ from how analysts and credit agencies previously adjusted leverage ratios for the "debt-like" operating lease obligations disclosed in the footnotes.
- **Potential impact on financial metrics or indirect financial impacts.** While the dual model may often limit the impact on income-based performance metrics, it may impact other financial metrics that utilize balance sheet elements, for example, debt-to-equity ratios or return on assets metrics. Further, there may be indirect impacts caused by these changes. For example, recording significant additional assets may affect state tax payments, while changes to key metrics may alter incentive compensation payments or earn-outs and perhaps even impact legal or regulatory capital.
- **Decision points and data needs.** Except for short term leases, all leases will be on the balance sheet. Decisions about a lease's structure will impact the amount of the right-of-use asset and lease liability as opposed to impacting whether it will be recorded on the balance sheet. Data needs for ongoing reporting and disclosure will change significantly.
- **Lease versus buy decisions.** Previously, some lease versus buy decisions may have been influenced by whether a transaction qualified for off-balance treatment. Given that virtually all leases will be reported on the balance sheet, companies may want to revisit their lease-versus-buy decision criteria.
- **Transition.** While not effective until 2019, prior comparative periods presented will need to be restated using a modified retrospective transition method, which requires the recognition of a right-of-use asset and lease liability at the beginning of the earliest comparative period presented in the year of adoption. Leasing software and systems may require upgrades and enhancements, which may require a significant runway to adequately prepare for transition.
- **State tax liabilities.** Changes to the reported asset balance may impact income apportionment among states, potentially attracting additional income to higher tax jurisdictions. State capital and net worth taxes may increase as a result of the changes in the balance sheet.

Opportunity

The last several years have seen a host of changes facing corporate real estate organizations. From cost management to outsourcing to systems changes to designing the workplace of the future, the role of the corporate real estate department has never been more complex. Nevertheless, the role of corporate real estate as a strategic function within an organization has often been overlooked or has not kept pace with the changes in the rest of the organization or market conditions.

Simply put, many senior executives and boards of directors have not viewed their corporate real estate departments as a significant element in driving the success of an organization. Recent focus on real estate monetization has begun to change those views. The advent of the new lease accounting standard may further spur changes in this mind-set.

Reconsidering corporate real estate strategy

Some fundamental questions

As discussed above, this is a dynamic time for those in the real estate industry or with significant investments in real estate. On top of the need to adopt the new leases standard, economic, business, and tax changes, have all combined to make it an ideal time to reconsider whether your organization has the appropriate real estate strategy. As you assess your current corporate real estate strategy, there are a number of fundamental questions that should be asked, such as:

- Do you have a strategy for your real estate assets that supports the business' wider strategic objectives?
- How do you hold your real estate assets as part of your capital structure (e.g., do you use intercompany leasing)?
- What are the drivers of your lease versus buy decisions?
- Do you have detailed information about all of your lease obligations?
- What are current market opportunities (e.g., lease rates/ purchase prices) and how would they affect your real estate strategy?
- How do federal, state, and local taxes factor into your corporate real estate decisions?
- How does your company manage occupancy costs?
- What is the potential impact of the new lease model on your company?
- Do your company's existing systems have the capabilities necessary to capture and aggregate the information necessary to satisfy the reporting and disclosure requirements of the new lease standard? Are system, process, control and personnel changes necessary?

Functional participation

Corporate real estate activity affects a number of key functional areas and any reconsideration of your approach should include, at a minimum, members of each of the following key constituencies:

- Accounting/reporting
- Treasury
- Legal/regulatory
- Operations
- Tax planning and reporting
- Information systems
- Human resources (e.g., impact on compensation agreements)
- Investor relations

Each of these functional areas may be impacted by the new accounting standard. Accordingly, many companies that are significant users of real estate are considering creating a "steering committee" comprised of individuals from each of these constituencies to help them consider the implications. A collaborative approach from the inception of the planning stage is vital to ensure that unexpected implementation issues are identified early in the process.

Many companies quickly identify some of the more significant transition impacts, such as the significant change in financial reporting or the potential impact on debt covenants and other metrics. However, other less obvious impacts also exist for particular companies or industries. In addition to the business implications detailed in the prior section, many companies will need to allow for incremental time and effort associated with executing leases as both lessors and lessees negotiate to achieve the most desirable accounting impact under changing dynamics. Accordingly, it is essential for companies to seek broad participation in the process of identifying and addressing the potential implications of the new lease accounting standard.

Factors that impact corporate real estate strategy

The new standard will be the catalyst for companies to take a fresh look at factors that influence their corporate real estate strategy, which is influenced by a variety of factors, as represented below.

The impact to corporate real estate strategy

- Reassess "lease-buy" decision criteria where buying is feasible
- Consider negotiation strategy around lease term - controlling space/economics versus accounting effect
- Consider pricing implications of option periods versus longer terms
- Consider common contractual terms and modify where appropriate - what is the "new normal"? (e.g., should you increase or eliminate certain contingent rent provisions)
- Evaluate the economic impact on more than just financial reporting, including regulatory capital, cost plus contracts, etc.
- Evaluate the tax impact, including federal, state, local and foreign taxes

Many companies are looking for a simple answer to the question, "how should we change our real estate strategy?" Unfortunately, the answer is, "it depends." As we will discuss further, the decisions around when and how to lease are affected by a large number of factors, including the need to control particular assets, operational flexibility, availability of alternatives, common industry practices, tax and regulatory impacts and expectations of management. Careful consideration of the impact and the company's specific circumstances will be required. It is not a "one size fits all" evaluation for all companies or for different types of transactions. Rather, management should be armed with an understanding of the impacts of the new model so they can create various strategies for major classes of transactions and then be able to apply those to specific situations as they arise.

Operational issues

A company's need for corporate real estate is driven in large part by both its current and planned physical requirements. Space needs can change dramatically over time—driven by a variety of factors, including growth/contraction plans, potential acquisitions, productivity improvements, and physical obsolescence. Further, local demographics may change needs for particular locations. These issues will vary significantly from company to company and by property type. The following examples help illustrate the diversity of potential issues based on a company's operations:

Example 1—Retail company

A retail company typically requires several different types of property for its operations, including (i) store locations (ii) warehouse locations, and (iii) key corporate offices in central business districts.

Example 2—Bank

Banks normally maintain a variety of property locations for their operations, including (i) bank branches (ii) processing operations (often in fungible office space in suburban markets), and (iii) key corporate offices in central business districts.

Generally, a company is more likely to lease real estate when its long-term property needs are unclear; operational flexibility is highly desirable and expected access to acceptable alternatives is good. Leasing has also historically carried the added advantage of providing companies with a form of off-balance sheet financing, which will generally not exist under the new standard.

Conversely, a company is more likely to buy when the company's long-term property needs are clear, the need for specific properties are expected to be stable and long-term, specific assets are needed and/or there are concerns with respect to the availability of acceptable alternatives. Expectations regarding capital appreciation of real estate assets may also drive decisions.

There are also many operational reasons why companies rent rather than own that may be unrelated to the accounting or even to the economics. One such reason frequently cited is that leasing allows tenants to avail themselves of professional property management. Does a bank, for example, want to maintain a staff of engineers, maintenance, or other personnel necessary to address the day-to-day issues surrounding management of real estate? In these circumstances, we may begin to see an expansion of service options that may be included in property management contracts.

Overriding operational considerations is often the impact of market practice or practical availability of property for purchase. Certain types of properties (e.g., retail store locations) may be unique and not generally available for purchase, whereas commercial office space may be more fungible and, in some cases, also more available for purchase.

With the loss of off-balance sheet accounting under the new standard, companies that presently lease may instead opt to own. Companies with low leverage and high credit ratings may have a substantially lower cost of capital than traditional real estate lessors, which may create a capital arbitrage benefit for owning rather than leasing in certain cases. Although counter-intuitive, under the new standard, companies with a better credit profile and lower borrowing costs will record a larger lease liability as a result of discounting the associated lease payments based on a lower incremental borrower rate when compared to a company with a lesser credit and higher borrowing costs, relative to the same lease.

We have already begun to hear of increasing potential purchase transactions involving single-tenant office buildings. It is possible that we will see an increase in certain property types converting portions of property to condominium interests as a result of the new standard.

However, this trend will be affected by the underlying reason companies are leasing, as discussed previously. It is also likely to vary significantly by property type. For example, converting portions of properties to condominium interests is more likely to occur for longer-dated leases in more physically static situations such as individual floors or blocks of floors in large office buildings or with single-tenant retail sites, both of which may be functionally independent. It is less likely to occur in relatively short or moderate duration leases with partial floors or in malls/strip centers, which are not functionally independent and may frequently require reconfiguration to accommodate a different tenant mix.

It is also interesting to note that this potential push towards more real estate ownership as a result of the new lease standard is, in fact, counter to the recent real estate monetization trends, which are having the effect of driving real estate assets off corporate real estate user's balance sheets. While the jury is still out, many market participants believe that the monetization trends will be the bigger influence and the ownership trend driven by the accounting ramifications will be secondary.

Today, in many cases, companies outsource their corporate real estate lease administration because commercial real estate service providers offer this service relatively inexpensively (in order to gain access to more lucrative transaction activity, such as leasing commissions). Outsourcing may be more cost effective than doing such administration in-house. However, in some cases, the additional information needed to account for leases under the new lease model may be sensitive to the company's lease negotiating position. Companies may be hesitant to allow such interested parties to have the necessary access to the information in order to prepare the required accounting documentation.

Economic issues

While the real estate market has generally improved over the past several years, not all of the impact from the financial crises in 2008 has been reversed. Vacancy rates for some property types and in some markets are stabilizing, but not uniformly across all property type or markets. Further, many property owners continue to struggle with declining cash flow from operations, liquidity issues, high fit-out costs, and to a lesser extent, near-term debt maturities. As a consequence, landlords may be interested in discussing asset sales and lease modifications—perhaps by trading a lower rent in exchange for a longer lease (i.e., so called "blend and extend" transactions).

Accordingly, the current environment presents both challenges and opportunities for users of corporate real estate. In certain cases, opportunities to buy assets at favorable prices may still exist, while in other cases, negotiating rent concessions currently or through "blend and extend" type transactions may yield lower "all-in" occupancy costs. Although these market issues exist irrespective of the potential impact of the new lease accounting model, the new standard focuses a spotlight on the issues as companies consider the implications of the new accounting rule.

Financing issues

For many industries and individual companies, alternative financing options to leasing may be limited or too expensive. As a result, leasing, historically, may have been the only option available, or, it may have been cheaper than other sources of financing available to the company. In many cases, this will not change irrespective of the accounting ramifications.

However, depending upon the credit quality of the company, corporate real estate departments may now want to reconsider purchasing assets that were previously subject to a lease. When underwriting the amount and terms of a commercial mortgage to a property owner, lenders will consider factors such as debt yields, coverage ratios, loan-to-value, the length of lease terms, likelihood of renewal, and credit quality of the tenants occupying the property. In some cases, the property owner cannot effectively fund property improvements necessary for the current operation of the property. A corporate real estate user/tenant (lessee) may have a better credit profile and lower cost of capital as compared to a particular property owner/landlord (lessor) or to the "average" credit in a pool of tenants at a site. If the tenant is committed to a longer term use of the property, such tenant may benefit from obtaining financing using its own credit rating versus the landlord's, which may be lower as a result of current market difficulties.

Many of these issues are also the drivers of the recent monetization trends. Companies may, in fact, want to sell a property subject to a long-term lease back at a high valuation and effectively monetize an asset using its own credit to drive the valuation. Under the new model, this will involve an evaluation under the new sale and leaseback rules and a new lease-related asset and liability will come on the books, even if it's a qualified sale and leaseback.

Tax considerations

Federal and state tax considerations often played a significant role in many corporate real estate strategic decisions. A clear understanding of the tax motivations and implications for both counterparties in a transaction is critical, as these factors may significantly affect the pricing as well as the range of transactions the parties may be willing to consider. In addition, the economic issues affecting either side of a transaction may have radically changed since the decisions were first made. A company with net operating losses may be more willing to undertake substantial restructuring to accelerate tax benefits or utilize the losses before they expire. A company with expiring capital loss carryovers may be seeking opportunities to generate gains. Tax sensitive transactions by entities with significant owned real estate are generating more interest once again—including sale and leasebacks, joint ventures, spin-offs, and real estate investment trust (REIT) conversion transactions.

In most cases, federal taxes will remain unchanged; however, significant federal deferred tax adjustments may need to be tracked as the related book amounts change.

For state income tax purposes, business income of a company is apportioned among the states by means of an apportionment formula. For states that utilize a property factor in the apportionment formula, the new lease standard may affect the amount of business income apportioned to a state. In general, a property factor includes all real and tangible personal property owned or leased by the company and used during the tax period in the regular course of business. In most states, property owned by a taxpayer is valued at its original cost and property leased by the taxpayer is valued typically at eight times its net annual rental rate. Certain states' tax codes provide that federal income tax rules apply when determining the property factor. Others, such as New Jersey, do not follow the federal income tax treatment and determine property factor values based on book value. Companies doing business in these states may have historically taken financial statement rent expense and applied a multiple when calculating property factor values. In such instances, the change in lease accounting may affect the calculation of the property factor, as companies may instead utilize the right-of-use asset to determine these values. Further, the compromise to allow for straight-line expense recognition for certain types of leases, including many property leases, actually slows down the amortization of the right-of-use asset and, as a result, may exacerbate the state tax issue.

Depending on the facts and circumstances of the company's specific portfolio, the impact could be an increase in state taxes if the relative allocation moves income from lower tax jurisdictions to higher ones. Of course, the reverse could also be true if the relative allocation moves from higher tax jurisdictions to lower ones. Unfortunately, however, the states with higher rental rates (and therefore higher rental assets under the new model) are also generally the states with higher taxes - thereby creating an expectation that in many cases, a state tax increase will result from the change in apportionment. Accordingly, a detailed analysis to consider these state tax impacts using the company's fact pattern may be necessary in order to devise a plan to minimize the impact.

State franchise/net worth taxes may also be impacted by the new standard. Certain states, such as Illinois, determine the value of a company for franchise tax purposes using US GAAP. In addition, this value may be apportioned to the state by use of a property factor, which is also calculated under GAAP principles. As a result, net worth taxes in certain states may increase due to the increased value of property reflected on the balance sheet.

Items that may be impacted include the applicable depreciation rules, specific rules limiting the tax deductibility of interest (for example, thin capitalization rules and percentage of EBITDA rules), existing transfer pricing agreements, sales/indirect taxes, and existing leasing tax structures (in territory and cross-border). A reassessment of existing and proposed leasing structures should be performed to ensure continued tax benefits and management of tax risks.

Internationally, the new lease accounting model may have other impacts on the tax treatment of leasing transactions. In many jurisdictions outside the United States, tax accounting for leasing is often based on accounting used for book purposes, which may be under the IASB's new standard. Refer to the "International divergence" section below. Given that there is no uniform leasing concept for tax purposes, the effect of the new standard will vary significantly, depending on the jurisdiction.

When tax does not follow the accounting model prescribed by the new standard, management may see an increase in the challenges of managing and accounting for newly-originated temporary differences, which will generate new deferred taxes in the financial statements.

Timely assessment and management of the potential tax impact will help optimize the tax position by enabling entities to seek possible opportunities and/or reduce tax exposures.

Regulatory issues

In some cases, the decision to lease was driven by regulatory issues particular to certain industries. For example, reimbursement rates paid on some government contracts are based on GAAP reporting. Today, for some contracts, the government will reimburse 100% of the cost of rent but will not reimburse for capital related items, such as interest and amortization/depreciation of owned real estate. With the elimination of the current operating lease model (where "rent" expense is replaced by amortization and interest – presented as a single line "lease expense"), government contracts and/or reimbursement rules may need to be modified to ensure that the intended economics of the arrangement continue. While regulators may ultimately view rent and lease expense the same, it is unclear at this point whether or how actual government regulations will be modified.

While the standard was still in a proposal phase, regulators were unwilling to provide an opinion on the potential regulatory implications until the standard was final and its effects were better understood. What is uncertain at this point is how regulatory agencies will react to the impacts this change will have on risk-based capital requirements and other key regulatory metrics. The effect of the change could be very significant to banks/broker dealers (see also "Intercompany Issues") and other regulated entities whose capital ratios and/or other metrics are closely monitored and that would be adversely affected if computed under the new model. Historically, banking regulators have provided limited relief for the impact of such accounting changes. While the lessor operations of many banks will not be significantly affected, those with significant lessee activity (e.g., bank branches, headquarter buildings, processing centers, and ATM locations) may be impacted. Based on initial discussions with regulators, there may be an adverse impact of adoption of the new standard on risk-based capital requirements. However, the specifics remain unclear as of now.

Intercompany issues

Many heavy corporate real estate users utilize a central real estate holding entity for owned and leased property, and then provide for intercompany charges to the consolidated subsidiaries using such assets. In some cases, the structures have been created (i) to take advantage of beneficial pricing (allowing companies to aggregate subsidiary needs to take bigger spaces), (ii) to obtain operating synergies and negotiate better terms, and (iii) for operational ease (allowing corporations with multiple subsidiaries to be flexible in allocating space between these units). It also may be driven by tax considerations (e.g., private REITs with beneficial state tax impacts). In some cases, companies execute intercompany leases, but, in others, no formal arrangement exists and costs are allocated through an intercompany expense charge. Under the new standard, these intercompany transactions will need to be reflected on each consolidated subsidiary's books, which may affect them from a regulatory standpoint (e.g., subsidiary broker dealers may be inadequately capitalized). The documentation of the arrangement will be much more important since it will drive the value of assets and associated liabilities for entities reporting on a stand-alone basis.

Governance, budgetary issues, and investment alternative issues

Some historical decisions to lease versus buy may have been driven by approval protocols and budgetary factors. For example, when a company is growing rapidly, it might have been faster and more efficient to execute a lease of real estate or equipment rather than going through the process to approve the purchase of a capital asset. In addition, internal budgeting may have led to a leasing bias since the upfront cash outlay is much lower than a purchase. If the approval rules follow the new lease model, an operating lease may now need the same level of approval as an outright purchase.

In addition, some decisions to lease may have been driven by a company's prior alternative investment options for available cash. Today, many companies are holding significant cash balances that are earning only nominal returns. In the near term, using some of this cash to buy certain types of assets—especially ones expected to be utilized for a substantial portion of their lives—instead of paying much higher implicit rates in leases would be accretive to earnings in the long term. However, because existing leasing activity under today's operating leases may not be visible to corporate treasury departments, this alternative use of cash may not be in focus and these opportunities may be missed.

Managing corporate real estate

In many organizations today, the corporate real estate department is viewed as more of an administrative function or "cost center" rather than a part of a strategic function or a competitive advantage. Further, corporate real estate departments may not have the infrastructure or systems to effectively track and manage the information necessary to make the various decisions, estimates, and periodic remeasurements required by the new standard. In some cases, they may not previously have been notified of changes, such as with regard to the expectations of renewals, on a timely basis.

Many companies that operate as a group of decentralized subsidiaries or ones that have grown larger through acquisition with significant legacy systems, may be challenged to capture, understand, and manage the necessary information related to real estate leases on a company-wide or even country-wide basis. Such systems may not be fully integrated into the larger enterprise-wide systems, including accounting and reporting. In addition, because of the length of a typical real estate lease, current management may not be aware of the original rationale for specific decisions, some of which may no longer exist due to changing circumstances. Changing this environment to a more centralized one may require significant cultural changes that may not be easy to accomplish.

In some cases, corporate real estate departments may have the responsibility for tracking real estate, but not enough resources and focus to (1) identify and manage excess capacity, (2) identify and seek reimbursement for overcharges for lease operating costs (e.g., common area maintenance and bill back overcharges), and/or (3) minimize other cash real estate occupancy costs. Finally, for many companies, existing tracking systems are informal, incomplete, or inaccurate. These "tracking systems" might be nothing more than a drawer for storing copies of leases, a notebook containing lease abstracts, spreadsheets, and non-integrated or out-of-date software applications.

Few companies today track property, plant, and equipment in a manual fashion. Yet, many companies are still accounting for their leases of corporate real estate using spreadsheets and accounts payable systems with no formal corporate real estate asset management system for these leased properties. Even for the more sophisticated corporate real estate groups that have asset management systems, these systems are often freestanding and utilized more for lease administration purposes, with no integration with the company's accounting systems.

Some companies may be able to adapt to the new information needs without significant upgrades or integration, but to do so would miss an opportunity to automate a previously labor-intensive activity and free up employees for other more productive uses. For example, under certain circumstances, the new standard will require the remeasurement and reallocation of consideration (e.g., between lease and non-lease components), creating the need to track additional new lease information. Given the additional complexities associated with the detailed tracking required for both the balance sheet and income statement accounts, efficiencies can be gained from enhancing system support and automation.

From a long-term sustainability perspective (for companies with substantial leasing activities), spreadsheet-based accounting may not be practical because of the significant maintenance required and resultant susceptibility to error. High-volume corporate real estate users will likely need new systems/processes to create a documentation trail of the initial judgments and track subsequent changes in estimates or assumptions. The system will also need to be largely automated to calculate any resulting computational adjustments. Full integration into the company's control structure and accounting systems will be necessary, as will the ability to generate the extensive quantitative information for the mandated disclosures.

Internal controls and processes

Many entities may not have robust processes and controls for leases, other than those related to initial classification and disclosures. In addition, the existing lease accounting model (absent a modification or exercise of an extension) did not require leases to be periodically revisited. The new standard requires leases to be remeasured for certain changes in estimates (for example, for certain changes in the expected lease term). Processes and controls will need to designed or redesigned to ensure proper management and accounting of all lease agreements. Such processes and controls need to address the accounting and reporting at inception and over the lease term, as well as provide for the monitoring of events both in and outside of the lessee's control that may trigger incremental accounting or remeasurement.

Initial recording on balance sheet, subsequent recognition of expense in the income statement, and the potential for remeasurement, reallocation, and reclassification of the lease and lease-related assets and liabilities will likely require complex changes to existing processes and internal controls, including support for significant management assumptions. Monitoring and evaluating the estimates and updating the balances may also require more personnel than currently available.

The timely assessment and management of the impact of adoption on processes, controls, and resource requirements will help reduce reporting risks. This includes ensuring adequate processes addressing the accounting in the related areas of tenant improvements, impairment evaluation, and tax accounting.

International divergence

As previously indicated, the IASB issued its new lease accounting standard on January 13, 2016 with a similar adoption date. While current lease accounting by lessees was largely aligned under current rules, the IASB's new standard creates some significant points of additional divergence from US GAAP. Most notably, while both standards put leases on balance sheet, the IASB adopted a single finance model for income statement purposes. Accordingly, US multi-national companies may need to track both models if they have to report on IFRS or other international standards for statutory purposes and then report on US GAAP for consolidated purposes, or vice versa. This will also add complexity to tax accounting.

IT and lease accounting systems

IT and lease accounting systems in the marketplace are based on the existing risks and rewards concept. They will need to be modified to the new right-of-use concept. While software developers have been working on designing systems to fully meet the needs of this new standard, these systems are not up and running yet – although some systems may capture some or all of the underlying data that may be needed to do the necessary computations. Development and implementation of suitable new modules or systems is likely to require significant lead-time. Lessees will have to account for and manage lease agreements differently (including existing operating lease agreements). They may need to implement contract management systems for lease agreements and integrate these with existing accounting systems. The IT and accounting solutions will need to be sufficient to meet both their current and future needs. In addition, if a company also has significant subleases, additional complexities will arise, as the company will be applying both lessor and lessee accounting.

Lessees may expect lessors to provide them with the necessary information to comply with the new leasing standard. However, lessors may not have, or may be unwilling to provide, the data requested by lessees. Consequently, lessees will need to capture such information themselves and may need to modify their systems accordingly.

Timely assessment and management of the impact on IT and lease accounting systems will help reduce business and reporting risks. We understand that some of the ERP systems providers are in the process of evaluating and developing upgrades and solutions that will allow for the accounting and reporting requirements of the new standard and related controls.

Financial reporting and impact on ratios

The financial statements will require restatement for the effect of the changes. The effects of the new standard should be clearly communicated to analysts and other stakeholders in advance. Transition disclosure requirements as to the potential implications of the new standard are already required. While initially most companies will say they are considering the impact of the new standard, as the date of the adoption gets closer, the disclosure of the potential implications is expected to be more granular and explicit.

Ongoing accounting for leases may require incremental effort and resources as a result of an increase in the volume of leases recognized on balance sheet; there is also a need to monitor events that may trigger reassessment of the lease term, variable rents based on an index or rate, residual value guarantees, and the impact of purchase options.

The impact of the new standard will not be limited to external financial reporting. Internal reporting information, including financial budgets and forecasts, will also be affected.

In many cases, the total expense for operating leases under the new standard may be the same as under today's operating lease accounting. However, that may not always be the case. For example, prior rent expense may have included amortization of deferred gains on qualified sale and leasebacks, which will now be recognized upon sale in a qualified sale and leaseback under the new standard.

Timely assessment of the new standard's impact on covenants and financing agreements will enable management to start discussions with banks, rating agencies, financial analysts and other users of the entity's financial data. Entities anticipating capital market transactions should consider the effects on their leverage ratios. Companies in the process of negotiating new or existing agreements should seek provisions in the agreements that specify how changes in GAAP impact financial covenants (i.e., whether covenant calculations are always based on then-current GAAP or on GAAP that was in effect when the agreements were signed).

Next steps

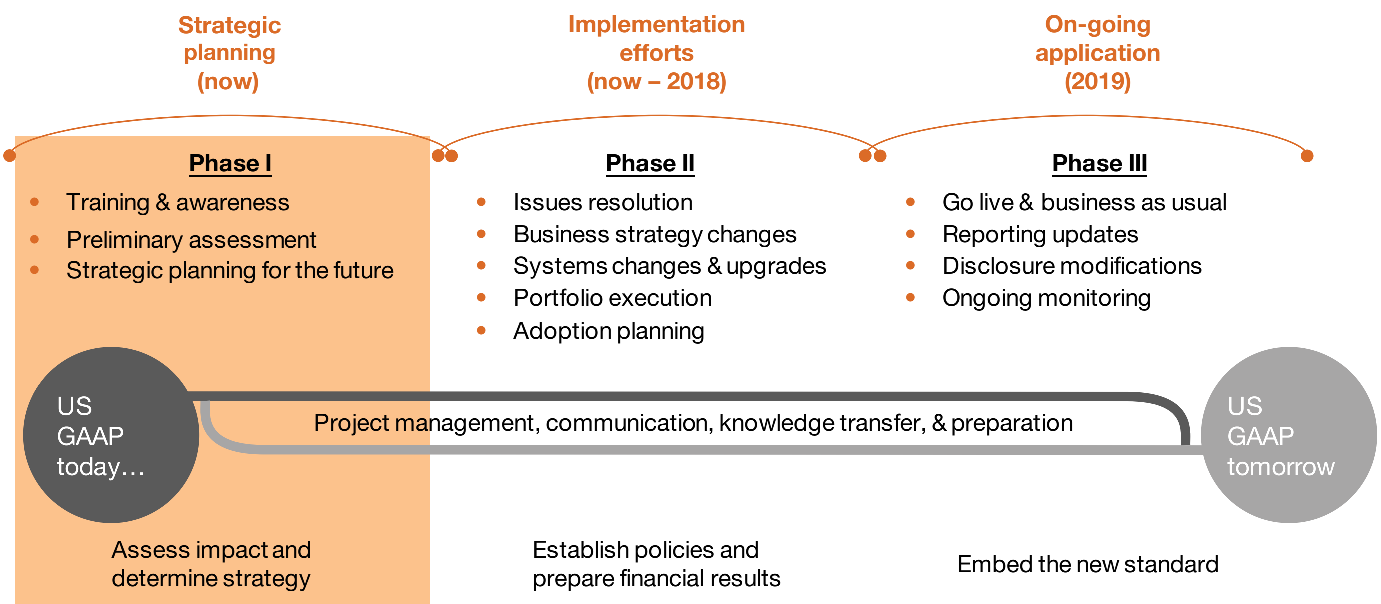
Prior to adoption, management will need to catalogue existing leases and gather data about lease term, renewal options, and payments in order to measure the amounts to be included on balance sheet. Gathering and analyzing the information could take considerable time and effort, depending on the number of leases, the inception dates, and the availability of records. In many cases, original records may be difficult to find or may not be available. Other factors, like embedded leases, which had not been a focus before, will need to be identified and separately recorded.

Given all of the above, these changes will necessitate potentially significant cultural changes as well as significant operational ones. While adoption of the new standard is not required for public business entities until 2019, organizations are well advised to begin considering the impact of these changes now, and to put into motion the steps needed to prepare the organization for the change. Under the modified retrospective transition approach, the 2019 financial statements will need to reflect adoption of the new standard as of January 1, 2017. In many cases, capturing data in real time may be more efficient than waiting until 2019.

Assuming adoption in 2019, the chart that follows depicts a potential transition plan with respect to evaluating the effects of the new lease model. Incremental corporate real estate strategy and systems changes would be performed concurrently with this plan.

The new standard will impact nearly every organization to some extent. As discussed in this document, the new standard will necessitate changes in the technical accounting, operational processes, and systems of many companies. We also believe that they may cause many to reconsider their overall corporate real estate strategy in a more holistic fashion, which may assist in identifying how the corporate real estate role can become a strategic driver of operational success, thereby providing the "Catalyst for Change in Corporate Real Estate." Beginning the process early will help ensure that implementation of the new standard is orderly and well controlled and that data from existing and new leases executed before implementation is captured from the outset. In addition, getting an early start may allow entities to consider potential adoption and negotiation strategy changes for new leases and the potential renegotiation of existing agreements in order to reduce the impact at adoption.

Timeline



Preparing for the change

- ❑ Educate affected individuals in all cross-functional areas about the new standard
- ❑ Create a cross functional "steering committee" to address the new standard and related transition
- ❑ Perform an inventory of your lease portfolio - understand what types of assets are leased and where the data resides
- ❑ Identify contracts likely to include embedded leases
- ❑ Consider modelling the transition impact on certain significant leases (or sample from a variety of lease types)
- ❑ Summarize existing systems and future needs
- ❑ Evaluate sufficiency of existing control processes and potential gaps
- ❑ Analyze potential income and other tax considerations (including federal, state, and foreign taxes)
- ❑ Identify contracts affected by the change in accounting (e.g., financial covenants, compensation agreements, earn-outs), the potential implications, and how terms should be modified in the future
- ❑ Identify regulatory issues affected by the change in accounting (e.g., regulatory capital implications and cost plus government contracts), the potential implications, and how terms should be modified in the future
- ❑ Consider potential changes in real estate leasing strategy (e.g., lease/buy, shorter vs. longer leases, modify common terms)

Key takeaways on transition

- **Be strategic:** Planning your transition will go much more smoothly if you have concrete data. Modeling selected leases will give you relevant data to share with internal constituents. It will also help you understand what data you have, what data you need, and how your leasing strategy may need to change to minimize any potentially adverse accounting implications resulting from the new standard.
- **Manage market reaction:** For many significant users of real estate (e.g., retail companies), managing investor and other user expectation during the transition will be critical. Analysts and shareholders may soon raise questions about the potential impact. Longer term, the changes to presentation and the potential impact on financial metrics, will require thoughtful communication.
- **Don’t wait:** In our discussions with clients, many expect adoption to take between 12 to 24 months – which doesn’t give a lot of time to spare for a 2019 adoption. While the adoption timetable will vary by company, most believe adoption will be complex and time consuming. Targeted and measured steps today will help you understand the complexity and duration of the transition effort and more importantly, what steps you can take today to modify existing or planned leases to minimize the effort of complying with the new standard.

How PwC can help

PwC's strengths – Our integrated approach

Our industry specialists have extensive technical accounting and financial reporting, valuation, tax, operational, regulatory, strategy, and industry expertise. By bringing together these professionals, PwC can offer something that most firms do not: an integrated advice model.

We regularly advise members of the private and public sectors, owners, users, and investors in real estate. We serve organizations throughout the real estate industry, including corporate owners/users, developers, hospitality organizations, real estate investors and REITs.

PwC provides audit, tax, or advisory services to over half of the 50 largest private equity firms in the world and to over 40% of the REITs listed in the S&P 500 index. In addition to our presence throughout the United State, globally, PwC has established dedicated practices in leading non-US real estate markets, including Berlin, Hong Kong, London, Mumbai, Paris, San Paulo, and Tokyo.

In addition to serving the real estate investor/operators, we have provided real estate focused services to many of the largest retail, healthcare, hospitality, and other real estate users. These services include accounting, advisory, tax, systems, and strategy to entities reconsidering their real estate usage and strategy as well as potential monetization strategies.

PwC has a global team of multidisciplinary professionals providing real estate services through all phases of the real estate lifecycle. We can help you understand not only the potential implications of the new lease standard, but also help you reconsider your overall real estate strategy.

PwC has a global team of multidisciplinary professionals providing real estate services...

…through all phases of the real estate lifecycle…

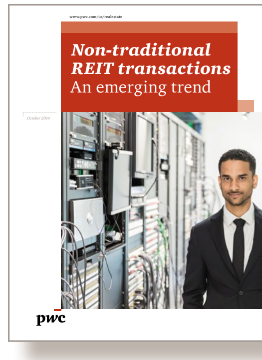
	Strategic planning	Deals	Capital formation	Business plan execution	Exit
Considerations	Are your real estate resources (time, talent, and money) properly allocated to generate value? Do you have a road map guiding your organization going forward and describing how it will get there? Are you prepared to navigate the obstacles and risks posed by organizational, financial, political, and stakeholder groups?	Have you validated the original assumptions of scope, risk, cost and approach in your real estate business case? Will you adjust these assumptions and the associated allocations? Does your internal team have capacity to deal with all phases of the due diligence process?	Have you fully vetted the financial structure of a deal, including capital markets alternatives? Are the needs of all stakeholders being met without compromising commercially attractive and tax–efficient arrangements? Do you have the appropriate materials for each stakeholder group?	Do you have a proven methodology in place for effectively and efficiently executing complex business plans? Are you managing assets across the portfolio to improve utilization and performance, reduce capital costs, reduce asset–related operating costs, extend asset life and improve your return on assets?	When divesting assets or businesses, have you planned for capital markets and fair value guidance to realize optimal return on assets for greater reinvestment potential?
Representative services	• Training, planning and implementation assistance with regard to new standard • Analysis of, or assistance with, evaluating financial and strategic impact of new standard • Market assessment / economic impact studies • Business case analysis • Equity market/story analysis • Sustainability strategy • Dispute avoidance strategy • IT and data strategy • Cybersecurity • Corporate real estate advisory • Merger or business acquisition considerations • REIT conversions	• Lease abstracting • Global fund, REIT, and investment tax structuring • Entity and corporate level financial due diligence • Cash flow modeling (ARGUS, DYNA, Excel) and model testing • Financial and tax entity-level due diligence • Cost segregation • Valuation for the purposes of business combinations • Capital markets advisory • Entity incorporations • Separation/stand-along cost analysis • HR/change management • Property due diligence services • Lease economic analysis and transfer pricing	• Deal structuring • Tax implications and structuring with respect to new standard • Sale-leaseback transactions • Loan underwriting/ origination services • Investor level tax considerations • IPO readiness assessments • Performance measurement services/Track record verification • Tax considerations relating to General Partner compensation • IPO Advisory • Debt offering advisory • Global fund, REIT, and investment tax structuring • Valuation consulting • Financial modeling/ model validation	• Complex accounting • Federal, state and international tax reporting/compliance • REIT testing/verification • Reorganization & insolvency services • Asset monitoring & asset management • Litigation & arbitration • Risk & regulatory work • IT and data architecture and integration • Process/control change consulting and implementation planning with respect to new standard • Operations outsourcing • Finance transformation • Capital markets services • Corporate secretarial • Evaluation/development of human capital and benefit programs • Evaluation/development of risk management programs	• Buy/sell side due diligence • Valuation • Disposition strategy • Accounting & financial management • Tax deferred exchanges • Compliance, reporting and tax • Complex accounting • Building sustainability performance measurement • Merger integration • Global fund, REIT, and investment tax structuring
Benefits	A better vision of your organization and its resources provides you with clearer expectations of your capabilities and overall business case.	What you don't know is always the most costly. By developing a careful understanding of the information at hand you are better positioned to negotiate and execute your transactions.	Having knowledge of and access to the capital markets before going to market allows you to accelerate the financing and deliver the best value for money to all your stakeholders.	Assistance with use or optimization of returns for real estate can proactively address risks before they occur.	Operational, financial, and risk management is critical throughout the real estate life cycle including exit.

Other PwC real estate publications

Our industry thought leadership publications provide up-to-date thinking about the regulatory landscape, evaluate emerging trends, and share ideas impacting the global real estate industry.

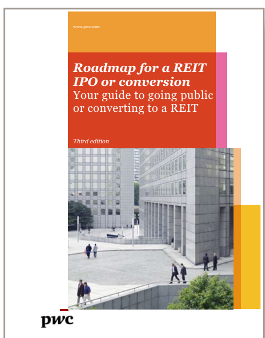
Unlocking shareholder value Real estate monetization strategies

This paper contains an overview of real estate monetization strategies, their perceived risks and benefits, and how PwC can help companies evaluate factors associated with this approach.



Non-traditional REIT Transactions: An emerging trend

This free-standing guide is focused exclusively on the unique issues and considerations that REIT transactions face.



Roadmap for a REIT IPO or conversion for traditional and non-traditional real estate companies

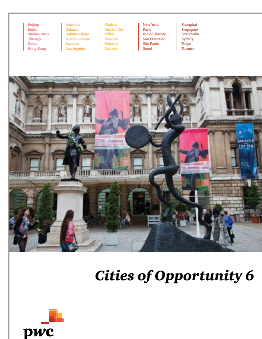
These PwC guides are prepared to help both traditional and non-traditional real estate companies address the IPO and REIT conversion process.

Emerging Trends in Real Estate

Based on personal interviews with and surveys from more than 1,000 of the most influential leaders in the real estate industry, this annual forecast will give you a heads-up on where to invest, which sectors and markets offer the best prospects, and trends in the capital markets that will affect real estate.

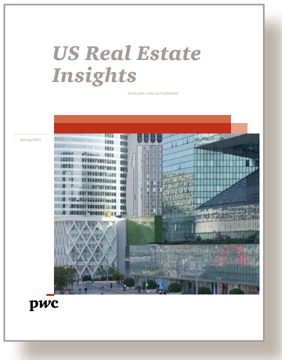
Real Estate 2020: Building the future

As confidence returns to real estate, the industry faces a number of fundamental shifts that will shape its future. PwC has looked into the likely changes in the real estate landscape over the coming years and identified the key trends which, we believe, will have profound implications for real estate investment and development.



Cities of Opportunity 6

This report analyzes the trajectory of 30 cities, all capitals of finance, commerce, and culture—and, through their current performance, seeks to open a window on what makes cities function best. We also investigate both the urbanization and demographic megatrends that shape our cities.



US Real estate insights
This quarterly publication provides our perspectives on the latest market and economic trends, regulatory activities and legislative changes affecting the real estate industry, as well as informed views of the most current developments in operations, business strategy, taxation, compliance and financing.

PwC Real Estate Investor Survey
The quarterly PwC Real Estate Investor Survey is widely recognized as an authoritative source for capitalization and discount rates, cash flow assumptions, and actual criteria of active investors, as well as property market information.

PwC Hospitality Directions US
This quarterly publication is a near-term outlook for the US lodging sector, commonly used by industry decision-makers and stakeholders to better understand the impact of policy and other macro-environmental factors on the sector's operating performance.

Where to find additional information:

If you would like further information on the new lease standard or assistance in determining how it might affect your business, please speak to your PwC engagement partner or representative. Alternatively, a list of PwC contacts has been provided on the last page of this publication.

Also, refer to:

- *CFOdirect,* which includes technical guidance on the new lease accounting standards
- *Adopting the new lease accounting standards,* for continually updated resources including updates on new developments to help you transition to the new leasing standards

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www.pwc.com/us/leasingsurvey

Lease accounting survey

June 2016

pwc

CBRE

About this survey

What will be the impacts from the sweeping changes to lease accounting finalized by the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB)? How are companies preparing for the coming changes?

To find out, PwC and CBRE surveyed executives from organizations' accounting, finance and real estate functions about actions they are considering to prepare for the new standards. Key findings from the survey, summarized here, reveal the challenges ahead and steps companies are taking now.

Responses were collected through an open, online survey between March and April of 2016. More than 500 executives responsible for lease accounting or lease management from across a wide range of industries participated in the survey.

Top findings and interactive tools online

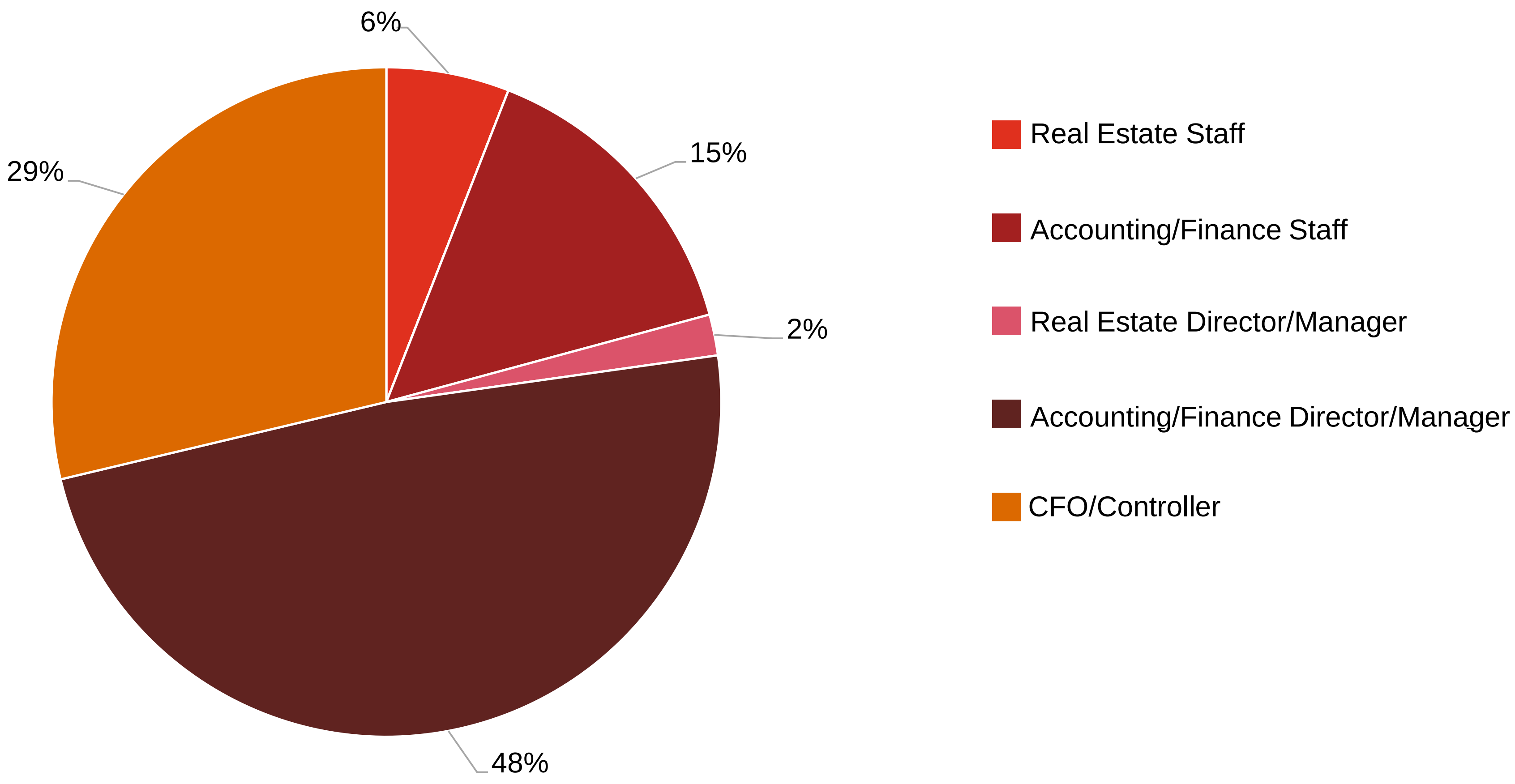
Visit our *2016 Lease accounting survey – top findings* page online for access to:

- Interactive data explorer
- Video interviews with PwC leasing specialists

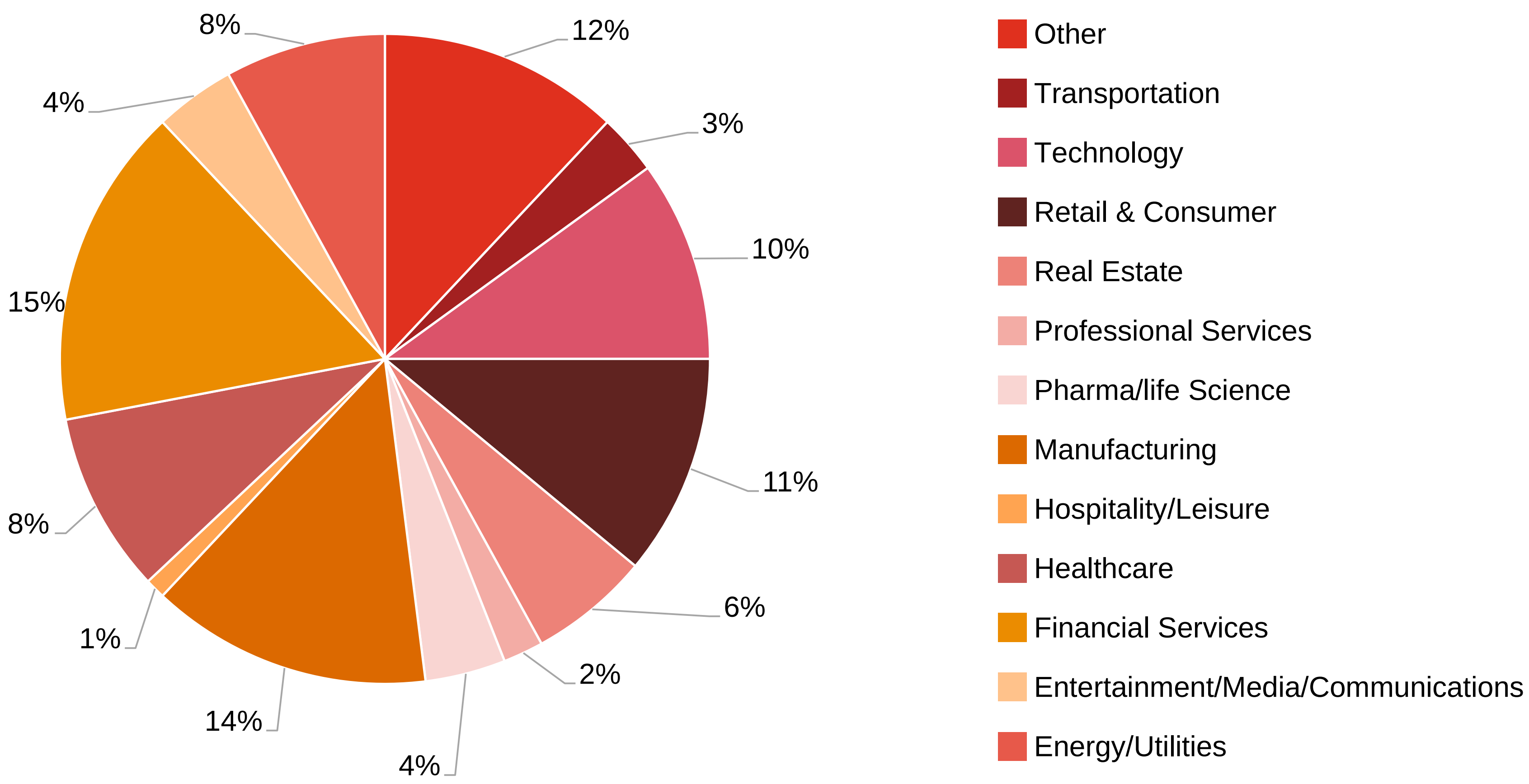
pwc.com/us/leasingsurvey

Table of contents

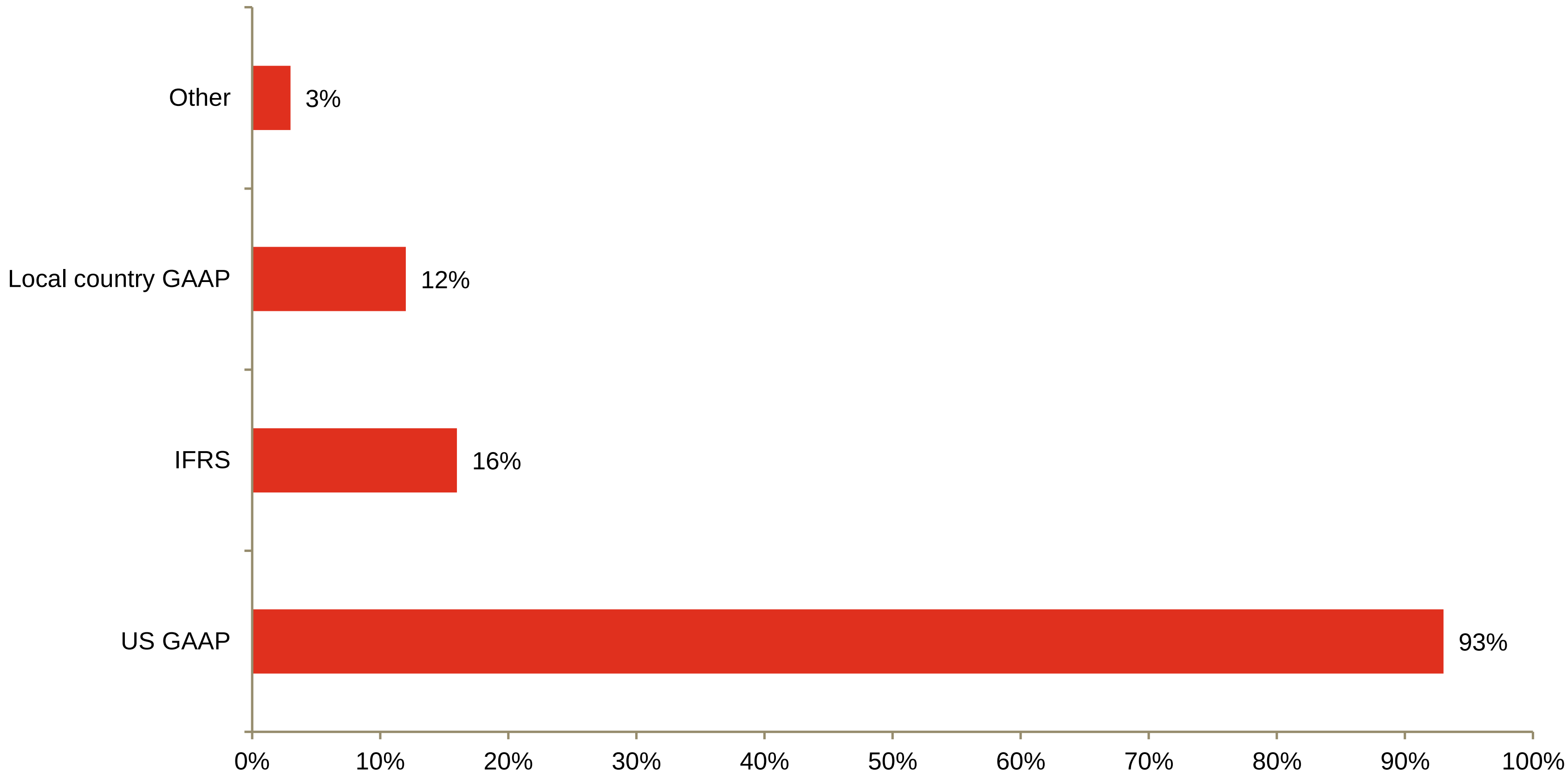
What best describes your job title?



Which of the following best describes your company's primary industry?

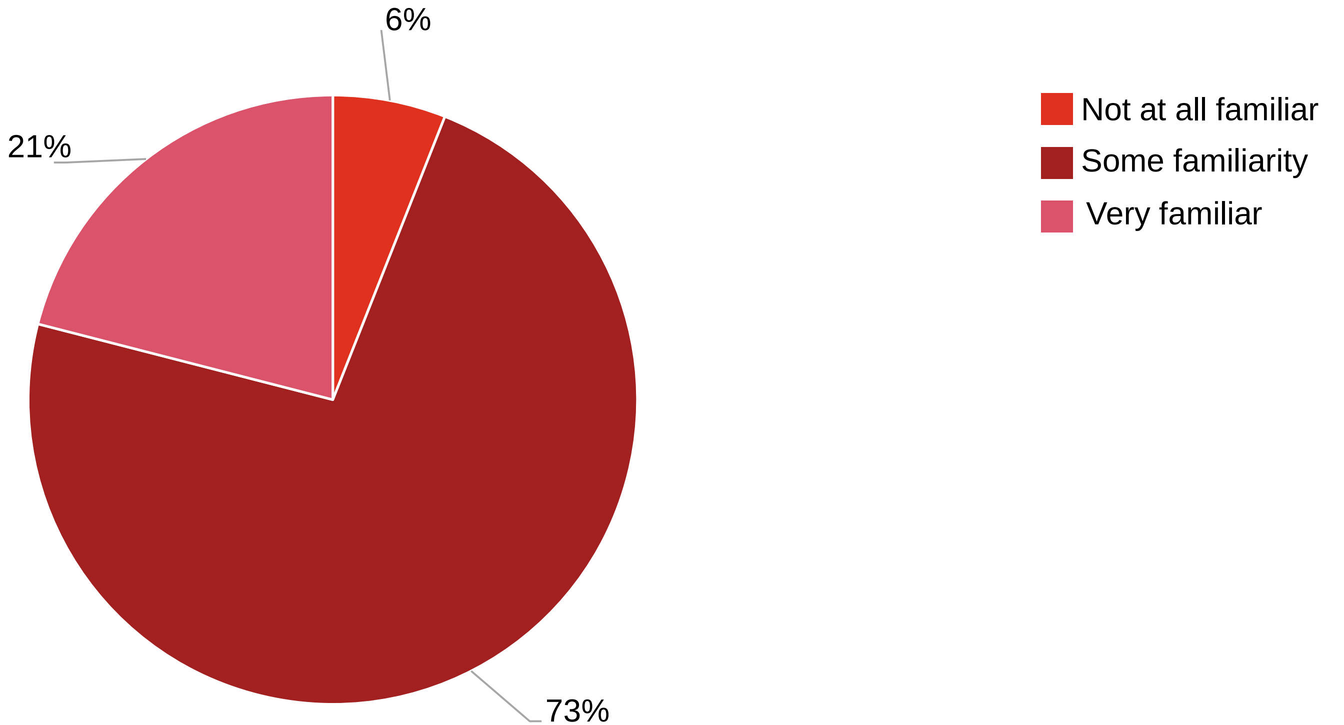


Please indicate which basis of accounting your company is required to report under (select all that apply):

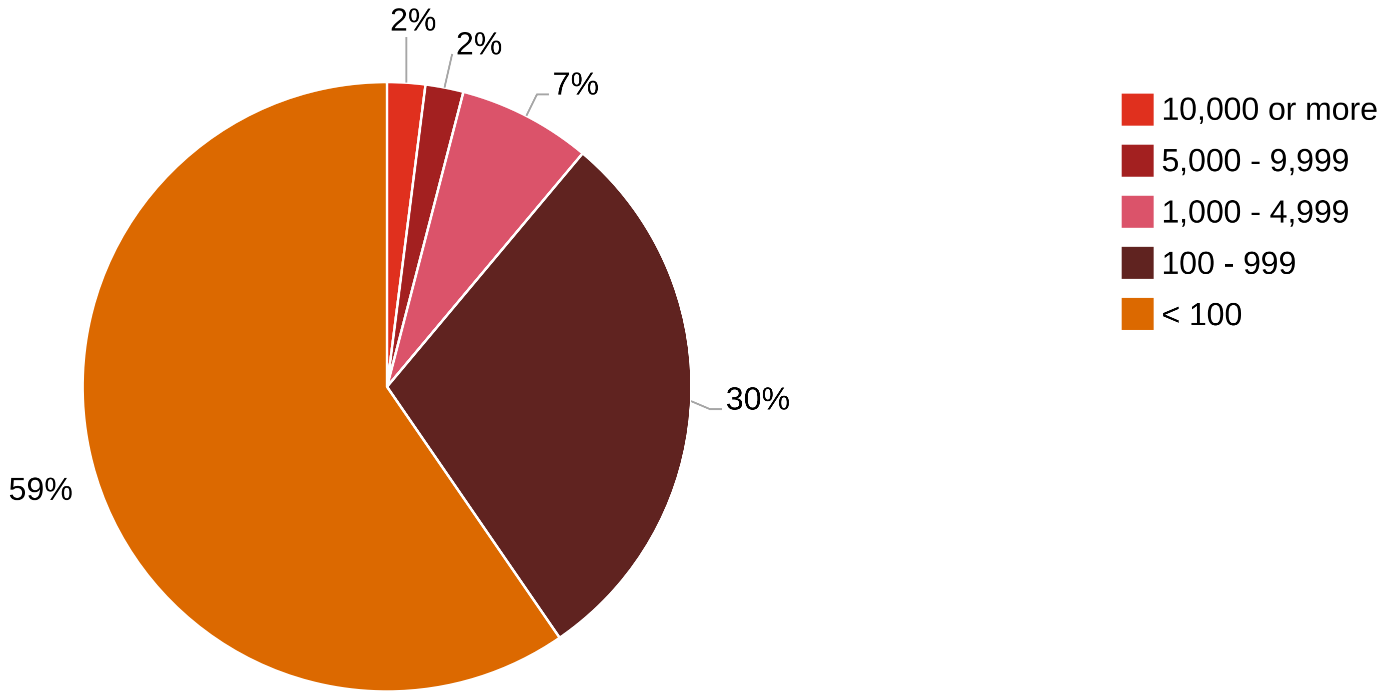


(Respondents were allowed to choose multiple answers so results do not total 100%.)

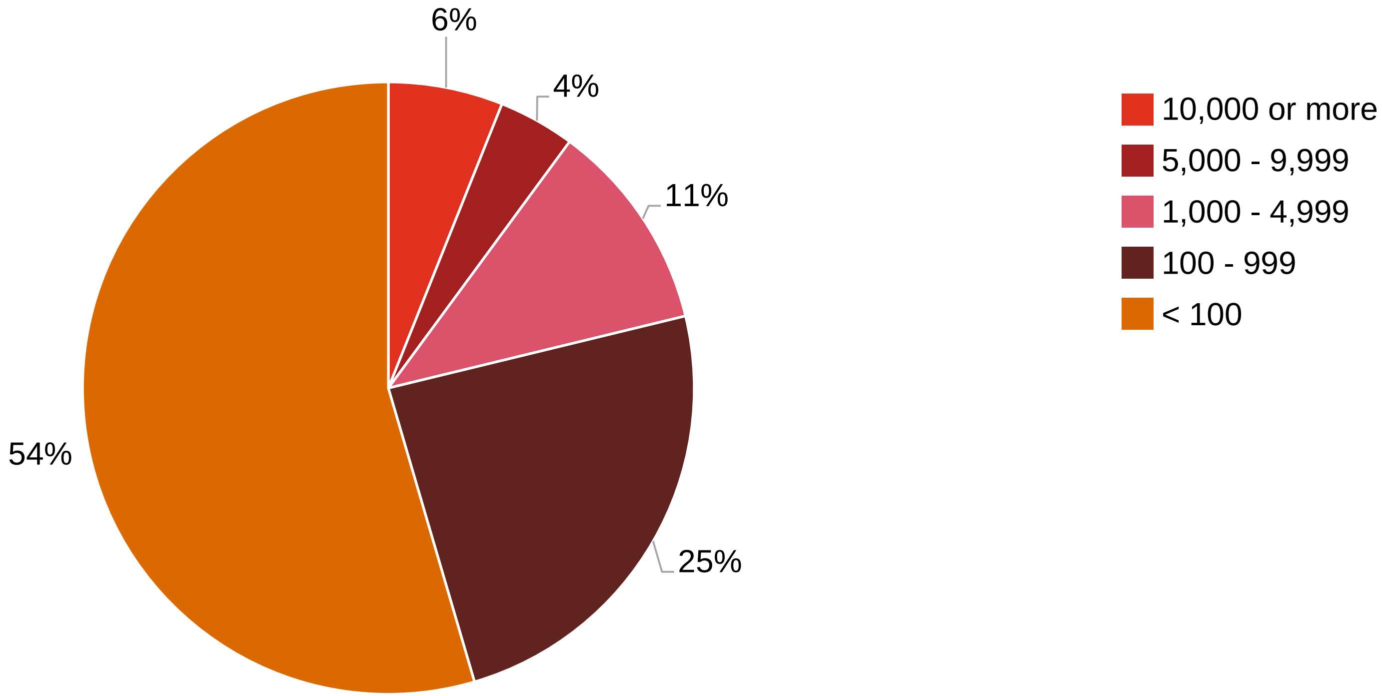
How familiar are you with the new lease accounting standards and their requirements?



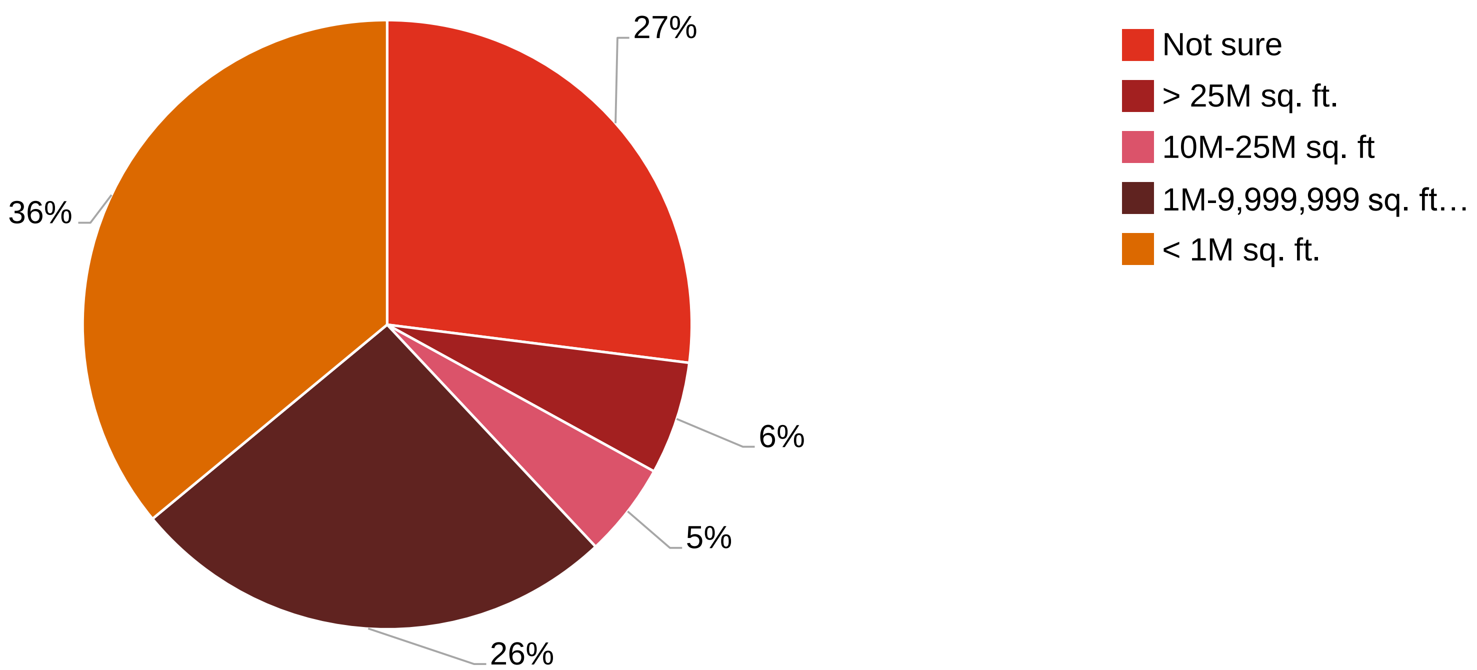
How many real estate assets are leased?



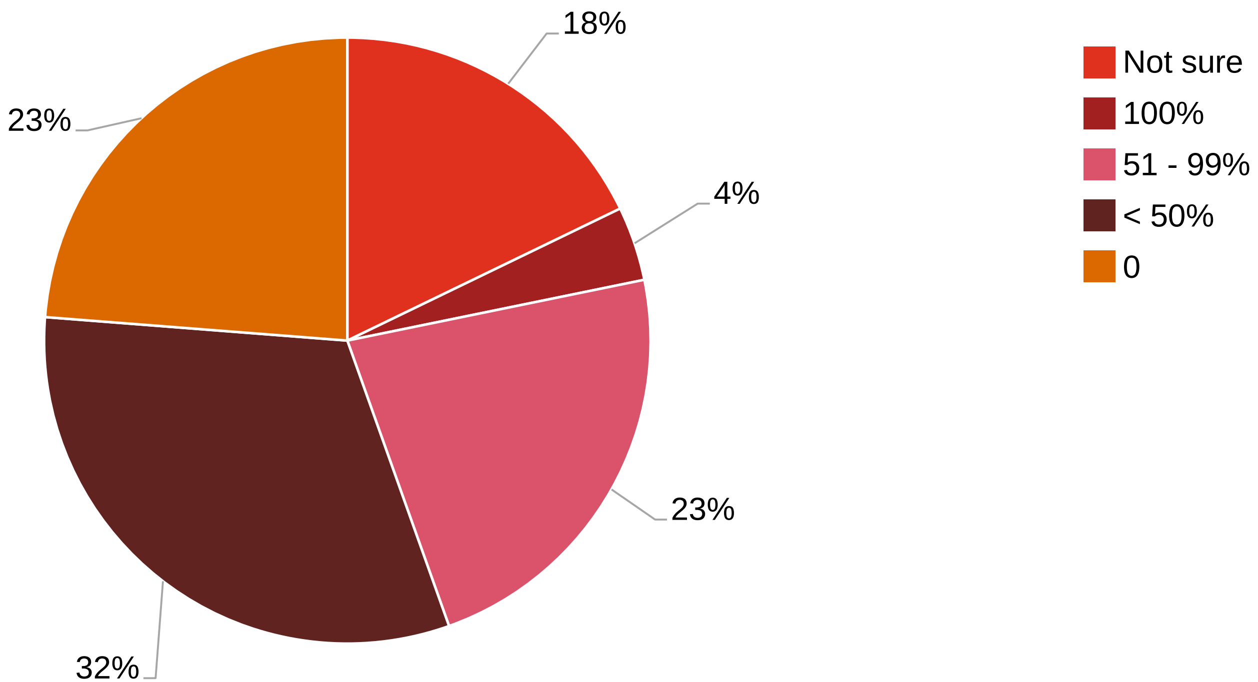
How many non-real estate assets are leased?



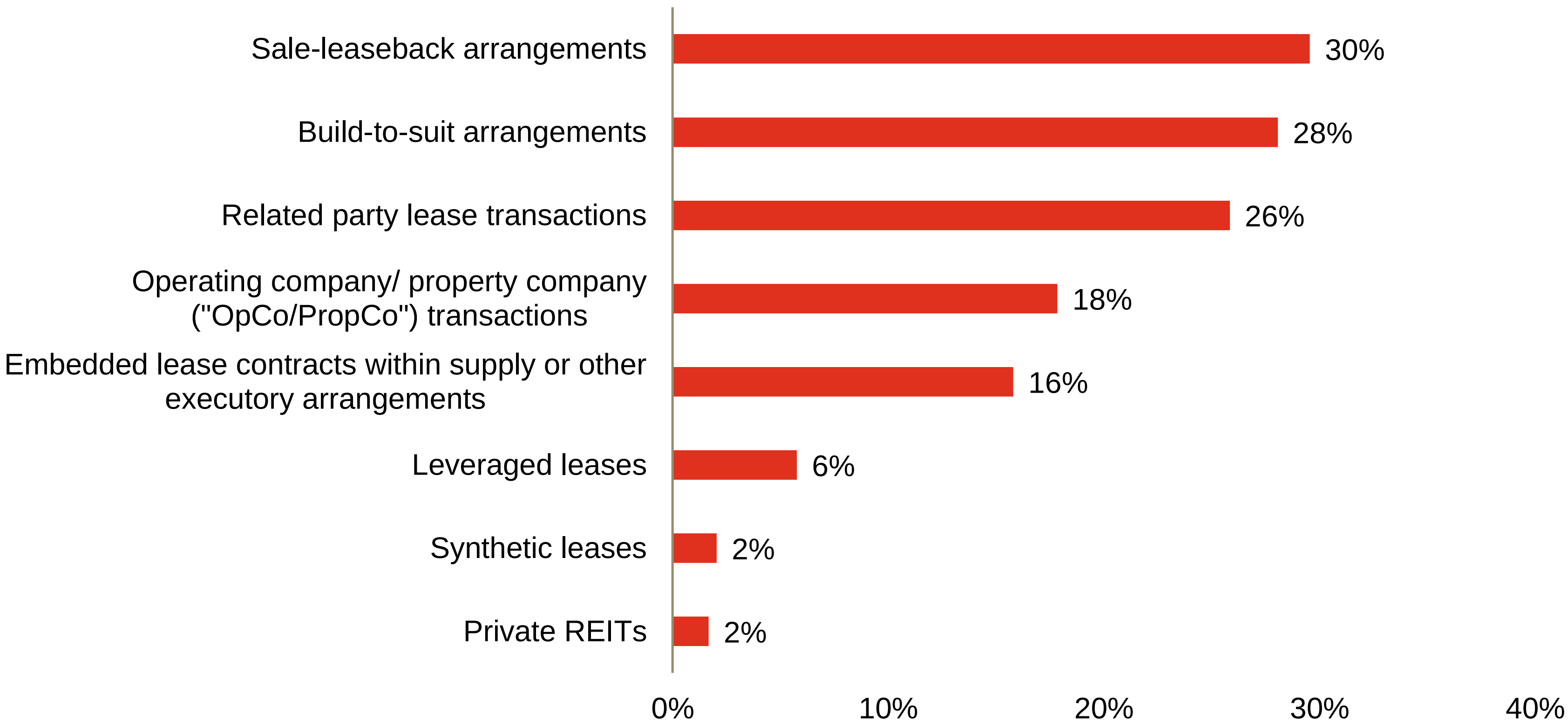
What is the approximate size (square feet) of your combined real estate portfolio, both owned and leased?



Approximately what percentage of your real estate portfolio is owned (based on square footage)?

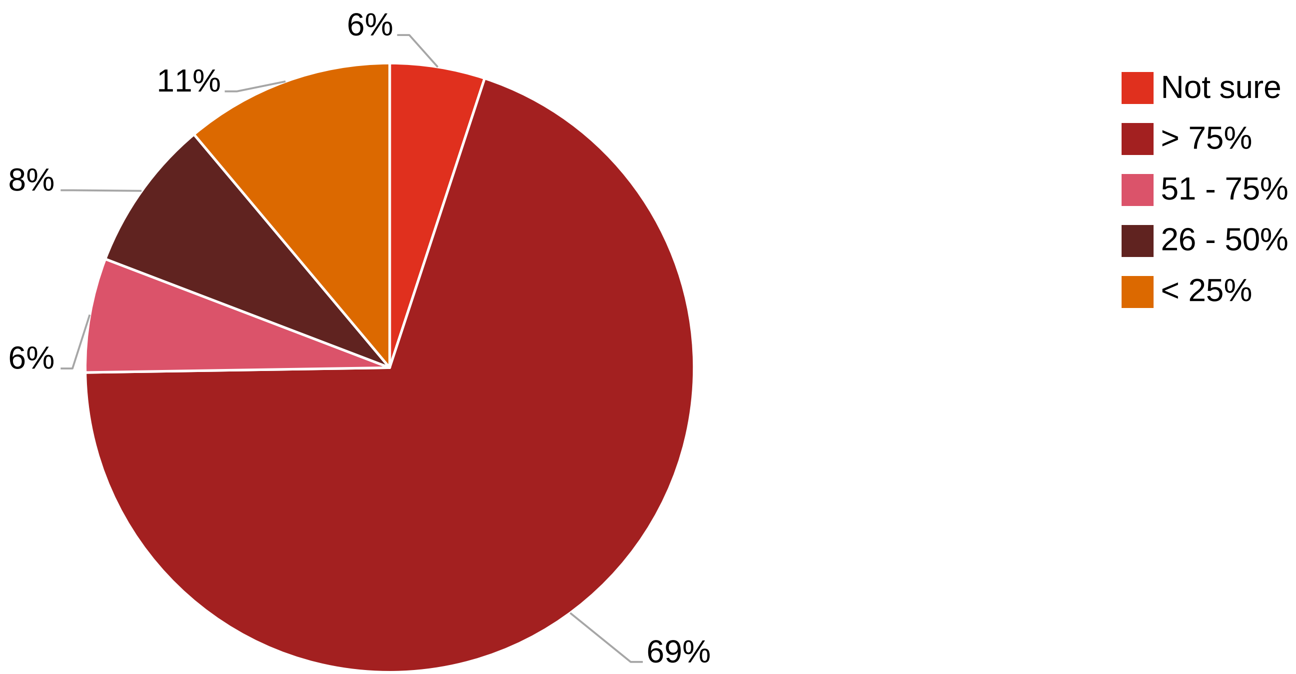


Do you have the following types of lease arrangements?

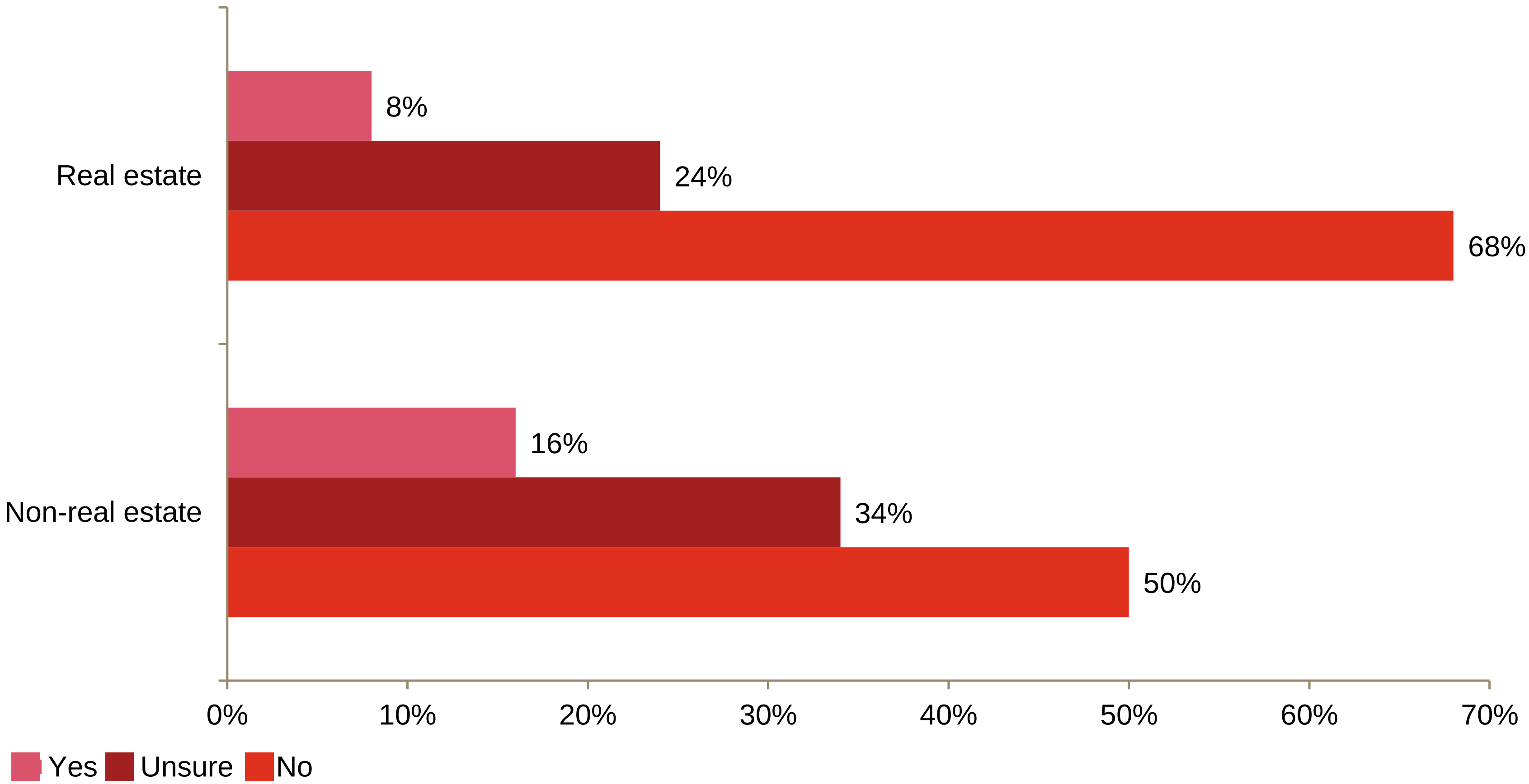


(Respondents were allowed to choose multiple answers so results do not total 100%.)

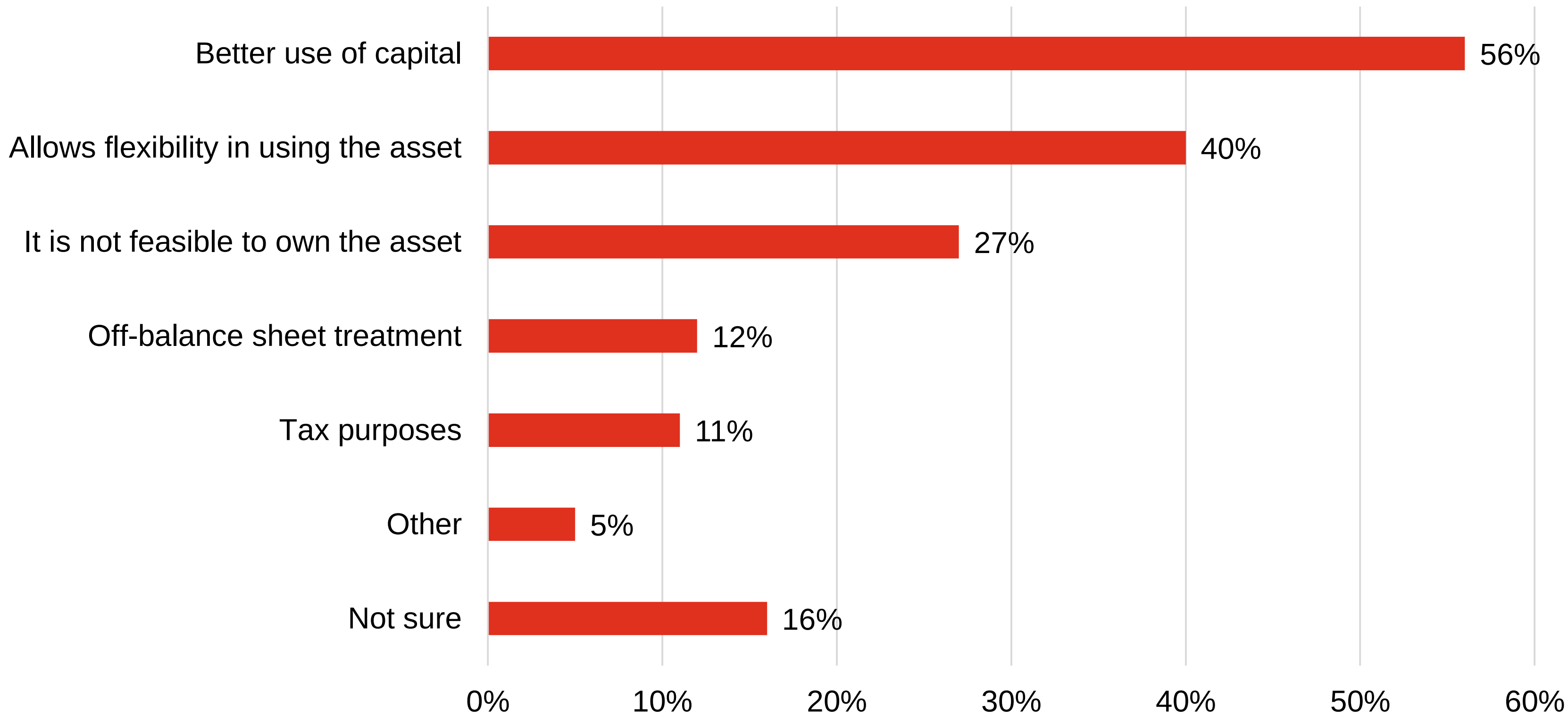
What percentage of your leases are based in the US?



As a result of the new standards, do you expect your company's lease vs. buy strategy to change?

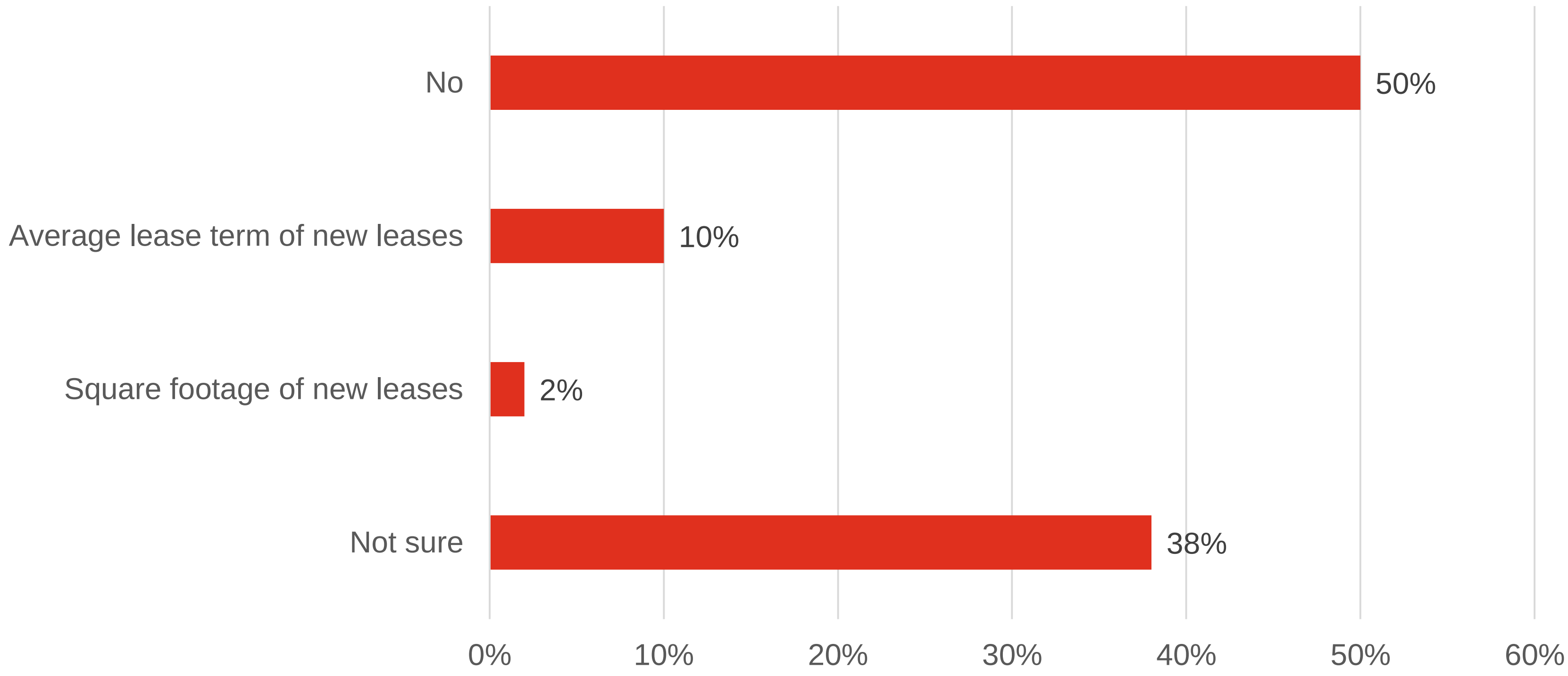


What drives your company's decision to lease vs. buy assets?

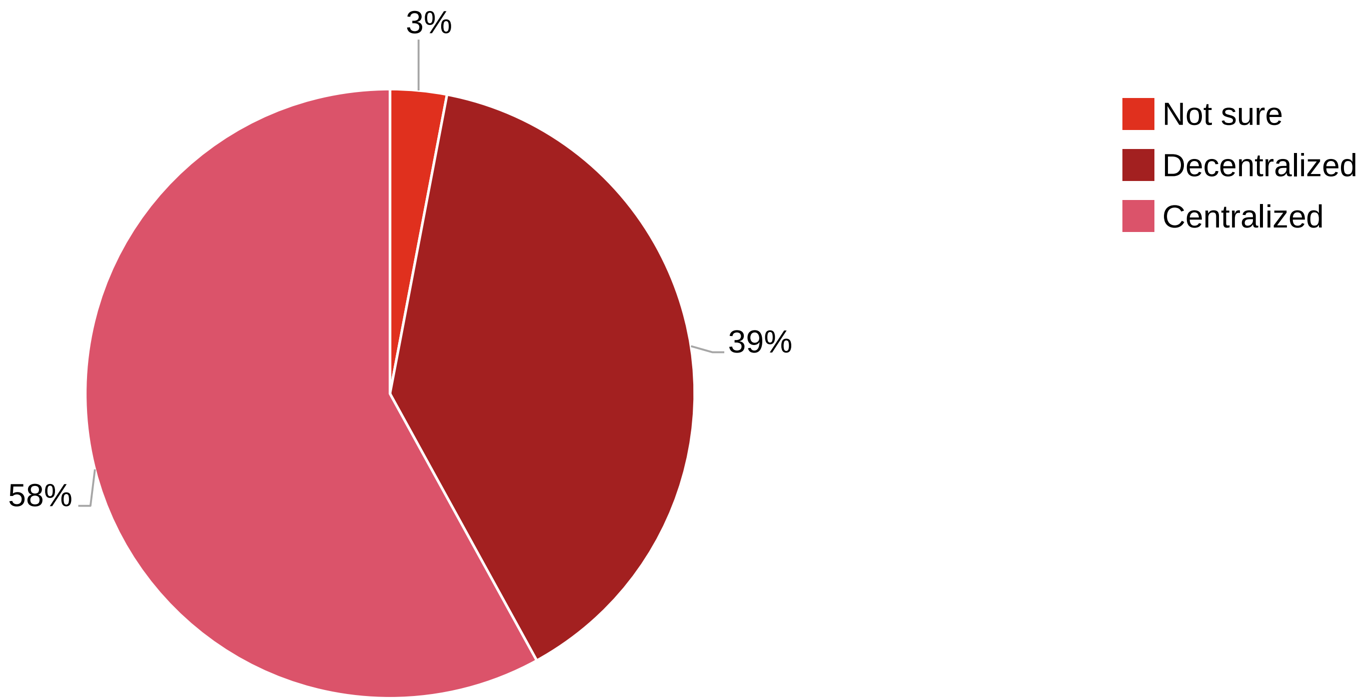


(Respondents were allowed to choose multiple answers so results do not total 100%.)

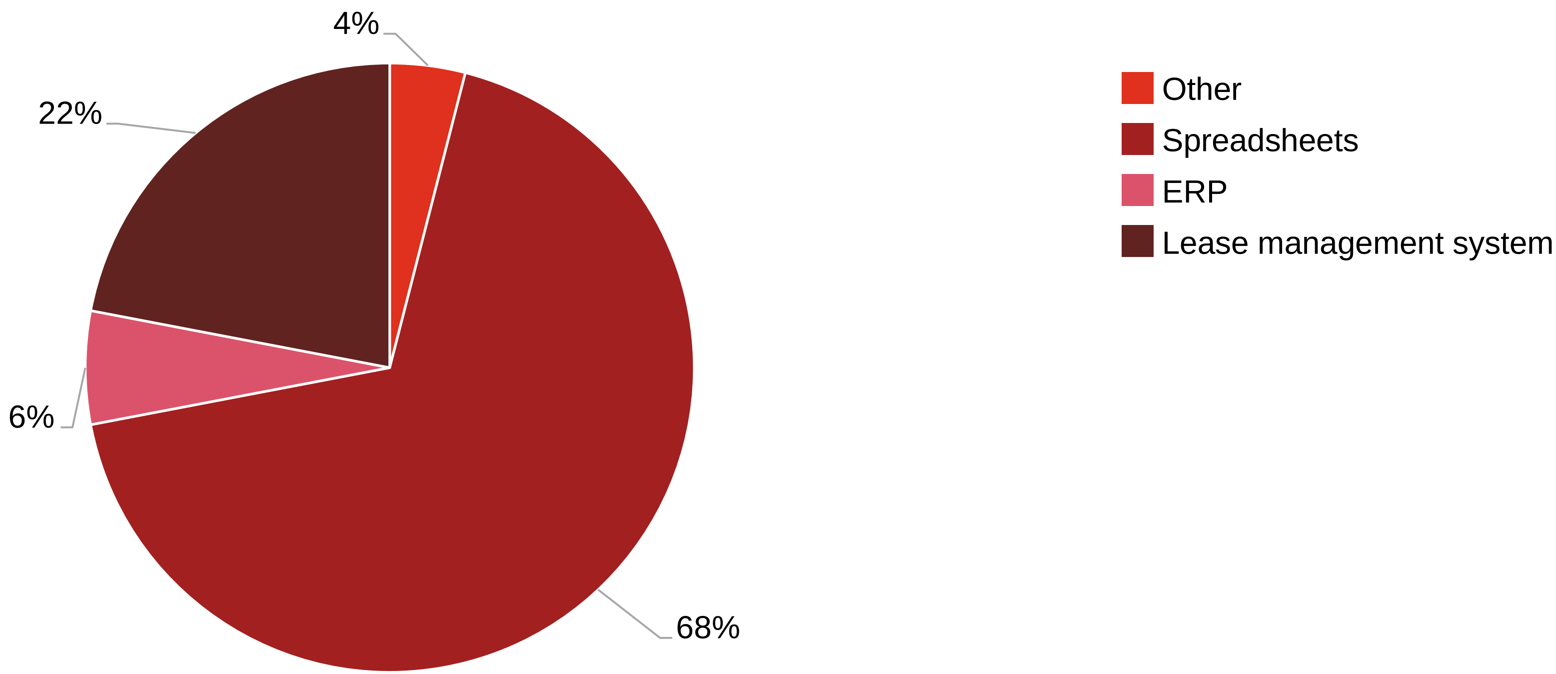
Do you expect your organization to reduce the square footage leased and/or the average lease term as a result of the new lease accounting?



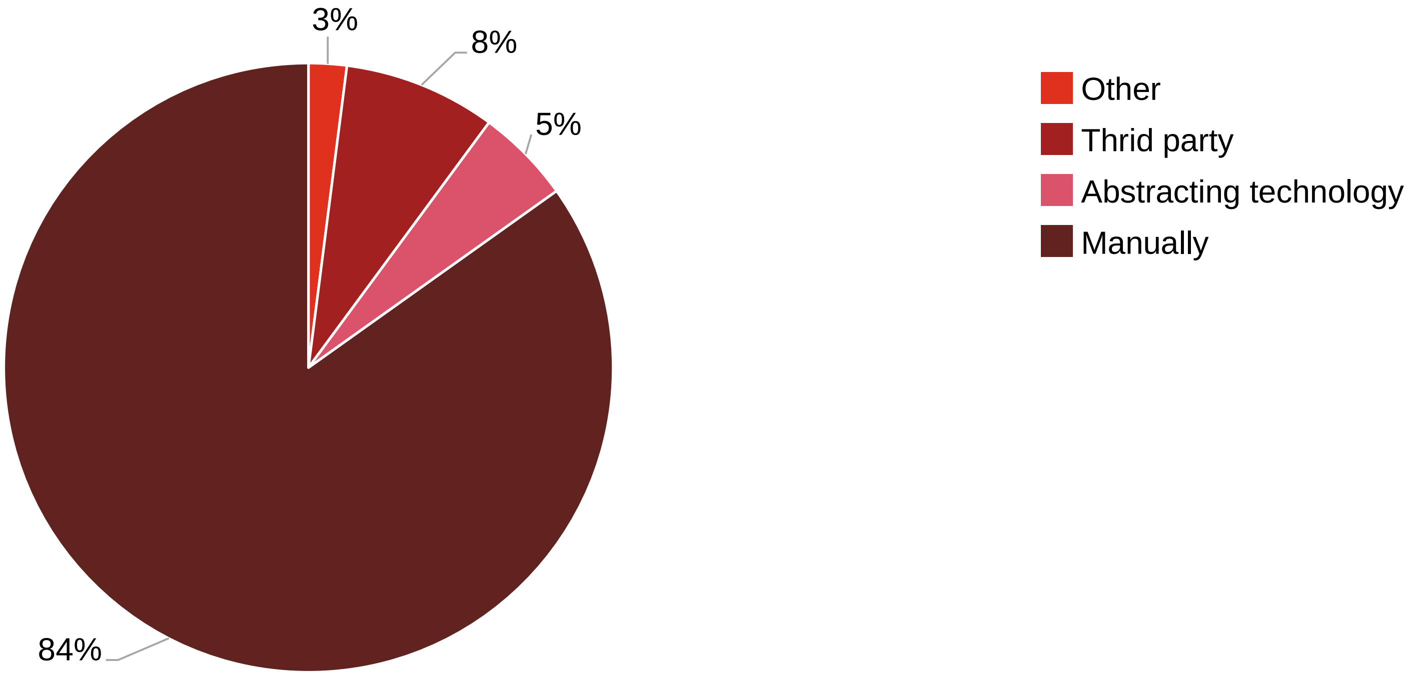
Does your organization have all its lease agreements and related accounting centralized or geographically dispersed?



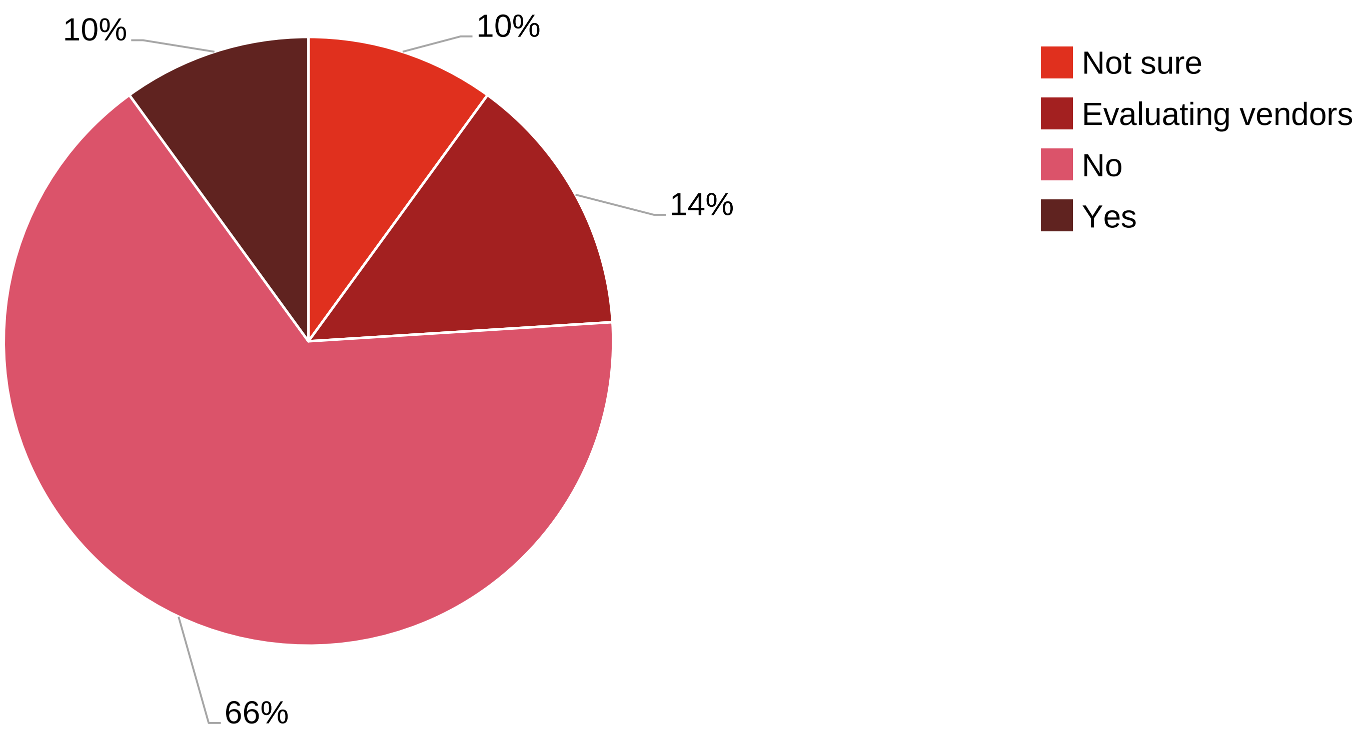
Which of the following best describes the primary system used for tracking leases and lease accounting?



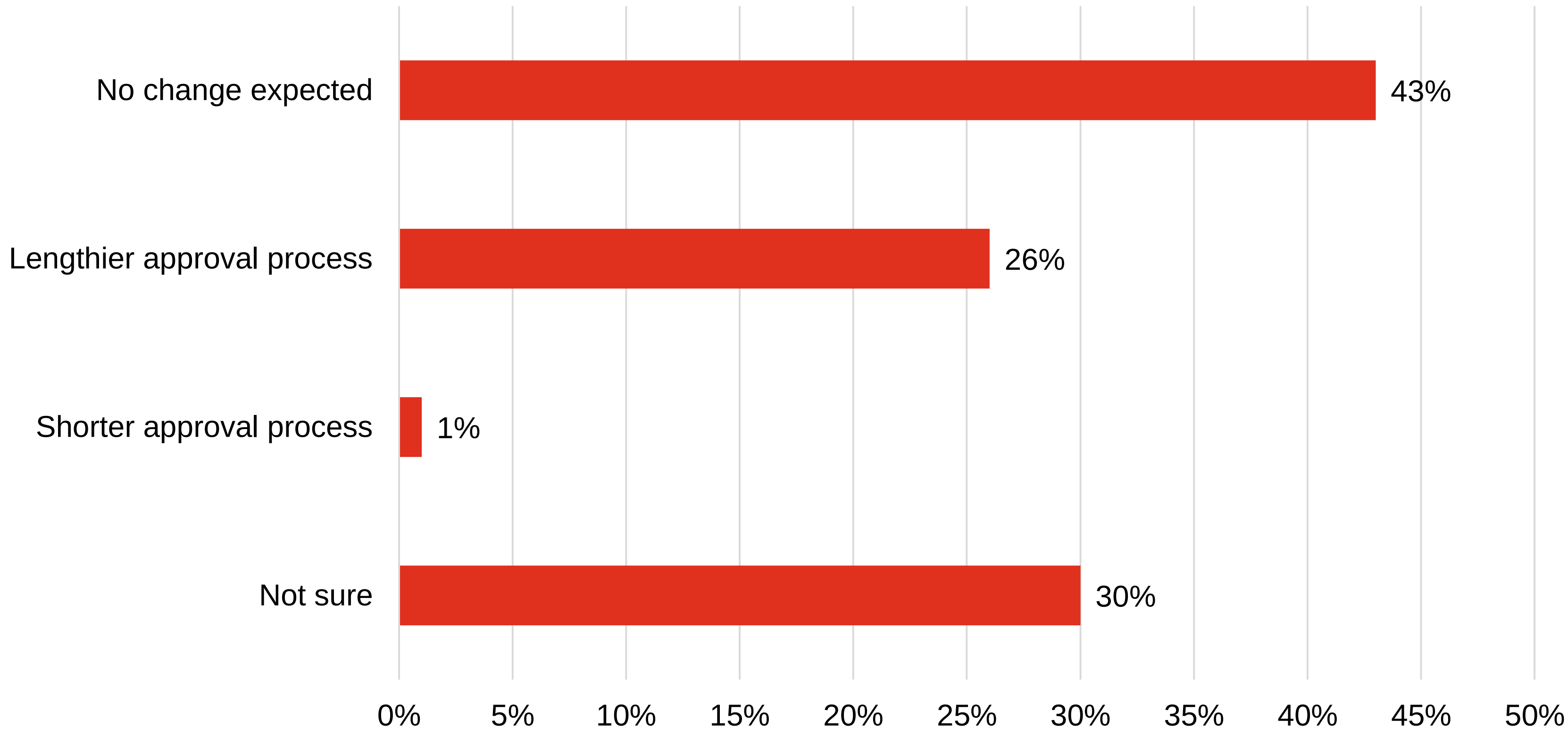
How do you currently abstract the key terms from your lease agreements?



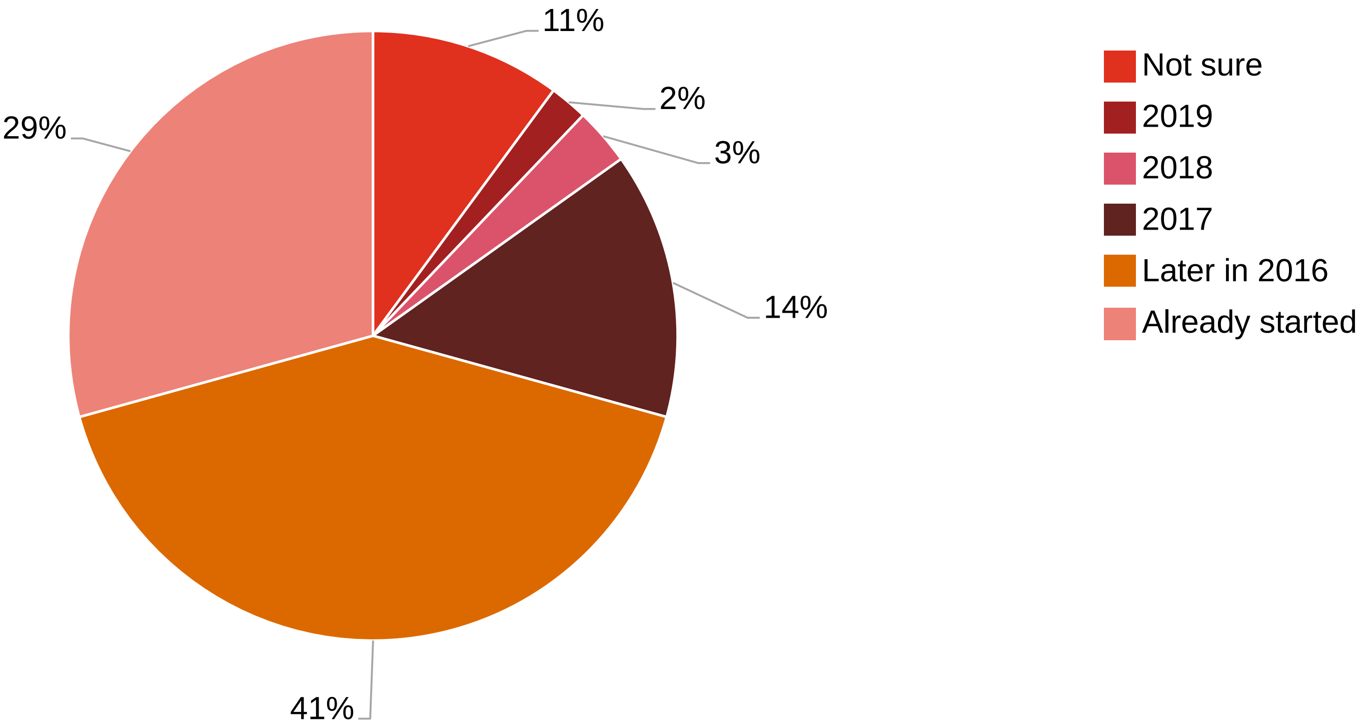
Have you selected a software solution to accommodate the new leasing requirements?



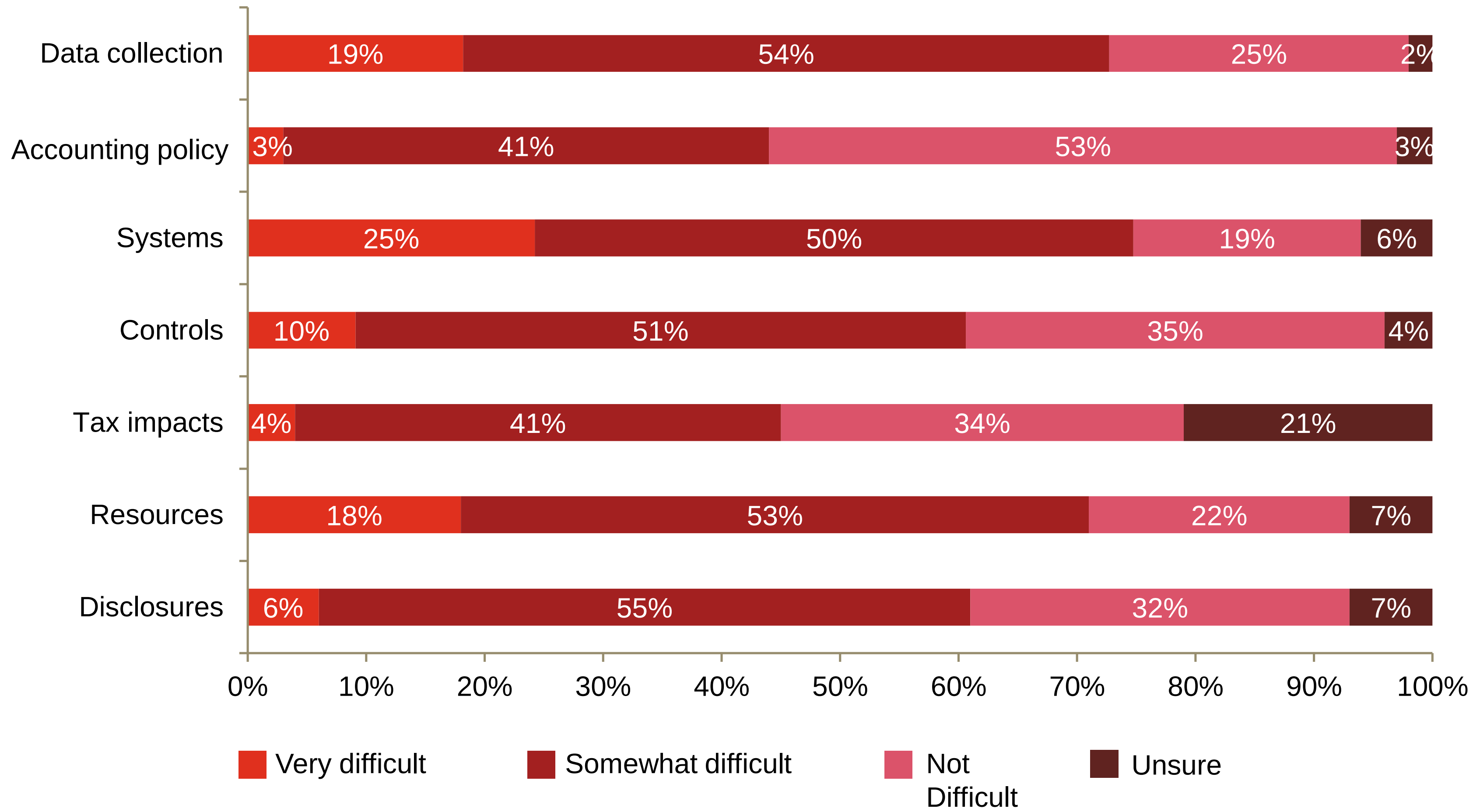
How do you expect the process and/or level of approvals necessary for leases considered material to change as a result of the new standards?



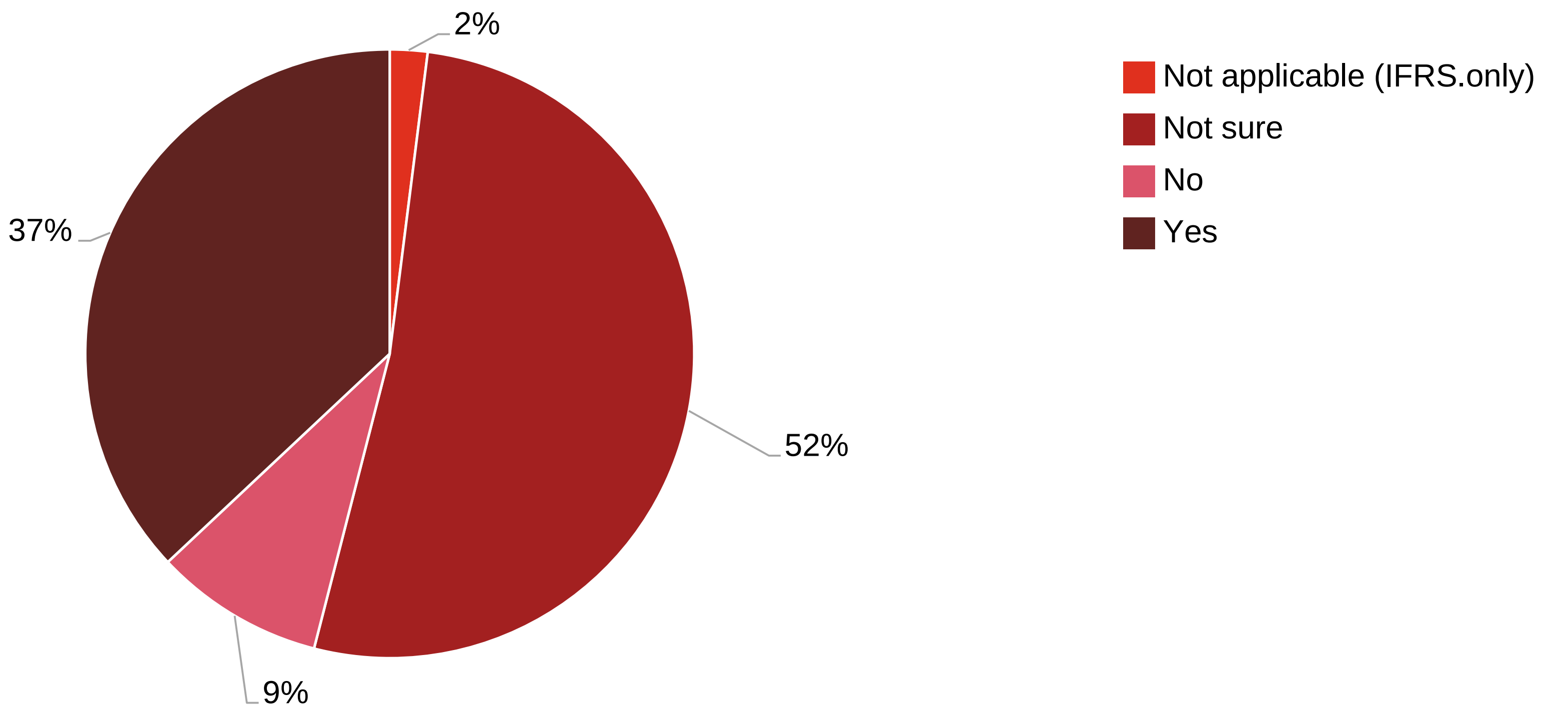
When does your company expect to begin implementation of the new standard and the related requirements?



For each of the following implementation considerations, please rate the potential difficulty level for:



FASB rules provide companies with certain specified reliefs upon transition that must be elected as a package and applied to all of a lessee's leases. Do you expect your company will take advantage of the specified reliefs upon adopting the new leasing standard?



Contacts

To have a deeper conversation about how the new lease accounting standards impact your organization, please contact your PwC representative or one of our lease accounting specialists:

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In the loop
March 2016

Lessor accounting: how the new lease and revenue standards interact

What you need to know

- Recent changes to the lessor accounting model to align it with the FASB's new revenue recognition guidance will have implications in two areas: transactions with variable payments and sales and leasebacks.
- Under the new standards, contracts with variable payments may be accounted for differently, depending on the type of variable payment and whether the transaction is subject to the revenue or leasing guidance.
- Lessors will need to apply the new sale and leaseback guidance, including evaluating the "sale" under the FASB's new revenue guidance.
- A failed sale and leaseback transaction will be accounted for as a loan.

Key changes to lessor accounting guidance

	Current GAAP	*New guidance*
Variable payments (consideration)	The leasing and revenue recognition guidance are generally aligned with respect to usage-based payments. Under either standard, lessors recognize variable payments as revenue in the period earned.	Leases guidance: Variable payments based on usage are not included in the lease receivable or lease income until earned. Revenue guidance: Variable payments may be recognized as revenue upfront, provided certain conditions are met.
Sale and leaseback transactions	Specific sale-leaseback guidance applies to seller-lessees of real estate. For sale-leasebacks of equipment, seller-lessees follow revenue recognition guidance applicable to sales of equipment and leasing guidance for the leaseback and recognition of any profit or loss on sale. Buyer-lessors follow guidance for purchases of property, plant, and equipment for all assets purchased and leasing guidance for the leaseback of the purchased asset to the seller-lessee.	Specific sale and leaseback guidance applies to both lessees and lessors, with the same model applied to transactions related to all assets. The transfer of the asset to the buyer must qualify as a sale under the new revenue recognition guidance.

The changes to lease accounting and their outcomes

The FASB recently issued its new guidance on lease accounting. While the changes are primarily targeted at lessee accounting, the lessor model was updated to align with certain changes made to the lessee model and the FASB's new revenue recognition standard. This alignment will result in the following implications.

- Whether a transaction with variable payments is subject to the revenue or leasing guidance may determine when revenue is recognized by the supplier.
- More transactions may fail to qualify for sale and leaseback accounting. A failed sale and leaseback transaction is considered a financing, and the buyer-lessor records a loan receivable, rather than the physical asset.

Leasing is fundamentally a revenue-generating activity for lessors…
ASU 2016-02, *Lease Accounting*, Summary

Contracts with variable payments

Consider a supply contract in which a manufacturer supplies equipment to a customer. Control of the equipment transfers at contract inception and the transaction qualifies as a sale under the new revenue guidance. During the following 12 months, at each month-end, the customer is required to pay the supplier (1) a fixed amount plus (2) a variable amount based on a percentage of sales from the use of the equipment during the month. The new revenue recognition model requires companies to estimate variable consideration and recognize revenue when control transfers. In this case, that is at inception.

In contrast, suppose a transaction with similar payment terms is subject to the lease guidance and classified as a sales-type lease. As such, the manufacturer (the lessor) would exclude the variable payments from contract consideration. Lease income would not be recognized for the variable payments at lease commencement; rather, it would be recognized when and if earned.

As the example demonstrates, whether the revenue or lease guidance governs the transaction impacts the timing of the lessor's revenue recognition.

What lessors should consider

Lessors and lessees in sales-type leases may have different preferences as to whether rent payments are fixed or variable. Lessors may prefer fixed payments, which are recognized as revenue at lease commencement. However, lessees may prefer variable payments based on usage, which are likely to reduce the lease liabilities on their balance sheets. Both parties need to consider which payment structure achieves their objectives.

Sale and leaseback transactions

In a sale and leaseback transaction, a seller-lessee sells an asset to a buyer-lessor and simultaneously leases it back.

The new leases standard introduces criteria for sale and leaseback accounting that apply to both lessees and lessors. This is a significant change for buyer-lessors. Previously, only lessees of real estate were subject to stringent conditions to qualify for sale and leaseback accounting. A buyer-lessor's purchase of an asset from and subsequent lease to a seller-lessee were accounted for as a separate purchase and lease.

To achieve sale and leaseback accounting under the new leases guidance, the transfer of the asset from the seller-lessee to the buyer-lessor must qualify as a sale under the new revenue recognition guidance. To do so, the buyer-lessor needs to obtain control of the asset, considering the indicators in the revenue recognition standard.

The existence of a leaseback that the seller-lessee classifies as a finance lease or the buyer-lessor classifies as a sales-type lease precludes the asset transfer being considered a sale as the seller-lessee effectively retains control of the underlying asset.

Also, certain types of repurchase options may preclude the transfer of an asset from being considered a sale. Those that are exercisable (1) at other than the asset's fair value at the time of exercise or (2) for assets without available, substantially similar alternatives would prevent the transfer of the asset from qualifying as a sale.

Repurchase options in equipment leases are typically at a fixed price, which is sometimes preferred as it avoids the uncertainty of a price based on fair value. A fixed-price repurchase option would prevent the transaction from qualifying as a sale.

Repurchase options related to real estate may also be problematic. Real estate is considered unique in that no two parcels have the same location. Due to the absence of a similar, alternative asset, the presence of a repurchase option in a sale and leaseback of real estate would prevent the transfer of the asset from qualifying as a sale.

In each of the above examples, because the transfer of the asset does not qualify as a sale, sale and leaseback accounting would be precluded.

What lessors should consider

In some cases, the provisions that prevent sale treatment may be subject to negotiation. For example, changes to contract terms can impact the control conclusion and repurchase options can be modified or removed. Given that the new guidance applies to both buyer-lessors and seller-lessees, both parties have the same objective and may be more open to negotiations to achieve a common goal.

Join our webcast and take our lease accounting survey

Webcasts on March 3 (replay available) and March 17

Survey: How will the new standards impact you?

In the loop

Executive-level insight into today's top financial reporting and regulatory issues

How PwC can help

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You may also want to see

In brief: Lease accounting: The long-awaited FASB standard has arrived

In depth: The leasing standard - A comprehensive look at the new model and its impact

In the loop: Are leases embedded in your contracts?

For more accounting and financial reporting developments, visit www.cfodirect.com.

Tax considerations associated with the new leasing standard

November 2016

In brief

In an effort to improve transparency and provide more meaningful information to users of financial statements, the FASB issued an Accounting Standards Update on Topic 842, *Leases*, on February 25, 2016. This new guidance will significantly impact the U.S. GAAP financial statement accounting for leases by lessees, eliminating the traditional concept of an operating lease. Under the new guidance, virtually all leases will be included on the balance sheet for lessees. The new lease accounting guidance will be effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018 (one year later for annual periods for entities not meeting the FASB's definition of a public business entity). Early adoption is permitted. The new standard must be adopted using a modified retrospective transition. Transition will require application of the new guidance at the beginning of the earliest comparative period presented.

The changes in accounting guidance will not impact how leases are treated for U.S. federal income tax purposes; however, as companies transition to the new leasing standard for financial reporting, changes to lease accounting policies, lease terms and conditions, and processes and systems used to track and account for leases may impact several areas within the tax function, including U.S. tax accounting methods, deferred tax accounting, state taxes, transfer pricing, and tax processes and systems.

In detail

Background of the new lease accounting model

Leasing transactions are commonly used by many organizations to secure the use of property or equipment with payments typically made over time. Certain leasing transactions, such as sale-leaseback, also allow lessees to monetize the fair value of the property while continuing to use it.

The FASB and IASB issued new standards earlier this year to address concerns about the current accounting lease model, which included allowing lessees to achieve off-balance sheet financing.

The following provides an overview of the new standard, *Leases (ASC 842)*, from the perspective of both, a lessee and a lessor.

Lessee accounting model

Under the new accounting model under ASC 842, lessees will need to recognize a right-of-use asset and a lease liability on the balance sheet for virtually all of their leases (other than leases that meet the definition of a short-term lease). The liability will be equal to the present value of the future lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs.

For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Operating leases will result in straight-line expense (similar to current operating leases), while finance leases will result in a front-loaded expense pattern (similar to current capital leases).

Classification will be based on criteria that are largely similar to those applied under current lease accounting, but without explicit bright lines.

Lessor accounting model

The model for lessor accounting in ASC 842 will be similar to the current model, but updated to align with certain changes to the lessee model (e.g., certain definitions, such as initial direct costs, have been updated) and the new revenue recognition standard. Similar to historical guidance, lessors will classify leases as operating, direct financing, or sales-type.

Lease accounting will continue to require significant judgments, including when making estimates related to the lease term, lease payments, and discount rate. Similar to today, the term of the lease will include the non-cancellable lease term plus renewal periods that are reasonably certain of exercise by the lessee or within the control of the lessor.

Leveraged leases

Leveraged lease accounting has been eliminated, although it has been grandfathered for existing arrangements.

PwC lease accounting resources

Included below are links to PwC lease accounting resources that provide a more expansive summary of the new lease accounting model:

- In brief: Lease accounting: The long-awaited FASB standard has arrived
- In depth: The leasing standard - A comprehensive look at the new model and its impact
- 10Minutes on the new US lease standard: How the new rules will bring changes to your financial statements
- Lessee accounting under the new leasing standard
- Lessor accounting under the new leasing standard
- PwC's comprehensive guide to the new US GAAP leases guidance

Tax considerations

The changes in accounting guidance will not impact how leases are treated for federal income tax purposes; however, as companies transition to the new leasing standard, changes to lease accounting policies, lease terms and conditions, and processes and systems used to track and account for leases may impact several areas within the tax function, including U.S. tax accounting methods, deferred tax accounting, state taxes, transfer pricing, and tax processes and systems.

Included below is a summary of several potential tax considerations when transitioning to the new leasing standard.

U.S. tax accounting methods

As part of companies' efforts in transitioning towards the adoption of the new leasing standard, additional leasing information may become available to tax departments. During this process, tax departments may identify necessary changes, or more optimal methods, related to their historical tax treatment of leases and related items. Specifically, tax departments may need to review the following U.S. tax accounting method items in conjunction with the adoption of the new leasing standard: characterization of leases (i.e., sale, lease, or financing); timing of income or expense under IRC Section 467; treatment of tenant improvement allowances; and treatment of lease acquisition costs. A tax change in method of accounting may be available to provide more appropriate or beneficial tax reporting prospectively for leases.

Deferred tax accounting

The measurement of book basis amounts associated with lease assets and liabilities may change upon adopting the new accounting guidance. For example, for lessees with leases classified as operating leases under the current accounting model, a right-of-use asset and lease liability will now be recorded under the new standard. However, the tax basis amounts may not change as the U.S. federal tax law is not changing, thus creating a change to deferred taxes. Tax departments will need to understand and assess any changes to the book basis of the lease assets and liabilities to ensure book and tax basis amounts are appropriately reconciled and deferred taxes are accurately recorded. In addition, if lease terms and conditions or policies change as a result of the adoption of the new standard, the tax basis and method may be impacted, and deferred tax considerations will need to be assessed.

From an income statement perspective, similar to the treatment today, book expense may be reversed for tax purposes. To the extent any impairment for a right-of-use asset is recorded for book purposes under Topic ASC 360, *Property, Plant, and Equipment*, it will also be reversed for tax purposes. The tax deduction for lease expense will be based on current tax methods (for example, in accordance with IRC Sec. 467 accrual path). Such differences between book and tax accounting would impact deferred tax computations.

State taxes

Certain states levy franchise taxes for companies doing business within a particular jurisdiction. Franchise taxes are generally based upon the net worth (stockholder's equity) of a corporation; however, various adjustments may be required (e.g., treasury stock, liabilities, reserves, etc.) to arrive at the taxable base. Implementation of the new leasing standard may impact the computation of a company's franchise tax base due to the requirement to record essentially all leasing transactions on the balance sheet for financial accounting purposes. Moreover, the property factor utilized in the computation of many state apportionment factors (for both income and franchise tax purposes) is determined through the use of an average owned property (generally, valued at its original cost) and eight times the net annual rent. After the adoption of new guidance, companies may need to change their process to gather the information for property factor computations, particularly if the right-of-use asset is recorded in the same balance sheet account or line item as other owned property.

Other non-income based taxes

Companies should consider whether the adoption of the new lease accounting standard will impact any other non-income based taxes. For example, a company should consider whether its property tax liability (if based on its financial accounting balance sheet) will change as a result of the proposed standard.

Companies should also consider if there will be any sale and use tax impact resulting from the adoption of the new lease accounting standard. For example, companies should assess whether a state would consider a lease transaction as a purchase, since companies will have lease transactions on the balance sheet after adopting the new standard.

International tax and transfer pricing

For companies with a global lease portfolio, consideration should be given to any local jurisdictional tax impacts resulting from a company's policy changes when adopting the new standard.

Similar to the considerations discussed above with respect to U.S. tax, companies will need to consider tax accounting method and tax impacts of the leasing standard in each foreign jurisdiction around the globe in which they operate upon transition. Depending on the number of jurisdictions and differences in rules across those jurisdictions, companies may require resources and changes to existing processes.

Companies should also consider differences between US GAAP and IFRS. Under the new IFRS leasing rules, lessees will no longer be able to recognize straight-line expense for virtually all leases. Instead, under the new IFRS rules, lease expense will be replaced by interest expense on the lease liability and depreciation expense due to depreciation of the right-of-use asset for virtually all leases.

The new leasing standard may also impact transfer pricing arrangements. Many profit level indicators and financial ratios are used to evaluate the consistency of intercompany pricing with the arm's length standard. For example, it may be appropriate to use the profit level indicator of return on operating assets ("ROA") to test the results of certain intercompany arrangements. Typically, these calculations have been based on balance sheet data prepared pursuant to U.S. GAAP. To the extent that the total assets of a legal entity will be increased due to the new standards, the computation of this ratio may be affected when compared to periods prior to adoption of the new standard. Multinational companies with intercompany arrangements should carefully evaluate how the financial ratios and profit level indicators utilized to assess the validity of the transfer pricing arrangements could be impacted as a result of the new lease guidance.

Tax data, process, and system considerations

Lease data is generally collected for different purposes including finance, accounting, procurement, IT, and tax. These various data collections often use unique processes and mechanisms, creating a significant variation in the quality, integrity, and relevance of the data across multiple information sources. Upon adopting the new lease accounting standard, opportunities and challenges may arise in regards to the associated processes and systems used to track lease data.

As processes and systems are evaluated for the new lease accounting standard, tax departments should actively participate to determine the impact to any lease data used for tax reporting purposes and ensure key lease data used for tax purposes continues to be available to the tax department. Opportunities may arise as part of this evaluation to attain lease data for tax reporting purposes that was previously not available. Lease data management and collection process improvements ranging from enhanced spreadsheet-based models and home-grown software solutions to ERP customization and end-to-end lease management module add-ons could significantly improve the organization's (including the tax department's) ability to access lease data and the global leasing processes.

Effective dates and transition

The new accounting guidance will be effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For entities not meeting the FASB's definition of a public business entity, the new accounting guidance will be effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted. The new standard must be adopted using a modified retrospective transition. Transition will require application of the new guidance at the beginning of the earliest comparative period presented.

The takeaway

As companies prepare to adopt the new lease accounting standard, tax implications and opportunities should be considered at each step of the implementation process.

For tax departments, during the adoption of the new accounting model it is important to review the data repository of the organization's entire lease portfolio, inclusive of renewal options, lease terms, payment schedules, etc. from both a financial accounting and income tax perspective. This will enable companies to effectively (i) identify differences between the current standard and new standard, (ii) inventory all existing leases and deferred income tax items associated with the leases, (iii) assist in the computation and reconciliation of book/tax differences, (iv) assess federal, state, and international tax impacts, and (v) implement a process to properly characterize a lease transaction under the new standard on a go forward basis, while at the same time assessing the tax treatment of each lease transaction.

Let's talk

For a deeper discussion of tax implication of changes to lease accounting standard, please contact your PwC engagement team or individuals listed here:

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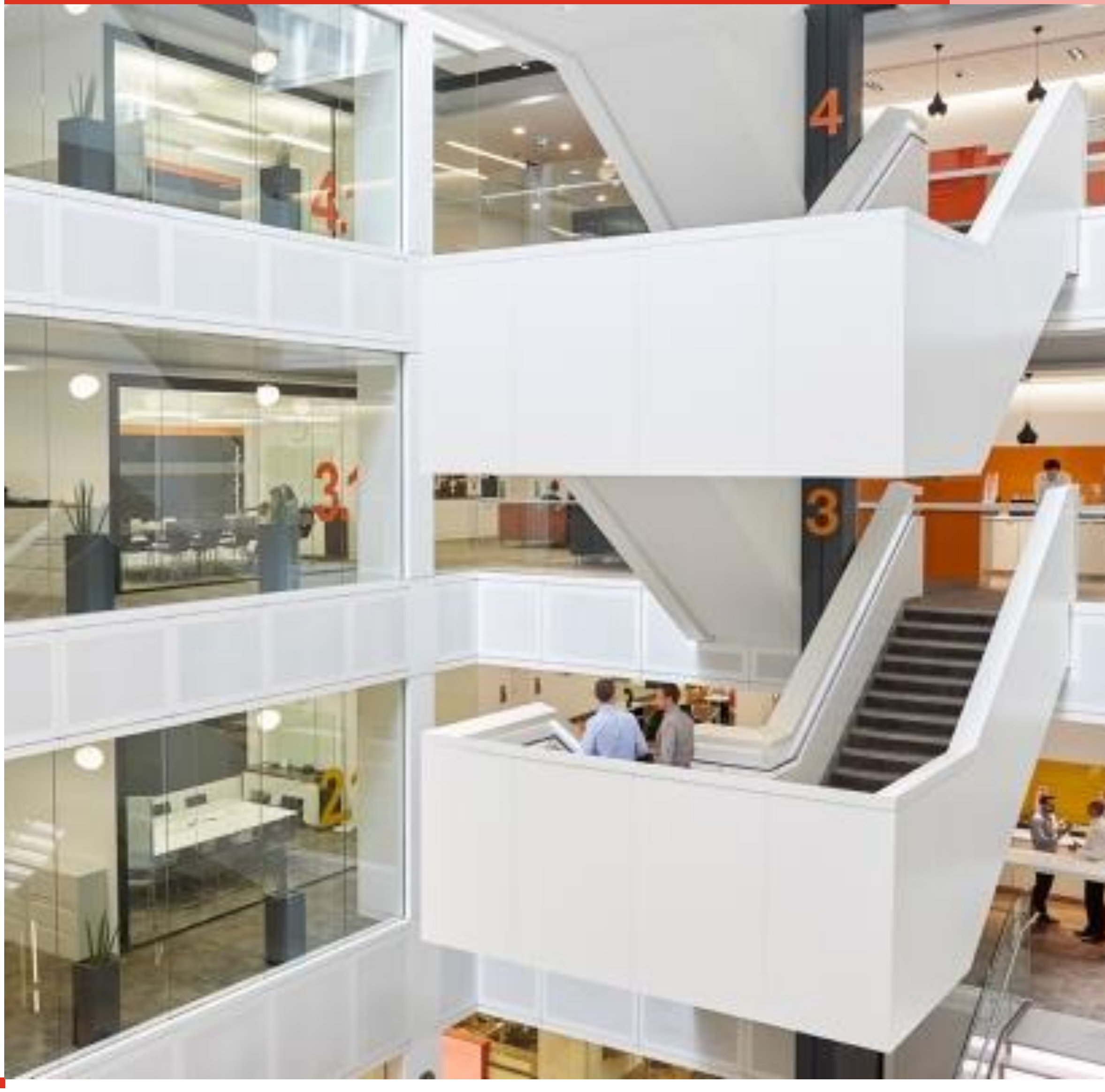
Impacts of the new leasing standard – beyond accounting

Consider these top systems, data and process challenges – and potential solutions

November 2016



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The new leasing standard in a nutshell

- Virtually all leases must be reflected on the balance sheet
- Rules are in effect for all fiscal years starting after December 15, 2018
- Retrospective requirement will oblige companies to spend time evaluating the financials of existing leases—in order to show them as comparisons starting in 2018

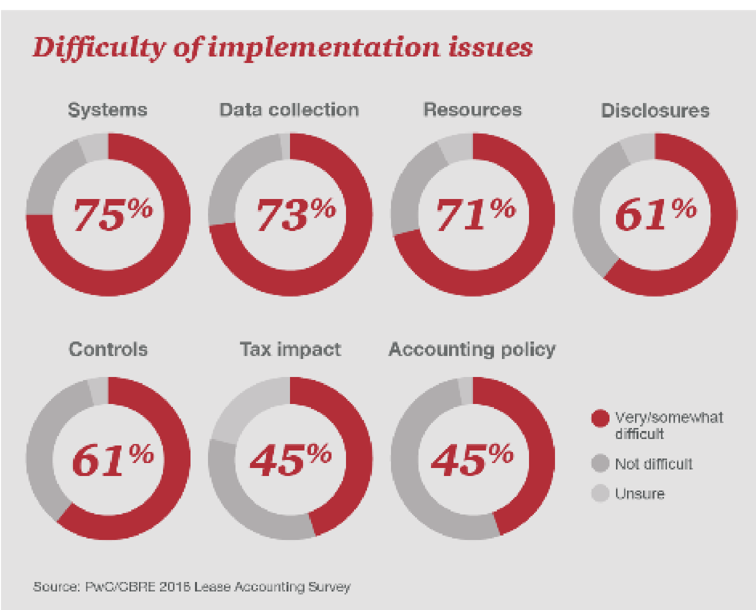
Consider these top systems, data, and process challenges – and potential solutions

When the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their new lease-accounting standard in early 2016, the clock started ticking on a sweeping set of changes that companies are going to have to implement in the next two years. But the adjustments will be needed beyond the accounting department because the new rules will impact any department that deals with leases—including procurement and corporate real estate—and virtually all of the systems and processes that companies use in managing their lease data.

At this still-early stage, companies' main concern does not lie principally in understanding the new rules, which, from a technical accounting perspective, are straightforward enough. In fact, in a June 2016 survey by PwC and CBRE, less than half of all companies said they thought the accounting policy itself would be hard to implement.[1] More companies said they expected the difficulties to come from the systems they'll have to put in place to meet the new requirement and from their resource constraints.

There are also uncertainties about the data collection that will be required for complying with the new standard. According to PwC's survey, 39% of companies currently manage their lease agreements and related accounting in a decentralized manner, which means they're going to have to gather information from dozens, perhaps hundreds, of separate sources. And even at companies that *have* centralized their lease data, the information may be in different kinds of spreadsheets or in original paper agreements or in scanned pdf files that contain inconsistent characterizations of lease terms and other fields. To put it another way, the term *centralized* doesn't necessarily mean usable.

Some of the most daunting challenges the new leasing standard will pose for companies are only tangentially related to accounting. What are the key hurdles companies must overcome as they transition to the time that the liabilities leases represent will be reported on their balance sheets? This is our view of what companies should be thinking about now so they are not playing catch-up when the rule goes into effect.



[1] *http://www.pwc.com/us/leasingsurvey*

Challenge 1: Reorganize your lease data

Companies are right to be concerned about their lease data. In addition to the lack of centralized lease information, many companies may have no information at all about small leases they hold—including, say, leases for office equipment—or about leases held at subsidiaries. Inadequate controls over lease data and missing information about who entered into or uploaded a lease agreement in the first place can cause additional problems.

As a consequence of those issues, many companies don't have complete and accurate information about their lease portfolios. Moreover, there is no single action they can take to remedy the situation – some leases exist in paper form only and have to be digitized. Already-digital leases may have to be scrubbed and cleansed. There has to be an audit trail that tracks any changes made to leases along the way. Some leases include data gaps that will have to be filled in. And then there's the problem of inconsistencies between leases—an inevitable result of the differences in templates used by lessors. Those inconsistencies have to be reconciled.

Fortunately, advances in unstructured data analytics are helping companies handle some of these challenges. Notably, improvements in optical character recognition and natural language processing have accelerated and enhanced the conversion of paper documents into consistent, machine-legible formats. In addition, machine-learning technology—by which computers learn from experience in their analysis of large data sets—can make the extraction and organization of key lease terms even more efficient. Over time, a system can come to recognize different types of documents, thereby enabling companies to classify leases into different categories; and it can automatically abstract key lease terms to reduce the amount of manual work required to channel critical lease information into a database.

The numbers and types of data problems that exist will determine how much time a company should allot for its initial data assessment and data-gathering activities. However, there is no question that for many companies, the task represents a big undertaking.

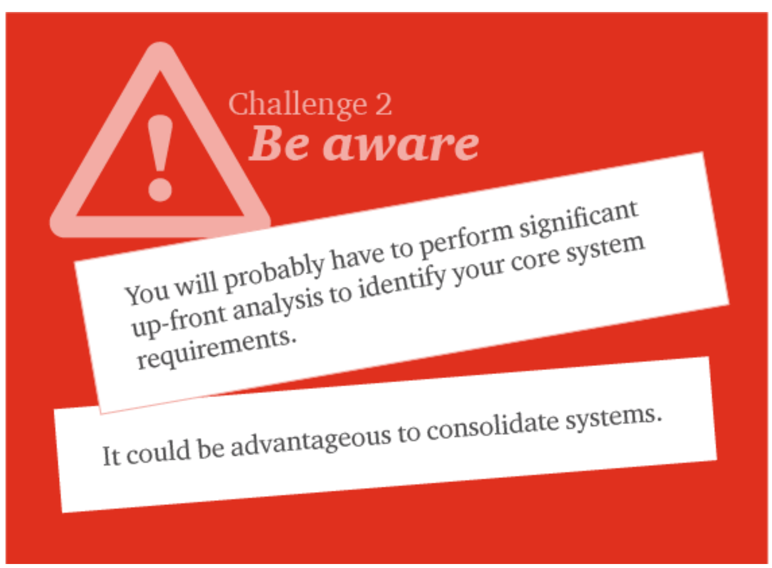
Challenge 2: Get the right systems in place

Once the new leasing standards have gone into effect, companies will need sustainable systems to handle their lease administration and accounting. Our survey found that for more than two-thirds of companies today, the default approach is to manage and account for leases by using spreadsheets. Under the new rules, spreadsheet use will become extremely difficult and time-consuming. With the high number of manual touch points required to track lease activity and maintain the accuracy of lease data within spreadsheet-based leasing inventories, spreadsheets present too high a risk of errors. Companies generally won't be able to rely on them when lease data moves to the balance sheet.

Most companies are planning to migrate to software solutions that are built specifically for the purpose—meaning that they are designed to perform the lease calculations required by the new standard. Many software companies that sell into the corporate accounting function are already developing modules that can handle the new lease accounting rules while offering operational benefits for the end-to-end lease management lifecycle. Implementing the right software can provide financial managers with the confidence they need for compliance and reporting.

For the 90% of companies that, according to our survey, haven't yet selected a software solution for this purpose, a period of self-assessment is in order. During this period, some companies (particularly those that rely heavily on spreadsheets, or those with complex operations) may want to consider developing an interim lease management solution that takes advantage of the data integration, visualization, and analytics tools currently on the market, many of which these companies may already use for other purposes.

Implementing a provisional solution can offer companies the time they need to take a proper inventory of the leasing systems they currently have in place, if any. If they have multiple systems, they should consider consolidating into a single system. A company with both equipment leases and real estate leases should decide whether it can manage both of those lease types with a single system. This is also the time to determine major features a next-generation lease accounting system should have—for instance, integration with accounts payable or procurement, and any special reporting or analytics capabilities. As they decide on those issues, companies will effectively be creating the set of core requirements they'll need in the vendor-selection process; and those requirements can also be used in an evaluation of software vendors' product roadmaps.



Challenge 3: Improve your lease-accounting processes

Because of the absence of a uniform way of processing leases—and because of the historical lack of dedicated accounting or software systems for maintaining leasing activity—most companies haven't followed consistent processes for requisitioning or monitoring leased property or equipment.

With leases moving onto the balance sheet, those inconsistencies will have to change. At most companies, leases will become part of financial statements, which will require a different level of scrutiny—not only scrutiny of the tracking of accounting treatment but also scrutiny of the processes surrounding lease management and lease lifecycles.

As a result of the increased attention expected to be paid to processes surrounding lease management, many companies will have the opportunity to rethink the ways they handle lease terminations, lease bookings, and lease negotiations. The new processes have to be documented so they can become standard operating procedures throughout the company. And as with any information that ends up in a company's financial statements and that is subject to Sarbanes-Oxley rules, strong internal controls have to be in place and adhered to.

The silver lining: A chance to improve the business model

In issuing the new guidelines, the FASB and the IASB focused on filling in a conspicuously empty portion of companies' balance sheets. Public US-based corporations with investors have no choice: they will have to comply with the new rules. But many of them should be looking to go beyond meeting the minimum requirements of compliance. They may be able to use the upcoming change as a springboard to making business-model improvements.

For instance, some companies may want to more directly involve their procurement departments in their leasing activities, allowing procurement to negotiate lease terms on an enterprise-wide basis. Other companies, having centralized their leasing data, may want to analyze the terms and conditions offered by their lessors—and thus do a better overall job of managing lessors and applying consistency or standards related to acceptable terms by asset. And all companies should seek to reduce or eliminate the cost leakage that results from not taking timely action on leases whose terms are expiring.

Companies may also want to standardize their leasing processes by incorporating necessary controls and establishing the circumstances when the lease-versus-buy model gets used. The stronger lease-versus-buy models incorporate additional factors into the discounted cash flow analysis that typically pertain to a company's leasing strategy, such as equipment-obsolescence risk or alternative-minimum-tax considerations. Finally, companies may want to consider performing periodic lease portfolio trend analyses to evaluate both positive- and negative-impact decisions so they can make timely leasing-strategy and leasing-process improvements.

Companies have an opportunity to go beyond meeting the minimum requirements of compliance. They may be able to use the upcoming change as a springboard to making business-model improvements.

Making better leasing decisions through portfolio analysis

Portfolio analysis reports can help companies identify trends in their leasing behavior they may wish to continue, adjust, or terminate. A few such reports include:

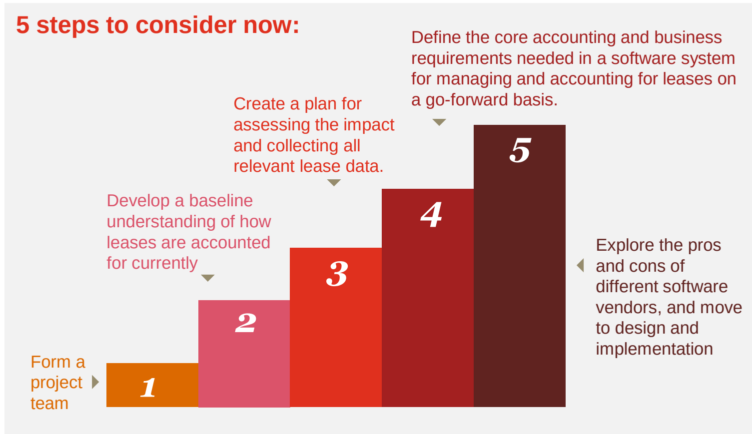
- **Lessor concentration.** This report shows the concentration of the portfolio by lessor and can drill down into asset type, year, region, and other attributes. The value of this type of analysis is that it can highlight potentially excessive concentration among a small group of lessors, or it can show where it makes sense to increase concentration among certain lessors.
- **Rate analysis by lessor.** This report compares rates for similar types of assets among lessors to see if they are comparable or not, and it may identify opportunities for better rate-shopping.
- **Expired leases.** This report shows leases that are past their original or renewal end date and require action. A similar report can show how long leases were held past their original or renewal end dates before action was taken. This type of analysis may reveal particular areas where this type of extended lease-holding is more prevalent than others (e.g. certain types of assets, certain business units, etc.).

Getting started

Adjusting to the new lease accounting rules is no small matter, and a lot of companies are unsure where to begin. Our suggestion would be to assemble a project team consisting of senior accounting staff, the chief financial officer, the controller, the main professionals responsible for real estate, and the main technology and system contacts.

An initial meeting can begin by asking what everyone knows and what everyone thinks of the company's existing lease processes. Such a meeting will likely provide the project team with a sense of how the company approaches leasing, of its relevant policies and procedures, and of where and how it maintains its lease records. After that, the company can dive more deeply into the structure of the leases it holds and the nature of its lease agreements. Some companies may have special circumstances that merit attention. For instance, the inclusion of lease obligations on the balance sheet could affect some companies' bond covenants depending on how the covenants are defined. Other companies may have to account for so-called embedded leases that involve equipment they are effectively renting as part of a larger outsourcing or service relationship.

Companies can begin to meet the data, systems, and process challenges related to implementing the new lease accounting standard by taking five steps:



In taking these steps, companies will get on the road to accomplishing what they must by 2018.

About PwC Risk Assurance

Today's business environment is different. More complex. More connected. Companies face new and unknown risks, but also new and untapped opportunities. PwC Risk Assurance is at the forefront of this change, ready to transform how you perceive – and capitalize on – risk.

We're constantly pioneering new ways to help you unlock risk as a catalyst for growth. We tap into our network of nearly 4,000 professionals – from risk and compliance practitioners to data scientists and technologists, to innovators – so you know what's coming and are ready to act.

Learn more about our services.

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