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Statement of Cash Flows
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Preface

June 2020

To the clients, friends, and people of Deloitte:

We are pleased to present the 2020 edition of A Roadmap to Applying the New Leasing Standard (the “Roadmap”). Since the issuance of ASU 2016-02\(^1\) (codified in ASC 842) on February 25, 2016, the FASB has focused on implementation efforts related to the adoption of ASU 2016-02. Over the past four years, the FASB has held multiple meetings\(^2\) to discuss implementation questions raised and challenges identified by stakeholders from several industries. In response to the feedback received, the FASB has issued several final ASUs\(^3\) that amend certain aspects of ASC 842 and may propose ASUs to further clarify or amend its guidance.

The body of the Roadmap combines the requirements in ASC 842 with Deloitte's interpretations and examples in a comprehensive, reader-friendly format. In addition, the Roadmap highlights (1) the requirements of ASC 842 that significantly differ from those in ASC 840 and IFRS 16 and (2) recent standard-setting developments (through the May 20, 2020, FASB meeting). We hope that this publication will enable entities to deal with some of the more challenging aspects of ASC 842 and may function as a quick resource guide for those who have a specific question and are looking for a clear answer, or it may serve as an all-encompassing guide for those who are still building up their knowledge base related to the new leasing standard.

Further, the updated edition of this Roadmap includes several new interpretations as well as some modifications to previously expressed views to reflect our latest thinking and input from standard setters and regulators. Appendix H highlights all new content as well as any substantive revisions to previous content.

Although the mandatory effective date for public companies has passed, challenging questions remain, and we expect new implementation questions to continue emerging. Accordingly, we will continue to develop guidance to help stakeholders with implementation.

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\(^1\) For a list of the titles of standards and other literature referred to in this publication, see Appendix F. For a list of abbreviations used in this publication, see Appendix G.

\(^2\) This Roadmap reflects decisions made by the FASB up through its meeting on May 20, 2020. Stakeholders are encouraged to continue to monitor activity at the FASB, SEC, and other standard setters or regulators for any relevant developments or interpretations that may affect the views expressed in this publication. See Chapter 17 for more information.

\(^3\) For a complete list of proposed and final ASUs and more information about how the ASUs issued amend certain aspects of ASC 842, see Chapter 17.
Subscribers to the Deloitte Accounting Research Tool (DART) may access any interim updates to this publication by selecting the document from the “Roadmaps” tab on DART’s home page. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.

We encourage you to use this Roadmap as a guide throughout your application of ASC 842 and to contact us with any questions or suggestions for future improvements. However, the Roadmap is not a substitute for consulting with Deloitte professionals on complex accounting questions and transactions.

We hope that you find this Roadmap helpful in achieving a successful adoption of the new guidance as well as in navigating the ongoing accounting requirements for leases after adoption.

Sincerely,
Deloitte & Touche LLP
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Chapter 1 — Overview

1.1 Background

Lease accounting under U.S. GAAP and IFRS® Standards has often been criticized as being too reliant on bright lines and subjective judgments. Many believe that such reliance has led entities to account for economically similar transactions differently and has presented opportunities for entities to structure transactions to achieve a desired accounting effect. Such criticism prompted the SEC — in its 2005 report on off-balance-sheet arrangements — to recommend that the FASB undertake a project on lease accounting. The FASB and International Accounting Standards Board (IASB®) added lease accounting to their agendas in 2006 as part of their Memorandum of Understanding to work toward convergence.

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

After working for more than a decade, in 2016, the FASB issued its new standard on accounting for leases, ASU 2016-02 (codified as ASC 842) while the IASB issued its own leasing standard, IFRS 16. The timeline below depicts the stages in the boards' development of their leasing guidance, beginning with the FASB's issuance of Statement 13 in 1976.
Lease Accounting Timeline

1982  IASC (predecessor to IASB) issues IAS 17.

EITF, IFRIC, etc., issue interpretations of FAS 13 and IAS 17; FASB and IASB amend and build upon FAS 13 and IAS 17, respectively.

2005  SEC targets off-balance-sheet financing.
2006  FASB and IASB initiate joint project on leases.

2009  FASB and IASB issue Leases: Preliminary Views (March).
2010  FASB and IASB issue first leasing standard exposure draft (August).

2013  FASB and IASB issue second leasing standard exposure draft (May).

2016  IASB issues its final standard IFRS 16, Leases (January 13).
      FASB issues its final standard ASU 2016-02, Leases, to be codified as ASC 842 (February 25).
2017  FASB issues ASU 2017-13 on amendments to SEC paragraphs (September).
2018  FASB issues ASU 2018-01 on the land easement practical expedient for transition (January).
      FASB issues ASU 2018-10 on technical improvements (July).
      FASB issues ASU 2018-11 on targeted improvements to transition and lessor accounting (July).
      FASB issues ASU 2018-20 on narrow-scope improvements for lessors (December).
2019  ASC 842 (for public business entities) and IFRS 16 become effective.
      FASB issues ASU 2019-01 on Codification improvements (March).
      FASB issues ASU 2019-10 on amended effective dates (November).
2020  FASB issues ASU 2020-05 on amended effective dates (June).

Although the project was initially a convergence effort and the boards conducted joint deliberations, there are several notable differences between ASC 842 and IFRS 16. We have highlighted those differences throughout this publication.¹

¹ See Appendix B for a summary of the differences between ASC 842 and IFRS 16.
1.2 Overview

ASC 842-10

05-1 The Leases Topic includes the following Subtopics:
   a. Overall
   b. Lessee
   c. Lessor
   d. Sale and Leaseback Transactions
   e. Leveraged Lease Arrangements

05-2 The Subtopics listed in paragraph 842-10-05-1 establish the requirements of financial accounting and reporting for lessees and lessors.

10-1 This Topic specifies the accounting for leases. An entity should consider the terms and conditions of the contract and all relevant facts and circumstances when applying this Topic. An entity should apply this Topic consistently to leases with similar characteristics and in similar circumstances.

10-2 The objective of this Topic is to establish the principles that lessees and lessors shall apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease.

The most significant change in ASU 2016-02 is its lessee model that brings most leases on the balance sheet. The ASU also addresses other concerns related to the lessee accounting model in ASC 840. For example, it eliminates the required use of bright-line tests for determining lease classification, thus eliminating a potential source of structuring. Furthermore, ASU 2016-02 aligns certain of the underlying principles of lessor accounting with those in ASC 606, the FASB’s revenue standard (e.g., up-front profit recognition through a sales-type lease is governed by whether control of the underlying asset is transferred to the lessee at lease commencement). The ASU also requires lessors to provide more transparent information about their exposure to the changes in the value of residual assets as well as how they manage that exposure.
The structure of the guidance in ASC 842 is depicted in the graphic below. This Roadmap is designed with this structure in mind.

ASU 2016-02 is effective for (1) public companies in periods beginning after December 15, 2018; (2) certain public NFPs\(^2\) in periods beginning after December 15, 2019; and (3) all other entities in periods beginning after December 15, 2021 (because of the deferral in ASU 2020-05, which was issued in June 2020). It represents a wholesale change to lease accounting; as a result, many entities will face significant implementation challenges during the periods leading up to the effective date and beyond.

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\(^2\) The deferral provided by ASU 2020-05 applies to public NFPs that have not issued financial statements or made financial statements available for issuance as of June 3, 2020. Public NFPs that have issued financial statements or have made financial statements available for issuance before that date must comply with the effective dates prescribed for public companies above.
### 1.3 Key Provisions

The table below highlights some of the key provisions of ASU 2016-02 and includes links to sections of this Roadmap that discuss these provisions in more detail.

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<thead>
<tr>
<th>Key Provision</th>
<th>ASU 2016-02</th>
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<tbody>
<tr>
<td><strong>Scope</strong> (Chapter 2)</td>
<td>The scope of ASC 842 includes leases of all property, plant, and equipment (PP&amp;E) and excludes:</td>
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<td>• Leases of intangible assets.</td>
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<td>• Leases to explore for or use nonregenerative resources.</td>
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<td>• Leases of biological assets.</td>
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<td>• Leases of inventory.</td>
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<td>• Leases of assets under construction.</td>
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<tr>
<td><strong>Identifying a lease</strong> (Chapter 3)</td>
<td>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.”</td>
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<td></td>
<td>• A leased asset must be specifically identifiable either explicitly (e.g., by a serial number) or implicitly (e.g., the only asset available to satisfy the lease contract).</td>
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<td>◦ Substantive substitution rights will need to be considered.</td>
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<td>◦ A physically distinct portion of a larger asset could represent a specified asset (e.g., one floor of a building).</td>
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<td></td>
<td>◦ A capacity portion of a larger asset will generally not represent a specified asset (e.g., 50 percent of a storage tank).</td>
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<td>• A contract conveys the right to control the use of the identified asset when the customer has both of the following:</td>
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<td>◦ The right to obtain substantially all of the economic benefits from its use.</td>
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<td>◦ The right to direct its use.</td>
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<tr>
<td><strong>Components of a contract</strong> (Chapter 4)</td>
<td>An entity is generally required to identify the lease and nonlease components of a contract that contains a lease. A contract may also contain multiple lease components. The right to use an underlying asset is considered a separate lease component if (1) a lessee can benefit from the use of the underlying asset either on its own or together with other resources that are readily available and (2) the underlying asset is not highly dependent on or highly interrelated with other assets in the arrangement.</td>
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<tr>
<td></td>
<td>When a contract includes multiple components, an entity is generally required to allocate the consideration in the contract to the various components. The guidance for lessors on allocating the consideration in the contract is separate from that for lessees.</td>
</tr>
</tbody>
</table>
### Key Provision | ASU 2016-02
---|---
**Lease term**  
*(Chapter 5)* | The lease term is the noncancelable period in which the lessee has the right to use an underlying asset together with optional periods (1) for which it is reasonably certain that the lessee will exercise the renewal option or not exercise the termination option or (2) covered by an option to extend (or not to terminate) the lease in which the exercise of the option is controlled by the lessor. Lessees will be required to reassess the lease term after lease commencement in certain circumstances; however, lessors are not required to reassess the lease term unless the lease is modified and the modified lease is not a separate contract.

**Lease payments**  
*(Chapter 6)* | Lease payments include:
- Fixed payments (including in-substance fixed lease payments).
- Variable payments that are based on an index or rate, calculated by using the index or rate that exists on the lease commencement date (i.e., the spot rate).
- For lessees, amounts that it is probable will be owed under residual value guarantees. For lessors, amounts at which residual assets are guaranteed by a lessee or by a third party.
- Payments related to purchase or termination options when the lessee is reasonably certain to exercise the option or is not reasonably certain not to exercise, respectively.

Lease payments do not include variable lease payments that are based on the usage or performance of the underlying asset (e.g., a percentage of revenues).

**Discount rate**  
*(Chapter 7)* | Lessees use the rate charged by the lessor (i.e., the rate implicit in the lease) if that rate is readily determinable. If that rate is not readily determinable, lessees will use their incremental borrowing rate as of the date of lease commencement.

Lessor use the rate they charge the lessee.

Private-company lessees can elect to use a risk-free rate.

**Lessee accounting**  
*(Chapter 8)* | As of the lease commencement date, a lessee recognizes:
- A liability for its lease obligation (initially measured at the present value of lease payments not yet paid).
- An asset for its right to use the underlying asset (i.e., the ROU asset, initially measured equal to the lease liability and adjusted for lease payments made at or before lease commencement, lease incentives, and any initial direct costs).

The lessee will use the effective interest rate method to subsequently account for the lease liability.

Two approaches are used for subsequently amortizing the ROU asset: (1) the finance lease approach and (2) the operating lease approach. Under the finance lease approach, the ROU asset is generally amortized on a straight-line basis. This amortization, when combined with the interest on the lease liability, results in a front-loaded expense profile in which interest and amortization are presented separately in the income statement. By contrast, the operating lease approach generally results in a straight-line expense profile that is presented as a single line item in the income statement.

The determination of which approach to apply is based on lease classification criteria that are similar to the requirements in IAS 17.
Chapter 1 — Overview

(Table continued)

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<thead>
<tr>
<th>Key Provision</th>
<th>ASU 2016-02</th>
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</thead>
<tbody>
<tr>
<td>Lessor accounting</td>
<td>The lessor accounting model retains the approach for operating and capital/finance (direct financing and sales-type) leases. However, the lease classification criteria will change, and the treatment of selling profit, if any, will be affected:</td>
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<tr>
<td>(Chapter 9)</td>
<td>- Selling profit would be recognized up front if the arrangement is a sales-type lease (i.e., if the transaction qualifies as a sale under ASC 606).</td>
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<td>- Selling profit resulting from a direct financing lease, if any, would be deferred and recognized as interest income over the lease term.</td>
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<td>Leveraged lease accounting is eliminated going forward (i.e., existing leveraged leases are grandfathered).</td>
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<tr>
<td>Lease modifications</td>
<td>A lease modification is any change to the contractual terms and conditions of a lease that results in a change in the scope of or the consideration for a lease.</td>
</tr>
<tr>
<td>(Chapters 8 and 9)</td>
<td>- A lessee/lessor would account for a lease modification as a separate contract (i.e., separate from the original lease) when the modification (1) grants the lessee an additional ROU asset and (2) the price of the additional ROU asset is commensurate with its stand-alone price.</td>
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<tr>
<td></td>
<td>- Lessees would account for a lease modification that is not a separate contract by using the discount rate as of the modification effective date to adjust the lease liability and ROU asset for the change in the lease payments. The modification may result in a gain or loss if the modification results in a full or partial termination of an existing lease.</td>
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<td>- Lessors would account for a lease modification in a manner generally consistent with the modification guidance in ASC 606.</td>
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<tr>
<td>Sale-and-leaseback transactions</td>
<td>A transaction is accounted for as a sale-and-leaseback transaction when control of the underlying asset is transferred from the seller-lessee to the buyer-lessee in accordance with ASC 606. In addition to the control transfer principle in ASC 606, the transfer of the underlying asset is not considered a sale if either of the following conditions is met:</td>
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<tr>
<td>(Chapter 10)</td>
<td>- The leaseback is a finance lease.</td>
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<td>- There is a repurchase option, unless (1) the exercise price of the option is at fair value and (2) alternative assets are readily available in the marketplace.</td>
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<tr>
<td></td>
<td>If control of the underlying asset is transferred to the buyer-lessee, the transaction is accounted for as a sale and leaseback and the entire gain on the transaction would be immediately recognized.</td>
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While the FASB published ASU 2016-02 in 2016, it is still developing additional guidance in an attempt to provide relief from the costs of implementing the standard and in response to stakeholder feedback on certain items. The FASB continues to monitor companies’ implementation efforts.

See Chapter 17 for more information on recent FASB activities.
Chapter 2 — Scope and Scope Exceptions

2.1 Property, Plant, and Equipment

2.2 Scope Exclusions
   2.2.1 Leases of Intangible Assets
   2.2.2 Leases to Explore for or Use Nonregenerative Resources and Leases of Biological Assets
   2.2.3 Leases of Inventory
   2.2.4 Leases of Assets Under Construction
   2.2.5 Other Scope Exclusions

2.3 Interaction With Other Accounting Standards
   2.3.1 ASC 606 — Revenue From Contracts With Customers
   2.3.2 ASC 815 — Derivatives and Hedging

2.4 Land Easements
   2.4.1 Background
   2.4.2 Scope
   2.4.3 Identifying a Lease
2.1 Property, Plant, and Equipment

<table>
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<tr>
<th>ASC 842-10 — Glossary</th>
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<tbody>
<tr>
<td><strong>Contract</strong></td>
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<tr>
<td>An agreement between two or more parties that creates enforceable rights and obligations.</td>
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<tr>
<td><strong>Lease</strong></td>
</tr>
<tr>
<td>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.</td>
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As indicated above, ASC 842-10-20 defines a lease as a “contract . . . that conveys the right to control the use of . . . property, plant, or equipment” (PP&E). In paragraph BC110 of ASU 2016-02, the Board acknowledges that only leases of “land and/or depreciable assets” are within the scope of ASC 842. Therefore, because the FASB ultimately decided to include only leases of PP&E within the scope of ASC 842, the scope of ASC 840 is effectively carried forward. Accordingly, leases of nondepreciable assets (e.g., inventory) are outside the scope of ASC 842, as detailed in ASC 842-10-15-1 (reproduced in Section 2.2 below).

In addition, an agreement involving PP&E must create enforceable rights and obligations to be within the scope of ASC 842. That is, it must meet the definition of a “contract” in ASC 842, which is defined the same way as it is in ASC 606.

2.2 Scope Exclusions

<table>
<thead>
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<tr>
<td><strong>15-1</strong> 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:</td>
</tr>
<tr>
<td>a. Leases of intangible assets (see Topic 350, Intangibles — Goodwill and Other).</td>
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<tr>
<td>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.</td>
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<tr>
<td>c. Leases of biological assets, including timber (see Topic 905, Agriculture).</td>
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<tr>
<td>d. Leases of inventory (see Topic 330, Inventory).</td>
</tr>
<tr>
<td>e. Leases of assets under construction (see Topic 360, Property, Plant, and Equipment).</td>
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</tbody>
</table>

Whether a contract is within the scope of ASC 842 is effectively a gating question; if a contract is within the standard’s scope, an entity must apply the guidance in ASC 842 to determine whether the contract is, or contains, a lease (as discussed in Chapter 3). In other words, if an arrangement includes a right of use or a lease of a type of asset described in ASC 842-10-15-1, an entity does not need to further apply the requirements of ASC 842 because the arrangement is explicitly outside its scope. Conversely, in an arrangement that involves the use of any other PP&E to comply with the enforceable rights and obligations of the contract, an entity must apply the requirements of ASC 842 to identify whether the contract is, or contains, a lease.
The decision tree below further expands on this gating question.

Start

Does the entity have a “contract,” as defined?

Yes

Is it a right to use intangible assets?

Yes

Account for it under ASC 350 or ASC 606.

No

Is it a right to explore for or use nonregenerative resources (e.g., oil, minerals)?

Yes

Account for it under ASC 330.

No

Account for it under ASC 932 or ASC 930.

Is it a right to use biological assets (e.g., timber, livestock)?

Yes

No

Is it a right to use inventory?

Yes

No

Is it a service concession arrangement within the scope of ASC 853?

Yes

Account for it under ASC 853.

No

Identify whether the contract is, or contains, a lease of PP&E (proceed to Chapter 3).

Yes

No

Other GAAP may be applicable, or the arrangement may not result in an accounting event.
Changing Lanes — Heat Supply Contracts for Nuclear Fuel

While ASC 840 explicitly applies to heat supply contracts for nuclear fuel, ASC 842 does not specify whether such contracts are within its scope. Accordingly, entities will have to assess such contracts to determine whether they meet the new definition of a lease. (See Chapter 3 for more information about how to identify whether a contract is, or contains, a lease.)

2.2.1 Leases of Intangible Assets

Entities commonly enter into arrangements that convey rights to use intangible assets (e.g., licensing arrangements, such as those involving software licenses). Rights to use intangible assets are outside the scope of ASC 842. As stated in ASC 842-10-15-1, entities should consider the guidance in ASC 350 when accounting for such arrangements. In addition, the owner of the intellectual property that is subject to the agreement should consider the implementation guidance on licensing in ASC 606.

Bridging the GAAP

The FASB acknowledges in paragraph BC110(a) of ASU 2016-02 that there is “no conceptual basis for excluding leases of intangible assets from the scope” of ASC 842. Indeed, the IASB allows entities to apply IFRS 16 to leases of certain intangible assets (i.e., except for rights held under a licensing arrangement for items such as films, video recordings, plays, patents, and copyrights). The FASB decided that such arrangements should be subject to a larger, more comprehensive review of the accounting for intangible assets at a future date before a customer is required (or allowed) to account for rights to use intangible assets within the scope of ASC 842.

2.2.2 Leases to Explore for or Use Nonregenerative Resources and Leases of Biological Assets

Paragraph BC110(b) of ASU 2016-02 indicates that the scope exclusion in ASC 842-10-15-1(b) applies to both (1) the intangible right to explore for nonregenerative resources such as oil, natural gas, and minerals and (2) the right to use the land that contains those resources. Such rights are accounted for under the industry guidance in ASC 930 (minerals) and ASC 932 (oil and natural gas) and are outside the scope of ASC 840. The Board did not consider it necessary to change this scope exclusion.

However, the Board acknowledges in the Background Information and Basis for Conclusions of ASU 2016-02 that leases of PP&E used to explore for or produce such nonregenerative resources (e.g., drilling rigs) are not part of this scope exclusion. Accordingly, mining and oil and gas entities should identify whether contracts that involve PP&E used in the exploration or production of minerals, oil, and natural gas are, or contain, leases (see Chapter 3).

In a manner similar to its observations on rights to explore for or use nonregenerative resources, the FASB observed in paragraph BC110(c) of ASU 2016-02 that the accounting for biological assets, including plants and animals, is best contained within a single, industry-specific Codification topic, ASC 905. Accordingly, rights to use biological assets are outside the scope of ASC 842.
Q&A 2-1A Rights to Use Land That Include More Than Natural Resource Rights

Question
If a lessee’s rights to use land are not limited to the right to explore for or use nonregenerative resources and biological assets (“natural resource rights”), how should those rights be evaluated?

Answer
Although natural resource rights are outside the scope of ASC 842, the guidance in ASC 842-10-15-1(b) indicates that rights to use land are not excluded from lease accounting solely because natural resource rights are included in the arrangement. ASC 842-10-15-1(b) states, in part:

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: . . .

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. [Emphasis added]

Therefore, if a lessee’s rights to use land contain both natural resource rights as well as the right to use the land in other ways, the lessee should consider whether the arrangement includes a lease of the land in addition to the natural resource rights. If so, the natural resource rights would be a nonlease component that should be separated from the lease component in the contract.1 In reaching this conclusion, we also considered paragraph BC110(b) of ASU 2016-02, which states, in part:

The Board decided that, consistent with previous GAAP, only leases of property, plant, and equipment (that is, land and/or depreciable assets) are within the scope of Topic 842. Consequently, none of the items in the list that follows, which is not intended to be an all-inclusive list, are in the scope of Topic 842. In addition to the fact that none of these assets are depreciable assets, the Board observed the following with respect to each: . . .

b. Leases to explore for or use natural resources, such as minerals, oil, and natural gas. That is because accounting practices for assets relating to exploration and evaluation are diverse and differ from the accounting for other types of assets. Furthermore, the accounting for assets related to the exploration and use of natural resources is specified in Topics 930, Extractive Activities — Mining, and 932, Extractive Activities — Oil and Gas. Leases to explore for or use natural resources also were excluded from previous GAAP. However, the determination of whether certain ancillary items were leases was less important in previous GAAP than in Topic 842 because the operating leases and services were accounted for similarly. Some stakeholders asked whether this scope exception referred solely to the intangible right to explore for these natural resources. The Board observed that this scope exception refers to that as well as to the rights to use the land in which those natural resources are contained. However, leases of equipment used to explore for natural resources (for example, drilling equipment) are not part of this scope exception. [Emphasis added]

1 If the lessee elects the practical expedient to combine lease and nonlease components (see Section 4.3.3.1), the natural resource rights would instead be combined with the land lease.
We believe that the reference to “land in which those natural resources are contained” is meant to extend the scope exception to surrounding land when the arrangement involves only the right to explore for natural resources (i.e., there will naturally be some land formations — whether surface or subsurface — that establish the parameters of the exploration rights). On the other hand, when the land can be used for other purposes, we believe that an entity should evaluate whether the arrangement contains a lease.

Consider an arrangement that includes both mineral rights and the right to develop an apartment complex on land. In this arrangement, a lease of land would not be precluded solely because the arrangement includes mineral rights. Rather, the mineral rights (natural resource rights) should be treated as a nonlease component in accordance with other GAAP.

2.2.3 Leases of Inventory

Like ASC 840, ASC 842 excludes rights to use inventory from its scope. In the Background Information and Basis for Conclusions of ASU 2016-02, the Board indicates that it decided to exclude rights to use inventory largely out of cost/benefit considerations. Specifically, in paragraph BC110(d), the Board observed that few arrangements could actually convey the right to control the use of an asset that is held for sale by the customer — or that is consumed in the customer’s production of goods or services to be available for sale — while the supplier continues to own that asset. Accordingly, the FASB decided that the costs of requiring entities to evaluate such arrangements under ASC 842’s definition of a lease (see Chapter 3) outweighed the benefits.

The example below illustrates a simple arrangement involving the use of precious-metals inventory. Because the arrangement is for inventory (i.e., for an asset that is consumed in the customer’s production of goods or services to be available for sale), it is outside the scope of ASC 842 and the parties are not required to assess whether the contract is, or contains, a lease.

**Example 2-1**

TJ Inc., an auto manufacturer, enters into a contract with EC Supply Company for 1,000 pounds of palladium over the next five years. TJ uses palladium in catalytic converters that are installed in the automobiles that it sells to third-party customers. TJ pays EC a fixed, monthly payment over the contract term. At the end of year 5, TJ must return 1,000 pounds of palladium to EC.

2.2.4 Leases of Assets Under Construction

Like rights to use inventory, rights to use assets under construction (e.g., construction work-in-progress or CWIP) are outside the scope of ASC 842 for cost-benefit reasons. Shortly before issuing ASU 2016-02, the Board decided to include guidance in ASC 842-40 that requires lessees and lessors to determine whether a lessee controls an underlying asset before the commencement of a lease. (See Chapter 11 for a detailed discussion of this guidance.) If it is determined that a lessee does control an asset before the commencement date, the lessee must (1) recognize the entire asset as the deemed accounting owner and (2) apply ASC 842’s sale-and-leaseback guidance to assess whether it may derecognize the asset on the lease commencement date. The guidance in ASC 842-40 addresses arrangements in which a lessee is involved in the construction of an asset before a lease commences.

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2 Assume that the land agreement in this arrangement meets the definition of a lease in accordance with ASC 842.
As the Board acknowledges in paragraph BC110(e) of ASU 2016-02, the FASB received stakeholder feedback indicating that the complexity of applying ASC 842 was likely to increase if an entity is required to assess whether a lessee (1) controls an underlying asset under construction or (2) controls the use of an underlying asset under construction (as would be the case if CWIP were within the scope of ASC 842). The Board decided that the benefits of performing this complex assessment would not outweigh the costs, given that such an evaluation would yield financial reporting results substantially similar to those under ASC 840. Accordingly, the FASB excluded rights to use assets under construction from the scope of ASC 842; however, lessees and lessors must still assess whether a lessee obtains control of an underlying asset under construction (i.e., the entire asset, and not just the right to use it) before lease commencement in accordance with ASC 842-40.

2.2.5 Other Scope Exclusions

2.2.5.1 Service Concession Arrangements

Service concession arrangements accounted for under ASC 853 are specifically excluded from the scope of ASC 840 in ASC 840-10-15-9A. However, ASC 842 does not explicitly contain the same scope exception. Rather, ASC 853-10-25-2 (as amended by ASU 2016-02) indicates that service concession arrangements that are subject to the scope provisions of ASC 853-10-15 will continue to be outside the scope of lease accounting:

The infrastructure that is the subject of a service concession arrangement within the scope of this Topic shall not be recognized as property, plant, and equipment of the operating entity. Service concession arrangements within the scope of this Topic are not within the scope of Topic 842 on leases.

2.2.5.2 Noncore Assets and Capitalization Policy Considerations

Paragraph BC111 of ASU 2016-02 acknowledges that “assets that are not essential to the operations of an entity” (hereafter referred to as “noncore assets”) may be less important to financial statement users because they “often are less material.” Accordingly, the benefits of recognizing leases of noncore assets may not justify the costs of requiring lessees to do so. The Board therefore considered excluding noncore assets from the scope of ASC 842 but ultimately decided against a scope exclusion for noncore assets for the following reasons:

• It is difficult to define noncore assets and to differentiate leases of noncore assets from leases of other assets.
• Entities’ interpretations of the definition of noncore assets are likely to differ, thereby reducing comparability for financial statement users.
• There is no GAAP distinction between noncore purchased assets and core purchased assets for capitalization purposes. Accordingly, there is little justification for distinguishing between rights to use noncore assets and rights to use core assets.

However, the Background Information and Basis for Conclusions of ASU 2016-02 indicates that the costs of applying ASC 842 would most likely be reduced through the use of capitalization and materiality policies. While there is no explicit scope exception for assets defined as, or determined to be, “noncore,” many such asset types may not be recognized on the balance sheets of lessees because they are small-dollar-value items whose amounts are beneath certain capitalization thresholds. Q&A 2-1 further expands on this concept and related considerations.
Q&A 2-1  Capitalization Policy Considerations

Many entities have accounting policies that establish a materiality threshold for capitalizing fixed assets (i.e., PP&E). Under such policies, expenditures below the established threshold are expensed in the period incurred rather than capitalized on the balance sheet and depreciated over the life of the asset.

Because ASC 842 requires entities to recognize a right-of-use (ROU) asset and lease liability for all leases (other than short-term leases) and does not contain a “small-ticket item” exception similar to that in IFRS 16,3 many entities have asked whether a similar capitalization threshold may be established for lease assets and lease liabilities under ASU 2016-02.

Question

Can a lessee use an appropriate capitalization threshold when evaluating the requirement to recognize, on the balance sheet, leases that otherwise must be recognized under ASC 842?

Answer

Yes. Paragraph BC122 of ASU 2016-02 states, in part:

> Entities will likely be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, which should reduce the costs of applying the guidance. An entity’s practice in this regard may be consistent with many entities’ accounting policies in other areas of GAAP (for example, in capitalizing purchases of property, plant, and equipment).

While ASC 842 does not contain a specific exemption, an entity is not required to apply U.S. GAAP to immaterial items; therefore, materiality is always a consideration in the preparation of financial statements. However, an entity should not simply default to its existing capitalization threshold for PP&E for the following reasons:

• The existing capitalization threshold for PP&E is unlikely to include the effect of the additional asset base introduced by the ASU. That is, the addition of another set of assets not recognized on an entity’s balance sheet may require a refreshed analysis of the entity’s capitalization thresholds to ensure that the aggregated amounts will not become material.

• The existing capitalization threshold for PP&E does not take into account the liability side of the balance sheet. Under ASC 842, if an entity wishes to establish a threshold that will be used to avoid accounting for both ROU assets and lease liabilities on the balance sheet, it must consider the materiality, in the aggregate, of all of its ROU assets and related lease liabilities that would be excluded when it adopts such a threshold.

One reasonable approach to developing a capitalization threshold for leases is to use the lesser of the following:

• A capitalization threshold for PP&E, including ROU assets (i.e., the threshold takes into account the effect of leased assets determined in accordance with ASU 2016-02).

• A recognition threshold for liabilities that takes into account the effect of lease liabilities determined in accordance with the ASU.

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3 Under IFRS 16, an entity may exclude leases for which the underlying asset is of low value from its ROU assets and lease liabilities. See paragraphs B3–B8 of IFRS 16 for information about how to assess whether an asset is of low value. Also, see Appendix B for a summary of the differences between ASC 842 and IFRS 16.
Another reasonable approach to developing a capitalization threshold for leases is to record all lease liabilities but to subject the related ROU assets to such a threshold. Under this approach, if an ROU asset is below the established capitalization threshold, it would immediately be recognized as an expense. In subsequent periods, entities would amortize the lease liability by using the effective interest method, under which a portion of the periodic lease payments would reduce the liability and the remainder would be recognized as interest expense.

In addition, when evaluating and applying a capitalization threshold for leases determined in accordance with the ASU, entities should consider the following:

- **The gross balance of each side of the lease entry** — It would be inappropriate for an entity to consider only the net balance sheet effect of the lease entry (which is often zero) when assessing materiality.

- **Disclosure requirements** — We expect that entities will often want to omit disclosures about leases that they have determined, on the basis of their use of capitalization thresholds (as discussed above), do not need to be recognized on the balance sheet. We believe that while it may be appropriate to omit such disclosures, an entity will need to consider the impact of the omitted disclosures when performing a materiality assessment to establish the thresholds.

- **Implications related to internal control over financial reporting (ICFR)** — As entities revisit and change (or create new) capitalization thresholds for financial reporting purposes, they should be cognizant of the related ICFR implications. In addition, entities should consider the Form 10-K and Form 10-Q disclosure requirements under SEC Regulation S-K, Item 308(c), with respect to material changes in ICFR.

- **SAB Topic 1.M (SAB 99)** — Entities may find the guidance on materiality in SAB Topic 1.M helpful when identifying an appropriate capitalization threshold for leases.

### Example

A lessee enters into a five-year lease of a machine to use in its operations. The lessee determines that its ROU asset and lease liability are $3,260 at lease commencement.

To identify an appropriate capitalization threshold for its ROU assets and lease liabilities, the lessee considers the following:

- The gross balances (rather than the net balance) of its ROU assets and lease liabilities.
- The disclosures that would be omitted if certain ROU assets and lease liabilities were not recognized.
- The appropriate internal controls needed for the lessee to apply and monitor the capitalization threshold.
- Overall materiality considerations in SAB Topic 1.M.

After considering these factors, the lessee determines that (1) an appropriate capitalization threshold for PP&E, including ROU assets, is $3,500 and (2) an appropriate recognition threshold for lease liabilities is $3,000. The lessee should apply the lower of the two thresholds when determining whether to record the lease on its balance sheet. Given that the initial measurement of the lessee's ROU asset and lease liability exceeds the $3,000 threshold established for lease liabilities (i.e., the lower of the two thresholds), the lessee should recognize the ROU asset and lease liability on its balance sheet at lease commencement.

Alternatively, the lessee may choose to recognize the lease liability of $3,260 but not the ROU asset on the basis of the established $3,500 threshold for PP&E, including ROU assets (i.e., the lessee may choose to expense the cost of the ROU asset at lease commencement).
2.3 Interaction With Other Accounting Standards

2.3.1 ASC 606 — Revenue From Contracts With Customers

ASC 842 has many areas of crossover between, or direct references to, ASC 606. For example, ASC 842 requires lessors to use the guidance in ASC 606-10-32-28 through 32-41 when separating, and allocating consideration to, the components in a contract (see Chapter 4 for a detailed discussion of those requirements).

In addition, the guidance in ASC 606 on sales with a repurchase agreement may require suppliers to account for certain contracts with a customer within the scope of ASC 842. The section below further discusses those requirements in ASC 606 and how they are related to ASC 842.

2.3.1.1 Repurchase Agreements

<table>
<thead>
<tr>
<th>ASC 606-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-66 A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.</td>
</tr>
<tr>
<td>55-68 If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. Consequently, the entity should account for the contract as either of the following:</td>
</tr>
<tr>
<td>a. A lease in accordance with Topic 842 on leases, if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with Subtopic 842-40.</td>
</tr>
<tr>
<td>b. A financing arrangement in accordance with paragraph 606-10-55-70, if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.</td>
</tr>
<tr>
<td>55-72 If an entity has an obligation to repurchase the asset at the customer's request (a put option) at a price that is lower than the original selling price of the asset, the entity should consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right, the entity should account for the agreement as a lease in accordance with Topic 842 on leases unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with Subtopic 842-40.</td>
</tr>
</tbody>
</table>

The guidance in ASC 606 on sales with a repurchase agreement (whether an obligation or an option) is intended to identify scenarios in which the supplier has not transferred control of the asset to the customer. That is, the economic substance of the sale, together with the repurchase obligation or right, is to convey to the customer control of the use of the asset for a certain period in exchange for consideration.

Example 62, Case B, in ASC 606 illustrates how a sale with a repurchase agreement that includes a put option would be accounted for as a lease. For this example and further discussion of the guidance in ASC 606 on sales with a repurchase agreement, see Section 8.7 of Deloitte’s A Roadmap to Applying the New Revenue Recognition Standard (the “Revenue Roadmap”).
Changing Lanes — Lease Classification in a Sale With a Repurchase Agreement

In the sale of an asset, an entity may “fail” the transfer-of-control guidance in ASC 606 because of an obligation or right to repurchase the asset (e.g., through a call option) for an amount that is less than its original selling price. As a result, in accordance with ASC 606-10-66-58, the supplier would not record a sale and recognize revenue from a contract with a customer but would instead account for the arrangement as a lease under ASC 842.

However, stakeholders have questioned whether it is possible for a supplier to fail sale accounting under ASC 606 but classify the arrangement under ASC 842 as a sales-type lease. If so, it would be possible for a supplier to transfer control (and thus recognize selling profit or loss at commencement) under ASC 842 but not under ASC 606. (See Chapter 9 for further discussion of a lessor’s accounting and classification.) In such cases, it appears that there would be an accounting arbitrage opportunity to structure transactions that achieve a desired financial reporting result.

Example 2-2

Supplier enters into an arrangement to sell a piece of equipment to Customer at its fair value, $10 million. The equipment has a 25-year economic life with a residual value of $0. Included in the arrangement is a call option granted to Supplier through which Supplier may repurchase the asset. The repurchase option is exercisable after 20 years (on a specified date). The strike price of the repurchase option is $2 million. In this scenario, it may be appropriate for Supplier to classify its arrangement with Customer as a sales-type lease and recognize selling profit or loss at commencement.

Connecting the Dots — Asymmetry Between Supplier and Customer in a Sale With a Repurchase Agreement

ASC 606 does not address the customer’s accounting for arrangements within its scope, so there is no requirement in ASC 606 for a customer in a sale with a repurchase agreement to account for that arrangement as a lease.

Therefore, a customer is likely to account for such an arrangement as a purchase of the asset (e.g., in accordance with ASC 360 for PP&E). In other words, while ASC 606 contains comprehensive guidance governing when a supplier transfers control of an asset, there is little guidance in U.S. GAAP governing when a customer obtains control.

Changing Lanes — Seller-Provided Residual Value Guarantees

Section 8.7 of Deloitte’s Revenue Roadmap notes that the FASB, in its deliberations with the IASB related to ASC 606 and IFRS 15, respectively, explicitly decided to view sales with a seller-provided residual value guarantee (e.g., when a seller provides its customer with a guaranteed amount to be paid on resale) differently from sales with a repurchase agreement. In paragraph BC431 of ASU 2014-09, the boards acknowledged that such arrangements are economically similar in terms of cash flows but differ with respect to the customer’s ability to control the asset. That is, the customer is “not constrained in its ability to direct the use of, and obtain substantially all of the benefits from, the asset” it purchased that is subject to a seller-provided residual value guarantee.

Further, the FASB recognized that its decisions on this topic would lead to a change in practice. Under ASC 605 and ASC 840, such arrangements are generally accounted for as leases. Accordingly, sales with a seller-provided residual value guarantee are subject to the five steps of the model in ASC 606 and are not accounted for as leases within the scope of ASC 842.
2.3.2 ASC 815 — Derivatives and Hedging

ASC 824-10

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.

Because leases are outside the scope of ASC 815-10, contracts within the scope of ASC 842 that meet the definition of a lease (see Chapter 3) are not accounted for as freestanding derivative instruments. However, the Q&A below examines other derivative and hedging implications an entity should consider in analyzing a leasing transaction.

Q&A 2-2 Derivative and Hedging Considerations for Leasing Transactions

Question
When analyzing a leasing transaction, what derivative and hedging implications should an entity consider?

Answer
An entity should consider ASC 815 and the relevant implementation guidance when analyzing leasing transactions.

One issue frequently encountered is determining whether a lease agreement contains an embedded derivative that must be separated from the lease contract and accounted for separately as a derivative instrument in accordance with ASC 815. Components of a lease agreement that might be considered embedded derivatives include, but are not limited to:

- Option arrangements, such as purchase or renewal options.
- Indexed rental payments.
- Additional rental payments that are contingent on the occurrence of an outside event or achieving a certain threshold.
- Rental payments denominated in a foreign currency.

The terms of any lease arrangement containing these or similar provisions must be analyzed to determine whether the provision meets the definition of a derivative described in ASC 815-10-15-83 and, if so, whether ASC 815 requires separate accounting for the embedded derivative. ASC 815-10-15-96 and other implementation guidance include extensive guidance on identifying and accounting for embedded derivatives that must be separated from their host contracts.

Lessors and lessees may want to enter into hedging transactions to reduce their potential cash flow variability. ASC 815 and relevant implementation guidance address the requirements for achieving hedge accounting and how to account for a hedging relationship.

See Section 2.3.2.1 for further discussion of derivatives embedded in leases.
2.3.2.1 Derivatives Embedded in a Lease

Certain variable lease payments (e.g., those that depend on an index or rate) could meet the criteria in ASC 815-15 to be bifurcated as an embedded derivative. Accordingly, the FASB acknowledged in paragraph BC119 of ASU 2016-02 that because ASC 842 does not require entities to measure such variable lease payments at fair value, “unrelated derivative contracts could be bundled with leases to avoid measuring such embedded derivatives at fair value.” Accordingly, the Board decided to retain the requirement to assess a lease contract to determine (1) whether any embedded derivatives exist and, if so, (2) whether they should be bifurcated in accordance with the guidance in ASC 815-15.

The assessment of whether an embedded derivative is clearly and closely related to its host contract (i.e., a lease within the scope of ASC 842) is based on the economic relationship between the embedded derivative and the host contract. To be considered clearly and closely related to a lease host, economic characteristics and risks of the lease contract should be similar to those of the embedded derivative. If the two are not clearly and closely related, the embedded derivative should be bifurcated and accounted for separately at fair value if the embedded feature satisfies the criteria of a derivative instrument on a freestanding basis.

The table and the Deloitte Q&As below highlight some of the economic characteristics that are and are not generally considered to indicate that an embedded derivative is clearly and closely related to a lease host contract.

<table>
<thead>
<tr>
<th>Clearly and Closely Related</th>
<th>Not Clearly and Closely Related</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lease host</strong></td>
<td></td>
</tr>
<tr>
<td>• Nonleveraged inflation indexes (see 815-15-25 (Q&amp;A 31)).</td>
<td>• Leveraged inflation indexes (e.g., two times consumer price index (CPI)) (see 815-15-25 (Q&amp;A 31)).</td>
</tr>
<tr>
<td>• Contingent rentals based on related sales or variable interest rates.</td>
<td>• Inflation index adjustments based on an economic environment that is different from that in which payments are made (e.g., Mexican peso–denominated lease payments that vary on the basis of inflation rates in the United States if none of the parties to the lease are U.S. dollar functional entities).</td>
</tr>
<tr>
<td>• Foreign currency payment features if payments are made in the functional currency of a substantial party to the lease (see 815-15-15 (Q&amp;A 02)).</td>
<td>• Certain leases payable in a foreign currency (e.g., lease payments in U.S. dollars between two Brazilian entities) (see 815-15-15 (Q&amp;A 02)).</td>
</tr>
</tbody>
</table>

Q&A 2-3  Rent Increases Based on Sales Volume

**Question**
Do lease contracts that contain provisions for rental increases based on sales volume contain an embedded derivative that needs to be bifurcated?

**Answer**
No. Consider a scenario in which Company ABC leases property from Company XYZ in Germany. The lease provides for annual rent increases based on a percentage of ABC’s retail sales in Germany during the calendar year. The increase is an adjustment to the following year’s rent payments.

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4 Deloitte Q&As are available in the FASB Accounting Standards Codification Manual on DART.
The lease contains an embedded contingent rent payment based on ABC's retail sales in Germany. The embedded derivative does not need to be accounted for separately because ABC's retail sales would qualify for the exception in ASC 815-10-15-59(d), which excludes from its scope non-exchange-traded contracts with underlyings that are the sales or service revenues of one of the parties to the contract. Therefore, this embedded derivative on a percentage of ABC's German retail revenues would not meet the definition of a derivative on a freestanding basis and would not need to be bifurcated in accordance with ASC 815-15-25-1(c).

Q&A 2-4 Interest Rate Adjustments in Leases

Question
Do lease contracts with adjustments that are based on interest rate changes contain an embedded derivative that should be bifurcated?

Answer
Generally, no. For example, assume that Company D has 10-year operating leases for retail stores and a distribution center. The operating lease payments are part of a synthetic lease transaction in which an off-balance-sheet special-purpose entity (SPE) has obtained debt financing and equity that it will use to construct the retail stores and distribution center. The SPE will lease these buildings to D. The leases require D to make quarterly variable lease payments on the basis of the LIBOR interest rate applied to the SPE's total debt outstanding. For example, if the SPE has drawn cash to begin construction on one of the new retail stores, D must begin to make interest payments to the SPE on that drawn amount.

The operating leases for the retail stores and distribution center have embedded derivatives that result in an adjustment to the lease payment and are based on interest rates (i.e., LIBOR). The embedded derivative does not need to be bifurcated because the obligation to make future payments for the use of the leased assets and the adjustment of those payments for changes in a variable interest rate index are considered clearly and closely related under ASC 815-15-25-22.

Note that SPEs should be evaluated to determine whether they are subject to ASC 810-10. Some “synthetic lease” transactions may have to be consolidated under ASC 810-10.

2.3.2.2 Residual Value Guarantees

As noted above in ASC 842-10-15-43, residual value guarantees that are accounted for under ASC 842, including any residual value guarantee between the lessee and the lessor, are not subject to the derivative accounting guidance in ASC 815-10. However, a third-party guarantor must assess whether any residual value guarantee that it writes on an underlying leased asset is subject to the guidance in ASC 815-10.

A leased asset subject to a third-party residual value guarantee will always be a nonfinancial asset (i.e., financial assets cannot be leased). Accordingly, a third-party guarantor may seek to avoid fair value measurement of the guarantee and instead use the scope exception in ASC 815-10-15-59(b) for contracts that are not traded on an exchange and that are settled on the basis of a price or value of a nonfinancial asset. Third-party guarantors will generally meet the second condition in ASC 815-10-15-59(b) because increases in the fair market value of the underlying nonfinancial asset reduce the third-party guarantor’s exposure and the asset’s owner therefore would not benefit from such an increase in value under the contract.
2.4 Land Easements

The objectives of the land easement amendments in ASU 2018-01, which was issued in response to feedback received by the FASB regarding implementation of ASU 2016-02, are to:

- Clarify that land easements entered into (or existing land easements modified) on or after the effective date of ASC 842 must be assessed under ASC 842.
- Provide a transition practical expedient for existing or expired land easements that were not previously accounted for in accordance with ASC 840. The practical expedient would allow entities to elect not to assess whether those land easements are, or contain, leases in accordance with ASC 842 when transitioning to ASC 842.

The amendments in ASU 2018-01 do not, and are not intended to:

- Provide illustrative or application guidance on whether land easements are, or contain, leases in accordance with the definition of a lease in ASC 842.
- Help entities identify the appropriate accounting framework for situations in which a land easement is not determined to be a lease under ASC 842.

See Section 16.5.3 for information about the effective date and transition provisions of ASU 2018-01.

2.4.1 Background

Generally, an easement is a right to access, cross, or otherwise use someone else's land for a specified purpose. Most easements provide limited rights to the easement holder, such as the right to cross over land or the right to construct and maintain specified equipment on the land. For example, an electric utility will typically obtain a series of contiguous easements so that it can construct and maintain its electric transmission system on land owned by third parties. Easements can be perpetual or term-based, be paid in advance or over time, and provide the customer with exclusive or shared use.

Historically, some companies have considered easements to be intangible assets under ASC 350. In fact, ASC 350 contains an example illustrating easements acquired to support the development of a natural gas pipeline. In contrast, some companies may have considered easements to be leases or executory contracts. When preparing their financial statements, many companies have presented prepaid amounts related to easements in the PP&E section of their balance sheets because easements are closely associated with the PP&E they support. We understand that reporting requirements of the Federal Energy Regulatory Commission may have also influenced the balance sheet geography for companies regulated by that agency.

Easements generally convey to the customer some rights associated with the use of land (i.e., PP&E). Therefore, questions have arisen about whether easements are within the scope of ASC 842 and, if so, whether the benefit to financial statement users of entities assessing those arrangements in accordance with the definition of a lease would outweigh the cost to the entities of doing so (both upon transition and on an ongoing basis).
2.4.2 Scope

ASU 2018-01 only addresses land easements. Although the FASB does not define this term, ASC 842-10-65-1(gg) and paragraph BC3 of ASU 2018-01 describe both a land easement and a right of way as a “right to use, access, or cross another entity’s land for a specified purpose.”

Further, ASU 2018-01 effectively breaks land easements into two groups on the basis of the effective date of ASU 2016-02: (1) land easements entered into (or existing easements modified) on or after the effective date (collectively, “new land easements”) and (2) land easements that existed as of, or expired before, the effective date (collectively, “existing land easements”).

For existing land easements that were not previously accounted for as a lease under ASC 840, ASU 2018-01 provides a practical expedient under which an entity may elect to “run off” all such easements by using its historical accounting approach for land easements. Importantly, an entity may elect this practical expedient even if it does not elect the package of practical expedients in ASC 842-10-65-1(f) that would allow the entity not to reevaluate whether any expired or existing contracts are or contain leases. See Section 16.5.2.1 for more information about this “package of three” practical expedients.

Connecting the Dots — No Analogies

We think that the FASB’s use of the term “land easements” is intentional. Therefore, we do not believe that an entity should analogize to the ASU’s favorable transition practical expedient for existing land easements when considering other types of arrangements.

For new land easements, ASU 2018-01 amends the illustrative example (Example 10) in ASC 350-30-55-30 as follows to clarify that ASC 350 may only be applied after a new land easement is determined not to be a lease in accordance with the definition of a lease in ASC 842:

Entity A is a distributor of natural gas. Entity A has two self-constructed pipelines, the Northern pipeline and the Southern pipeline. Each pipeline was constructed on land for which Entity A owns perpetual easements that Entity A evaluated under Topic 842 and determined do not meet the definition of a lease under that Topic (because those easements are perpetual and, therefore, do not convey the right to use the underlying land for a period of time). The Northern pipeline was constructed on 50 easements acquired in 50 separate transactions. The Southern pipeline was constructed on 100 separate easements that were acquired in a business combination and were recorded as a single asset. Although each pipeline functions independently of the other, they are contained in the same reporting unit. Operation of each pipeline is directed by a different manager. There are discrete, identifiable cash flows for each pipeline; thus, each pipeline and its related easements represent a separate asset group under the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10. While Entity A has no current plans to sell or otherwise dispose of any of its easements, Entity A believes that if either pipeline was sold, it would most likely convey all rights under the easements with the related pipeline.

In addition, paragraph BC11 of ASU 2018-01 states, in part:

The Board noted that a land easement conveys (in various forms) a right to use land and that a right to use land needs to be evaluated to determine whether it is within the scope of Topic 842. Accordingly, the amendments in this Update provide clarity that an entity should apply Topic 842 to a land easement to determine whether that easement is or contains a lease. [Emphasis added]

Changing Lanes — New Land Easements Must First Be Evaluated Under ASC 842

The FASB makes its objective for new land easements very clear in paragraph BC11 of ASU 2018-01, and the amendment to ASC 350-30-55-30 helps reinforce the scope hierarchy in GAAP with respect to such easements. That is, all new land easements must first be assessed under ASC 842 to determine whether the arrangement is, or contains, a lease.
If an arrangement is not a lease, other GAAP may be applicable (e.g., ASC 350, ASC 360). However, in paragraph BC11 of ASU 2018-01, the Board explains that it intentionally did not address the appropriate accounting guidance to apply in these situations:

> While there may be diversity about which guidance an entity should apply when a land easement is not a lease, that diversity is outside the scope of the amendments in this Update and, accordingly, the amendments do not modify an entity’s accounting for land easements that are not leases.

### 2.4.3 Identifying a Lease

ASU 2018-01 is not intended to provide illustrative or application guidance about whether new land easements\(^5\) meet the definition of a lease in ASC 842. Therefore, stakeholders and respondents may continue to raise questions about the application of the definition of a lease to new land easement arrangements, and it is possible that the FASB, IASB, and SEC staffs will want to share their perspectives as those questions are raised. Companies involved in land easement arrangements should consult with their accounting advisers and monitor developments on the topic.

The required accounting once ASC 842 is effective will ultimately depend on the facts and circumstances of each arrangement. However, to determine whether a new land easement contract is, or contains, a lease in accordance with ASC 842-10-15-2 through 15-27, entities may find it helpful to group the contracts into one of two categories, further discussed below: (1) perpetual easements and (2) term-based easements. In addition, we recommend that high-volume users of easements begin their analysis by (1) segregating term-based arrangements on the basis of similar contractual provisions and (2) investigating the rights retained by the landowner in those arrangements. This may streamline the process since many easements will have similar or identical provisions and therefore would be expected to result in similar accounting.

#### 2.4.3.1 Perpetual Easements

ASC 842-10-15-3 states, in part, “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” (emphasis added). When a land easement is perpetual, we would not expect the arrangement to meet the definition of a lease given the lack of a stated term. As indicated by the amendments to ASC 350-30-55-30, rights conveyed in a land easement into perpetuity (i.e., for an unlimited time) are not conveyed “for a period of time” in accordance with ASC 842-10-15-3.

Arrangements with stated terms are not considered perpetual even if the terms are very long (e.g., 100 years). On the other hand, a use condition contained in a perpetual easement (e.g., when an easement conveys rights to the customer into perpetuity, as long as those rights are used only to run fiber-optic cable) would not affect the conclusion that a land easement is perpetual.

#### 2.4.3.2 Term-Based Easements

For term-based easements, the analysis will most likely be more extensive and involve a consideration of the right to control the use of the underlying land. That is, in accordance with ASC 842-10-15-4, entities will need to assess whether the customer in the arrangement has the right to (1) obtain substantially all of the economic benefits from using the land throughout the period of use and (2) direct the use of the land throughout the period of use. Accordingly, many easement arrangements may not convey the right to control the use of the land to the customer given that the supplier continues to enjoy economic benefits derived from the use of the land and that the rights to direct the use of the land that are conveyed to the customer are limited (i.e., generally only for a specified purpose).

\(^5\) Although this section focuses on land easements, we believe that the concepts discussed herein can also be applied to other types of land-use rights, including those provided by the government in certain jurisdictions (e.g., countries that prohibit land ownership by foreign investors). We think that entities should generally assess whether such land-use rights are leases before considering other applicable GAAP.
For example, in an arrangement in which a utility (as the easement holder) is allowed to run electric transmission assets through a farmer’s fields (i.e., transmission lines that run over or under the farmer’s fields), it will be important to understand whether the farmer can still use the acreage subject to the easement (i.e., the acreage under or over which the lines run). If so, the utility may conclude that it does not have the right to control the use of the land because the farmer retains (1) rights to direct the use of the land (e.g., rights to farm the land), (2) economic benefits associated with the land that are not insignificant (e.g., the crops yielded from farming), or (3) both (1) and (2). On the other hand, there may be easement arrangements that effectively convey the right to control the use of the land to the easement holder through the rights conveyed or through use restrictions imposed on the landowner.

In addition, to appropriately identify the unit of account, an entity sometimes may need to more carefully consider the identified asset in an easement arrangement, as illustrated in the common scenarios below.

Example 2-3

A customer enters into a land easement arrangement with a farmer for the right to pass a natural gas pipeline under the farmer’s land. At issue is whether the identified asset includes the entire plot of land or whether the land should be broken down into surface and subsurface rights, the latter of which the parties would evaluate to determine whether the customer has the right to control the use of the land.

If the identified asset is the entire plot of land, the parties are less likely to conclude that the customer has the right to obtain substantially all the economic benefits from use of the land because the farmer retains the surface rights (e.g., to farm the land). However, if the identified asset is only the subsurface rights, the customer might have the right to obtain substantially all the economic benefits from using the area below the surface of the land. Further, subsurface rights for the same plot of land may also be stacked in such a way that one customer has an easement for the depth of 5 to 10 feet below the surface while another customer has an easement for the depth of 10 to 20 feet below the surface.

Example 2-4

A customer enters into a land easement arrangement with a farmer for the right to construct and maintain 25 wind turbines on the farmer’s 500-acre plot of land. Each wind turbine will be constructed on individual acre plots. At issue is whether the identified asset is the entire 500-acre plot of land or whether there are 25 identified assets, each one acre of land.

As in the previous example, if the identified asset is the entire 500-acre plot of land, the parties are less likely to conclude that the customer has the right to obtain substantially all the economic benefits from use of the land because the farmer retains all of the rights to the economic benefits of the remaining 475 acres. However, if the identified assets are 25 individual acre plots of land, the customer may have the right to obtain substantially all the economic benefits from using each individual acre plot.

Connecting the Dots — An Entity Will Need to Use Judgment to Determine the Unit of Account

At its November 29, 2017, meeting, the FASB indicated that it would not provide additional, formal guidance on determining the unit of account with respect to performing the lease assessment for an easement. However, several Board members pointed out that an entity will need to use judgment in determining the unit of account and that diversity in practice could arise in this area. Board members have publicly expressed this view at previous meetings, including a July 2017 roundtable and an August 2017 meeting. Further, it was noted that the need to use judgment is not limited to scenarios involving subsurface rights (e.g., rights to run

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6 See Q&A 2-5 for additional considerations related to subsurface easements.
7 See footnote 6.
gas pipelines underground). Board members specifically discussed easements that convey only surface rights, including rights to construct renewable energy assets (e.g., wind or solar), noting that an entity will also be required to employ judgment in considering these arrangements and that there could be more than one approach to determining the unit of account.

On the basis of these views, we believe that, in practice, some will conclude that the unit of account is the entire land area defined by the easement contract (i.e., a larger area) while others will decide that a new unit of account should be established and assessed each time the easement holder occupies a portion of the land (i.e., a smaller area, such as the area taken up by a concrete pad used to serve as the foundation for a windmill or a transmission tower). We believe that either of these approaches is acceptable.

Q&A 2-5 Treatment of Subsurface Rights as an Intangible Asset

As indicated in Example 2-3, certain easements may give an entity the right to use area beneath the surface of the land (i.e., the subsurface). Questions have arisen about whether land below the surface should be considered a unit of account that is separate from the land's surface in the identification of whether a lease exists. Alternatively, others have questioned whether the right to use the subsurface is akin to an intangible asset (e.g., air rights) that is outside the scope of ASC 842.

**Question**

Is it acceptable to treat the right to use the area under the land’s surface (i.e., the subsurface) as an intangible asset that is outside the scope of ASC 842?

**Answer**

It depends. We believe that it may be appropriate to analogize to air rights in certain circumstances, such as those involving the use of subsurface space to facilitate the build-out of a gas or electric distribution system. We generally support an analogy to air rights given the fact that above-ground (air) and below-ground (subsurface) uses are often commercially interchangeable. For example, an electric utility can run its electric wires 35 feet above the ground or 2 feet below the ground, either of which will accomplish the same commercial objective. Note that this analogy does not apply to all underground scenarios (e.g., those involving the basement of a building or an underground parking garage).

We believe that when a subsurface easement conveys rights akin to air rights, an entity is permitted, but not required, to consider an arrangement that provides a right to access the subsurface as an intangible asset by analogy to air rights. Air rights are intangible assets under ASC 805-20-55-37, which states:

> Use rights such as drilling, water, **air**, timber cutting, and route authorities are **contract-based intangible assets** to be accounted for separately from goodwill. Particular use rights may have characteristics of tangible, rather than intangible, assets. For example, mineral rights are tangible assets. An acquirer should account for use rights based on their nature. [Emphasis added]

Under this approach, subsurface rights are outside the scope of ASC 842. The right to use the land’s surface would be considered a unit of account that is separate from subsurface rights.
We generally believe that if a company does not analogize to air rights and instead evaluates its subsurface easements under ASC 842, the land below the surface should be considered a unit of account that is separate from the land's surface in the identification of whether a lease exists. Some have advocated a “vertical slice” approach (i.e., evaluating the right to use the surface and subsurface as a single unit of account); however, we believe that such an approach can lead to inappropriate conclusions (e.g., a conclusion that an entity is not leasing the land because it is not also receiving the subsurface rights).

Companies should apply a consistent approach to assessing their subsurface easements and should consider disclosing this approach, if such disclosure would be material.
Chapter 3 — Identifying a Lease

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3.2 Definition of a Lease
  3.2.1 Process for Identifying a Lease
  3.2.2 Embedded Leases
  3.2.3 Joint Operations or Joint Arrangements
3.3 Identified Asset
  3.3.1 Explicitly and Implicitly Specified Assets
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3.8 Decision Tree for Identifying a Lease
3.1 Introduction

As indicated in the decision tree in Section 2.2, whether a contract is within the scope of ASC 842 is only a gating question. Once an entity determines that the contract is within the scope, it must then proceed through the analysis in ASC 842-10-15 to determine whether the contract is, or contains, a lease.

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-2 At inception of a contract, an entity shall determine whether that contract is or contains a lease.</td>
</tr>
<tr>
<td>15-7 In making the determination about whether a contract is or contains a lease, an entity shall consider all relevant facts and circumstances.</td>
</tr>
</tbody>
</table>

Although a contract is not recognized and measured until commencement if it is a lease (see Chapters 8 and 9 for a detailed discussion of lessee and lessor accounting, respectively), the lease identification analysis must be performed at inception. If an arrangement is determined not to be, or not to contain, a lease, an entity must look to other U.S. GAAP (e.g., ASC 606) to determine the appropriate accounting and must apply the appropriate recognition and measurement guidance in such GAAP at whatever time is required, which could be at a contract’s inception.

Changing Lanes — Definition of a Lease Is the New Line Between On- and Off-Balance-Sheet Treatments

Under ASC 842, the determination of whether an arrangement is or contains a lease is critical. A lessee’s failure to identify leases, including those embedded in service arrangements, is likely to lead to a financial statement error given that ASC 842 requires entities to reflect all leases, other than short-term leases, on the balance sheet (see Chapter 8 for further discussion of the lessee accounting model). On the other hand, if a customer concludes that a contract is a service arrangement and does not contain an embedded lease, the customer is not required to reflect the contract on its balance sheet (unless it is required to do so by other U.S. GAAP).

<table>
<thead>
<tr>
<th></th>
<th>ASC 842</th>
<th>ASC 840</th>
</tr>
</thead>
<tbody>
<tr>
<td>On-balance-sheet treatment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Off-balance-sheet treatment</td>
<td></td>
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</tbody>
</table>

The assessment of the arrangement may be more critical under ASC 842 than under ASC 840 because, under ASC 840, the balance sheet and income statement treatment of operating leases is often the same as that of service arrangements. In other words, under ASC 840, the difference between on- and off-balance-sheet treatments often depends on whether the lease is classified as operating or capital. Under ASC 842, however, all leases (other than short-term leases) are on the balance sheet. Therefore, an off-balance-sheet treatment will often depend on whether an arrangement meets the definition of a lease.
3.2 Definition of a Lease

ASC 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).

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). . . .

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.

ASC 842-10-15-3 indicates that a lease is a contract — or part of a contract — in which a supplier conveys to a customer “the right to control the use of identified [PP&E] for a period of time in exchange for consideration.” The following graphic illustrates this relationship:

Although the definition of a lease in ASC 842-10-15-3 includes the phrase “in exchange for consideration,” the identification of a lease does not depend on whether the contract contains stated or cash consideration. See Chapter 6 for a detailed discussion of lease payments and what constitutes consideration.

3.2.1 Process for Identifying a Lease

To help entities determine whether a contract is, or contains, a lease in accordance with ASC 842-10-15-3 and 15-4, the FASB included a flowchart in its implementation guidance. Each piece of this flowchart will be further discussed throughout the remainder of this chapter.

ASC 842-10

15-8 Paragraph 842-10-55-1 includes a flowchart that depicts the decision process for evaluating whether a contract is or contains a lease.
Identifying a Lease

The following flowchart depicts the decision process to follow in identifying whether a contract is or contains a lease. The flowchart does not include all of the guidance on identifying a lease in this Subtopic and is not intended as a substitute for the guidance on identifying a lease in this Subtopic.

Start

Is there an identified asset? Consider paragraphs 842-10-15-9 through 15-16.

Yes

Does the customer have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use? Consider paragraphs 842-10-15-17 through 15-19.

Yes

Does the customer or the supplier have the right to direct how and for what purpose the identified asset is used throughout the period of use? Consider paragraphs 842-10-15-20(a) and 842-10-15-24 through 15-26.

Customer

Neither; how and for what purpose the asset will be used is predetermined.

Supplier

The contract contains a lease.

No

No

Did the customer design 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?

Yes

Yes

The contract does not contain a lease.

No

No

Did the customer have the right to operate the asset throughout the period of use without the supplier having the right to change those operating instructions?

Yes

Yes

The contract contains a lease.

No

No

Customer Supplier

Neither; how and for what purpose the asset will be used is predetermined.
Connecting the Dots — Not a Step-by-Step Process

The FASB’s flowchart in ASC 842-10-55-1 appears to suggest that the lease identification assessment comprises a series of steps. For example, the flowchart seems to imply that, in determining whether it has the right to control the use of an asset, an entity must determine whether there is an identified asset in the contract before it can move on to assessing the right to control the use in the following sequential manner:

1. Whether there is an identified asset.
2. Whether the customer has the right to obtain substantially all of the economic benefits from use of the identified asset.
3. Whether the customer has the right to direct the use of the identified asset.

However, Example 10, Case A, in ASC 842-10-55-124 through 55-126 (reproduced in Section 3.7.10) states that when the customer in a contract does not have the right to control the use of PP&E, an entity does not need to assess whether the PP&E is an identified asset. Accordingly, we do not think that it is necessary for lease identification to be performed on a step-by-step basis. (However, a step-by-step assessment is required for the specific evaluation of whether the customer has the right to direct the use of the asset — see Section 3.4.2 for further discussion.)

One way to think about identifying a lease is that the definition of a lease sits on a three-legged stool. Each leg represents one of the three requirements in ASC 842-10-15-4: (1) the contract depends on an identified asset; (2) the customer has the right to obtain substantially all of the economic benefits from use of the PP&E; and (3) the customer has the right to direct the use of the PP&E. If you were to kick out any one of the three legs (i.e., if you were to determine that a contract does not meet any one of the requirements), the stool falls over and the definition of a lease is not met.
The following flowchart illustrates an entity’s determination of whether a contract is, or contains, a lease and ties into the discussion in the remainder of this chapter:

**Connecting the Dots — It’s All About Control**

The notion of control is critical in ASC 842. The concept is used to identify a lease as well as to classify one when it is identified (see Chapters 8 and 9 for a discussion of the lessee’s and lessor’s classification, respectively). Accordingly, there is effectively a two-step process related to the control concepts behind the FASB’s ROU model in ASC 842:

- **Step 1** — Determine whether the customer has the right to control the use of an identified asset. If so, the contract is, or contains, a lease. If not, the *supplier* has the right to control the use of the asset.

- **Step 2** — Determine the *extent of* the customer’s control over the use of the asset. There is a range of outcomes from this step. However, if enough control of the use rests with the customer, the customer effectively obtains control of the entire asset. The extent to which the customer has control of the use of the asset governs the classification of the lease and its accounting.
In paragraphs BC124 and BC125 of ASU 2016-02, the FASB notes that the control concept in the definition of a lease (i.e., step 1 as described above) should be compatible with the same concept articulated in the revenue standard (i.e., ASC 606) and the consolidation guidance (i.e., ASC 810). Further, paragraph BC134 of ASU 2016-02 indicates that, in the determination of whether a customer has the right to control the use of an asset under ASC 842, the concept of control should have “power” and “benefits” (or “economics”) elements, just as ASC 606 or ASC 810 do for control of a good (or service) or another entity, respectively.

The following table compares the control principles from the leasing, revenue, and consolidation standards:

<table>
<thead>
<tr>
<th>ASC Reference</th>
<th>Consolidation</th>
<th>Revenue</th>
<th>Leasing</th>
</tr>
</thead>
<tbody>
<tr>
<td>810-10-25-38A</td>
<td>&quot;A reporting entity shall be deemed to have a controlling financial interest in a VIE if it has both of the following characteristics: a. The power to direct the activities of a VIE that most significantly impact the VIE's economic performance [power element] b. The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE [economics element].&quot;</td>
<td>&quot;Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of [power element], and obtain substantially all of the remaining benefits from, the asset [economics element].&quot;</td>
<td>&quot;To determine whether a contract conveys the right to control the use of an identified asset . . . 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 [economics element] b. The right to direct the use of the identified asset [power element].&quot;</td>
</tr>
</tbody>
</table>

3.2.2 Embedded Leases

Section 3.1 clarifies the balance sheet impact of properly differentiating between a lease and a service under ASC 842. Further, certain contracts may not be wholly a lease or wholly a service; in fact, it is not uncommon for some service arrangements to contain a right to control the use of an asset. The Q&A below addresses whether an entity should assess such arrangements to identify whether there is a lease.

Q&A 3-1 Assets With a Significant Service Component

An entity may enter into a service arrangement that involves PP&E necessary to meet the contract’s performance obligations. The importance of the PP&E to the overall delivery of the service may vary depending on the type of arrangement.
For example, a customer contracting for transportation services to ship a package from Munich to Milwaukee may care little about the PP&E used to perform the services. In contrast, a customer contracting a vessel and crew for a specified period to transport its goods where and when it chooses is likely to be more concerned with the PP&E used in the arrangement. Both arrangements, however, involve a significant service component provided by the supplier to operate the PP&E used to fulfill its transportation obligations.

Often, the assessment of whether a contract is or contains a lease will be straightforward. However, the evaluation will be more complicated when a service arrangement involves a specified physical asset or when both the customer and the supplier make decisions about the use of the underlying asset. Examples of these more ambiguous and complex arrangements include those that involve cloud computing services (i.e., if there is a lease of the supporting equipment, such as mainframes and servers) and cable television services (i.e., if the cable box provided to the customer is a leased asset).

**Question**

Does an entity need to evaluate a service arrangement that involves the use of PP&E to determine whether the arrangement contains a lease?

**Answer**

Yes. In accordance with ASC 842-10-15-2, an entity is required at contract inception to identify whether a contract contains a lease. Not all leases will be labeled as such, and leases may be embedded in larger arrangements. For example, supply agreements, power purchase agreements (PPAs), and oil and gas drilling contracts may contain leases (i.e., there may be an embedded lease of a manufacturing facility, generating asset, or drill rig, respectively). If an entity identifies PP&E in an arrangement (either explicitly or implicitly), the customer and supplier must both determine whether the customer controls the use of the PP&E throughout the period of use.

### 3.2.2.1 Embedded Leases and Service Providers

In a manner consistent with the discussion in Q&A 3-1, it is important to review contracts (particularly service contracts) to determine whether they are or contain a lease. When the service provider also conveys control of PP&E to a customer, an embedded lease (to the customer) is likely to exist. On the other hand, when the customer conveys control of PP&E to the service provider to facilitate the delivery of the service, it is less likely that there is an embedded lease in the arrangement. The Q&A below elaborates on this scenario and provides illustrative examples.

### Q&A 3-1A Accounting for Customer-Furnished Assets

In certain industry sectors, it is common for a customer to provide a vendor with the use of an asset (e.g., a piece of customer-owned equipment) so that the vendor can provide goods or services to the customer (i.e., the “vendor’s revenue contract”). The vendor’s use of the equipment is typically limited to activities defined in the contract that by their nature only benefit the customer. Further, the vendor would not have the right to opt out of using the customer-owned equipment (i.e., the vendor could not choose to bring vendor-owned or vendor-leased equipment). In summary, the vendor typically must use the customer-furnished asset and the asset’s use is contractually limited to fulfilling the terms of the vendor’s revenue contract with the customer (i.e., the asset cannot be used to satisfy the terms of other contracts of the vendor and may not be assigned to third parties).
Stakeholders have questioned whether, when an entity accounts for arrangements in which customer-furnished assets are used exclusively to fulfill the vendor’s contract with the customer, the arrangement includes either of the following:

- One or more embedded leases that should be accounted for separately (i.e., a lease from the customer to the vendor and then a corresponding lease back from the vendor to the customer); some may describe such accounting as accounting for the arrangement on a gross basis.

- No leases (such accounting is sometimes described as accounting on a net basis, suggesting an equal and offsetting exchange of rights because the substance of the transaction is that no leases exist).

**Question**

Should arrangements in which customer-furnished assets are used exclusively to fulfill the vendor’s contract with the customer be accounted for separately (i.e., on a gross basis with imputed consideration for the leases) or as if no leases exist (i.e., on a net basis)?

**Answer**

It depends. We believe that an entity should carefully evaluate the facts and circumstances to determine whether control of an asset is transferred through the rights to use the asset as conveyed in the arrangement. In some cases, it will be appropriate to recognize a lease; however, we believe that when the three criteria outlined below are met, control of the asset is not conveyed to one party (vendor) and then transferred back to the owner (customer).

When the three criteria are met, the substance of the transaction is that there are no leases (i.e., neither inbound nor outbound) and the accounting should therefore be on a net basis (i.e., there are no separate accounting effects related to the customer-furnished assets). However, if these criteria are not met or are only met for a portion of the term of the use of the customer-furnished asset, the vendor and customer should evaluate whether the customer has leased its asset to the vendor.

The vendor (potential lessee/sublessor) and customer (potential lessor/sublessee) should not treat customer-furnished assets as embedded leases (and recognize the gross effects of such leases) only if all of the following three criteria are met:

1. **Linked contracts** — The right to use the asset is directly linked to the revenue arrangement. That is, the arrangement is executed as part of one contract or each part of two or more contracts is deemed to be combined and accounted for as a single transaction since the contracts are interdependent.

2. **Coterminous period** — Some or all of the period of use of the asset is coterminous with the revenue arrangement. As discussed further below, if the period of use for the asset begins before or ends after the revenue arrangement, this condition would only be satisfied (and therefore net treatment would only be appropriate) for the overlapping period.

3. **Restricted use** — During the coterminous period identified in criterion 2, the vendor’s use of the asset is either restricted contractually or limited practically to solely transferring the goods or services promised in the revenue arrangement, including restricting the vendor from assigning or transferring the rights of the asset without the customer’s consent.
Accordingly, when all of the above criteria are met, there are no leases of the asset and there would be no gross-up of revenue and related expense (i.e., both the customer and the vendor would account for the arrangement as a typical service contract) for the period in which the vendor’s use of the identified asset coincides with the related revenue contract (including renewal/extension options). If the vendor can use the identified asset for a period longer than the related revenue contract, there may be a lease for the excess period (i.e., use of the asset before or after the related revenue contract begins or ends, respectively, provided that control is conveyed to the vendor before or after the revenue contract begins or ends, respectively). Therefore, the counterparties would need to determine whether a lease commences when the related revenue contract expires (or before it starts) because the output from the use of the identified asset is no longer limited to satisfying the related revenue contract.

The examples below illustrate situations in which the three criteria are met and the arrangements would be accounted for on a net basis.

**Example 1**

**Customer-Furnished Equipment**

Contractor C enters into a three-year arrangement with Governmental Agency G, the customer. Under the arrangement, C provides G with military base operations related to mail and food services while G owns and will provide C with exclusive use of its mail sorting and delivery equipment and food service equipment over the three-year term to execute the services. That is, G owns and will provide the use of all equipment that C would need to deliver its services to G. The terms of the contract explicitly limit C’s use of the equipment to activities defined in the contract as “contract activities,” and such contract activities directly benefit G through the services provided by C under the arrangement. Further, C cannot assign or transfer its rights under the contract or further sublease the equipment.

In this example, the three criteria are met as follows:

1. **Linked contracts** — The right to use the equipment is directly linked to the revenue arrangement. That is, the military base operations arrangement is executed as a single contract that includes C’s use of G’s equipment to execute the contract activities that directly benefit G.

2. **Coterminous period** — The period of use of the equipment is coterminous (i.e., aligned) with the three-year arrangement for military base mail and food services.

3. **Restricted use** — The right to use the equipment is contractually restricted to solely transferring the services promised in the military base operations arrangement. That is, C cannot use the equipment to derive other economic benefits (through offering services to other customers or for C’s internal use). In addition, the contract explicitly restricts C from assigning or transferring its rights under the contract or further subleasing the equipment.

Accordingly, there is no lease of the mail sorting and delivery equipment or the food service equipment. Therefore, G will not recognize lease income as a lessor for C’s right to use its assets and a separate lease expense associated with the embedded lease in the services it receives from C. Similarly, C will not recognize lease expense as a lessee for its right to use G’s assets and separate lease income for its provision of an embedded lease within its service revenue agreement.
Example 2

Customer-Furnished Property

Vendor V enters into a five-year arrangement with a customer, Freight Carrier F, to provide the maintenance services on F's railcars. The maintenance facility that V will use to execute its services is owned by F. That is, F owns and will provide exclusive use of its maintenance facility to V to perform all the maintenance work over the five-year term. The terms of the contract explicitly limit V's use of the maintenance facility to activities defined in the contract as “contract activities.” Accordingly, V cannot use the maintenance facility (1) to service any customer other than F or (2) for its internal use. Vendor V cannot assign or transfer its rights under the contract or further sublease the maintenance facility.

In this example, the three criteria are met as follows:

1. **Linked contracts** — The right to use the maintenance facility is directly linked to the revenue arrangement. That is, the maintenance services arrangement is executed as a single contract that includes V's use of F's maintenance facility to execute the contract activities that directly benefit F.

2. **Coterminous period** — The period of use of the maintenance facility is coterminous (i.e., aligned) with the five-year arrangement for maintenance services.

3. **Restricted use** — The right to use the maintenance facility is contractually restricted to solely transferring the services promised in the maintenance services arrangement. That is, V cannot use the maintenance facility to derive other economic benefits (through offering services to other customers or for V's internal use). In addition, the contract explicitly restricts V from assigning or transferring its rights under the contract or further subleasing the maintenance facility.

Accordingly, there is no lease of the maintenance facility. Therefore, F will not recognize lease income as a lessor for V's right to use its maintenance facility and a separate lease expense associated with the embedded lease in the maintenance services it receives from V. Similarly, V will not recognize lease expense as a lessee for its right to use F's maintenance facility and separate lease income for its provision of an embedded lease within its service revenue agreement.

3.2.3 Joint Operations or Joint Arrangements

Companies in a number of industries enter into joint arrangements to achieve a common commercial objective. These arrangements may include the use of specified PP&E for a stated time frame. Accordingly, under ASC 842-10-15-4, entities should evaluate such arrangements to determine whether they have the right to control the use of an asset throughout the period of use.

**ASC 842-10**

15-4 . . . 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.

**Bridging the GAAP — No Joint Definitions**

The terms “joint arrangement” and “joint operation” are defined in IFRS Standards but not in U.S. GAAP. Under IFRS 11, a joint arrangement is “an arrangement of which two or more parties have joint control” and a joint operation is a type of joint arrangement “whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.”

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1 While this example focuses on the maintenance facility itself, a similar analysis would apply to the land on which the maintenance facility resides. Furthermore, we believe that there are scenarios involving vendor-owned assets attached to customer-owned land (e.g., vendor-owned solar panels attached to customer-owned land) whereby the land use rights would be subject to the guidance in this Q&A.
Although ASC 842 does not define these two terms, their use in U.S. GAAP is aligned with that in IFRS Standards. The terms appear in ASC 842-10-15-4 for two reasons:

1. The FASB and IASB decided that the definition of a lease in ASC 842 would be converged with that in IFRS 16.
2. The FASB wanted to close a structuring opportunity so that entities cannot come together in a joint arrangement or joint operation structure to avoid identifying a lease and recognizing lease assets and lease liabilities.

Connecting the Dots — Joint Operating Agreements in the Oil and Gas Industry

Entities in the oil and gas industry often enter into joint operating agreements (JOAs) in which two or more parties (i.e., operators and nonoperators), without setting up a separate or new legal entity, collaboratively explore for and develop oil or natural gas properties by using the experience and resources of each party. These agreements often require the use of leased equipment. Questions have arisen regarding ASC 842's lease assessment requirements for parties to JOAs. While we expect that the analysis of JOAs will be largely based on facts and circumstances, the example and analysis below should be helpful to companies as they consider these arrangements.

Example 3-1

Three companies — A, B, and C — form a JOA to execute an offshore drilling program. For the companies to fulfill the JOA's objective, a specific asset (e.g., a drill rig) will be necessary. Company A will act as the counterparty to major contracts of the JOA, including a five-year contract to lease a specific drill rig from its owner (Lessor X).

**Question 1: Which Party, if Any, Is Leasing the Rig?**

Given A's role as primary obligor in the drilling rig's lease (the rig's owner may not be aware of the JOA and the parties that constitute it), A will generally be deemed the lessee in the arrangement. Accordingly, A will record the entire lease on its balance sheet. Even though other parties will receive economic benefits from the rig, those benefits arise from the JOA and do not affect the economic-benefits analysis of the contract between A and the rig's owner, X.

**Question 2: What Is the Effect of the JOA?**

The JOA's terms may represent a sublease of the rig from A to the JOA. That is, ASC 842 requires the parties to the JOA to consider the terms and determine whether the JOA is, or includes, a “virtual” lessee of the rig. Although the JOA is typically not a legal entity that prepares financial statements, a conclusion that the JOA is a lessee of the rig would have the following implications:

- Company A, as sublessor, would separately account for its sublease to the JOA (apart from its head lease with X, the rig's owner).
- Each party to the JOA would need to consider other GAAP (e.g., proportionate consolidation guidance) that may require it to record its pro rata portion of lease assets and lease liabilities.

Note that the “other GAAP” mentioned in Question 2 of the example above may vary by industry (e.g., proportionate consolidation guidance is not applicable in many industries). Also note that the analysis should be performed at the appropriate level, which may not always be the JOA. The “joint operation” or “joint arrangement” mentioned in ASC 842-10-15-4 could be a subset of a JOA to the extent that multiple parties have agreed to jointly use an identified asset for a defined time frame. For example, in a five-year JOA involving five parties, if three of the parties agree to jointly develop a property by using a specified drill rig for the first two years, it may be necessary to evaluate that two-year agreement to determine whether it contains a lease.
The above example is not meant to suggest that most JOAs will contain leases but to highlight and explain the analysis that ASC 842-10-15-4 requires for joint arrangements involving the use of specified PP&E. We encourage entities affected by this issue to check with their auditors and accounting advisers for input on the accounting for specific arrangements.

### 3.3 Identified Asset

In accordance with the definition of a lease in ASC 842, fulfillment of the contract must depend on the use of an identified asset. This is an important concept, as the Board notes in paragraph BC128 of ASU 2016-02, because the customer must know the asset over which it is agreeing to have a right to control the use. Similarly, paragraph BC105(a)(1) of the 2013 leasing exposure draft (ED) explained that in contracts that do not involve an identified asset (e.g., a service), the customer does not have the right to control the use of an asset.

Effectively, the FASB recognized that if an arrangement does not contain an identified asset, it is unlikely that the customer has the right to control the use of an asset. Accordingly, the Board decided against broadening the concept of identified assets to include, for example, assets of a particular specification. The Board stated as much in paragraph BC105(a)(2) of the 2013 leasing ED:

> In most contracts for which there is no identified asset, the customer does not have the right to control the use of an asset. Consequently, widening the definition in that respect would possibly have forced some entities to go through the process of assessing whether the customer obtains the right to control the use of an asset, only to conclude that it does not. That would potentially have increased costs for little benefit.

**Connecting the Dots — Explicit and Implicit Identification Are Consistent With ASC 840**

Paragraph BC128 of ASU 2016-02 states that the “requirement that there be an identified asset is substantially the same as the requirement in previous GAAP that a lease depends on the use of a specified asset.” In addition, ASC 840-10-15-5 notes that a specified asset may be either explicitly or implicitly specified in the arrangement, which is consistent with ASC 842-10-15-9. Therefore, we do not expect ASC 842 to significantly differ from ASC 840 with respect to the explicit or implicit identification of an asset.

However, the identified-asset notion in ASC 842’s definition of a lease will differ from ASC 840 regarding the assessment of substitution rights. See **Section 3.3.3** for a detailed discussion of this issue.
In many cases, the PP&E being leased will be identified by serial number, VIN, GPS coordinates, etc. However, the assessment sometimes may be more complex. The decision tree below illustrates the process an entity should consider when determining whether PP&E is identified in the contract:

The remainder of Section 3.3 walks through this decision tree in greater detail.
3.3.1 Explicitly and Implicitly Specified Assets

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

The most observable forms of identified assets are those that are explicitly specified in the arrangement. Typically, an asset is explicitly specified through the inclusion of a serial number or part number in the contract. For example, if a customer enters into an arrangement to lease a computer server and the contract states that the customer has the right to use Server ABC123, the server is explicitly specified. Alternatively, if the contract states that the customer has a right to use any of the company’s servers that meet certain specification and functionality requirements, the server is not explicitly specified.

If an asset is not explicitly specified in the contract, an entity should consider whether an asset is implicitly specified in the arrangement. As stated in ASC 842-10-15-9, an asset that is implicitly specified can qualify as an identified asset. This concept is further expanded in paragraph BC128 of ASU 2016-02:

Nonetheless, when assessing whether there is an identified asset, an entity does not need to be able to identify the particular asset that will be used to fulfill the contract to conclude that there is an identified asset. Instead, the entity simply needs to know whether an asset is needed to fulfill the contract from commencement. If that is the case, an asset is implicitly specified.

The following examples illustrate cases in which assets are implicitly specified:

**Example 3-2**

**Railcars**

Customer JB enters into a contract with Supplier TK to use a railcar to transport hazardous liquids over a three-year period. The contract does not explicitly specify the railcar that will be used to transport JB’s products but does stipulate that the railcar used must be capable of transporting hazardous bulk commodities (e.g., hazardous liquids and gases). Supplier TK has a large fleet of railcars but only one railcar that is designed to transport hazardous bulk commodities. Therefore, although the railcar is not explicitly specified in the contract, it is implicitly specified because TK has only one railcar that can be used to fulfill the contract.

If other, similar railcars are readily available to TK in the marketplace, substitution rights may need to be considered in the analysis as well. See Section 3.3.3 for further discussion of substitution rights.

**Example 3-3**

**Servers**

Customer TP, a health care provider, enters into a contract to store sensitive customer information subject to HIPAA regulations in a server farm. The contract does not explicitly specify the server farm that will be used by TP. However, because of the highly sensitive nature of the information that will be stored in the servers, the contract states that the server farm used must meet specific security and encryption requirements. Although the supplier has various server farms across the country, it only has one server farm with servers outfitted to match the security and encryption requirements outlined in the contract. Therefore, although that server farm is not explicitly specified in the contract, the server farm is implicitly specified as a result of the contractual provisions. To determine whether there is an identified asset, the parties must next assess whether the contract involves a capacity portion of the implicitly specified server farm that represents substantially all of the capacity of the server farm (see Section 3.3.2).
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Example 3-4

Satellites
Supplier KB enters into a contract with Customer NL for satellite services so that the end users of NL’s services can communicate across the globe. Supplier KB operates and maintains several satellites in orbit. However, the services NL offers include global communication with specific compression and encryption. Accordingly, NL needs a satellite that can transmit a unique signal that is specifically compressed and encrypted. Supplier KB only has one satellite in orbit that can transmit this signal. Therefore, although this satellite is not explicitly specified in the contract, it is implicitly specified because of the terms of the contract with NL. To determine whether there is an identified asset, the parties must next assess whether the contract involves a capacity portion of the implicitly specified satellite that represents substantially all of the capacity of the satellite (see Section 3.3.2 below).

Connecting the Dots — Identified Assets When the Customer Has the Right to Select and Use Parcels of Land Within a Larger Plot
Certain contracts grant customers the right to select and use a parcel of land within a larger plot of land for a period of time. In these situations, the customer would need to assess whether it has exclusive use of the parcels selected and whether the landowner retains the right to use the remainder of the land that has not been selected by the customer. Questions have arisen regarding whether the specified asset in these arrangements is the specific parcel(s) of land selected by the customer or the larger plot of land. This determination is based on facts and circumstances, and reasonable judgment may need to be applied. The example below illustrates such scenarios. Also see Section 2.4 for a similar discussion related to land easements.

Although an asset may be explicitly or implicitly specified in the arrangement, an entity must also evaluate whether (1) the specified asset is a portion of a larger asset and whether that portion is physically distinct or substantially all of the larger asset’s capacity and (2) the supplier has the right to substitute the underlying asset throughout the period of use and, if so, whether the supplier’s substitution right is substantive. See Sections 3.3.2 (below) and 3.3.3 for further discussion of portions of assets and substantive substitution rights, respectively.

3.3.2 Portions of Assets (Capacity and Physical Distinctness)

ASC 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.

An entity will need to use judgment in distinguishing between a lease and a capacity contract. ASC 842-10-15-16 clarifies that a “capacity portion of an asset is an identified asset if it is physically distinct” (e.g., a floor of a building).

Example 3-4A

Use of a Portion of a Fiber-Optic Cable
Customer M, a telecommunications provider, enters into a 10-year contract with Supplier R for the right to use two fibers in a fiber-optic cable to transport data from New York City to London. Each fiber within the fiber-optic cable is physically distinct, and the contract explicitly specifies the two fibers that will be provided to M; therefore, the arrangement contains an identified asset.
On the other hand, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of the capacity of a pipeline) is not an identified asset unless the portion represents substantially all of the asset’s capacity. ASC 842 does not define the term “substantially all.”

Q&A 3-2 Determination of Whether a Capacity Portion of an Asset Meets the “Substantially All” Threshold

Question
How should an entity determine whether a capacity portion of an asset meets the “substantially all” threshold to be considered an identified asset?

Answer
Although ASC 842 does not define “substantially all,” it uses the term in the context of determining whether a capacity portion of an asset represents an identified asset as well as in discussion of the lease classification test (i.e., determining whether the present value of the lease payments represents substantially all of the fair value of the underlying asset). To help entities determine whether the “substantially all” criterion is met in the lease classification test, the FASB included implementation guidance that allows entities to use a 90 percent threshold. Specifically, paragraph BC73 of ASU 2016-02 states, in part:

Nevertheless, the Board understands that entities need to ensure the leases guidance is operational in a scalable manner, which often requires the establishment of internal accounting policies and controls. As a result, the Board included implementation guidance in Topic 842 that states that one reasonable application of the lease classification guidance in that Topic is to conclude, consistent with previous GAAP, that . . . 90 percent or greater is “substantially all” the fair value of the underlying asset.

Likewise, we think that 90 percent should generally be used to determine whether a capacity portion of an asset meets the “substantially all” threshold. Therefore, under this guidance, if the capacity being used by the customer is 90 percent or more of the asset’s total capacity, the customer is using substantially all of the capacity of the asset and the capacity portion represents an identified asset (subject to the guidance on substantive substitution rights, discussed in Section 3.3.3). Companies should consult with their auditors, accounting advisers, or both if they are considering the use of a different percentage threshold for this purpose.

Again, the FASB’s decisions regarding portions of larger assets reflect the importance of the control concept and establishing which party to the arrangement controls the right to use an asset. Paragraph BC133 of ASU 2016-02 states, in part, the following:

The Board concluded that a customer is unlikely to have the right to control the use of a capacity portion of a larger asset if that portion is not physically distinct (for example if it is a 20 percent capacity portion of a pipeline). The customer is unlikely to have the right to control the use of its portion because decisions about the use of the asset are typically made at the larger asset level. [Emphasis added]
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The examples below illustrate the application of the guidance in ASC 842-10-15-16.

Example 1

**Use of a Portion of a Pipeline**

Customer C enters into a five-year contract with Supplier S for the right to transport natural gas through S's pipeline from the Marcellus shale supply region in Pennsylvania to the New York/New Jersey demand region. The contract specifies the amount of the pipeline's capacity that C may use throughout the five-year period. In each case, S has the right to contract with other customers for the remaining capacity not being used by C.

**Case A — Capacity Is Substantially All**

The contract gives C the right to use 93 percent of the capacity of S's pipeline. In this case, because 93 percent represents substantially all of the pipeline's capacity, the arrangement contains an identified asset.

**Case B — Capacity Is Not Substantially All**

The contract gives C the right to use 26 percent of the capacity of S's pipeline. In this case, C does not have the right to use substantially all of the pipeline's capacity; therefore, the arrangement does not contain an identified asset.

Example 2

**Use of a Portion of a Warehouse**

**Case A — Contract Does Not Contain an Identified Asset**

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

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

**Case B — Contract Contains an Identified Asset**

Assume the same facts as in Case A, except that the operator's warehouse can only store up to 1,100 pallets, rather than 10,000. In addition, assume that the operator cannot relocate the inventory to a different facility.

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

Q&A 3-3  Pipeline Laterals and First-Mile/Last-Mile Connections (Identified Asset)

Pipelines are generally constructed and operated in sprawling and integrated networks that transport natural gas, oil, and refined products from supply regions to demand regions. Some customers are connected to, and receive deliveries of transported commodities through, the larger pipeline system via dedicated laterals. In addition, a pipeline system must, by its nature, have starting and ending points. Therefore, these customers are connected to the pipeline system through laterals, because they are connected to the first mile or last mile of the larger pipeline system.
Customers connected to a lateral or first mile/last mile of a pipeline system enter into contracts with the pipeline system owner for transportation services through the network to their connection point. Those contracts should be assessed to determine whether they are, or contain, leases of the lateral or first mile/last mile.

**Question 1**
Are pipeline laterals and first-mile/last-mile connections to the larger pipeline system identified assets?

**Answer**
Yes. ASC 842-10-15-16 (reproduced above) states that 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)” (emphasis added). Pipeline laterals and first-mile/last-mile connections therefore are physically distinct from the larger asset (i.e., the integrated pipeline system) and are identified assets.

The FASB addressed this question at its May 10, 2017, Board meeting on implementation issues related to ASC 842. The Board agreed that under ASC 842-10-15-16, a pipeline lateral is an identified asset and that the assessment of whether it is a lease must focus on whether the customer has the right to control the use of the identified asset in accordance with ASC 842-10-15-4 (reproduced in Section 3.2).

See Q&A 3-13 for further discussion of the analysis related to whether the customer has the right to control the use of the identified asset (i.e., the pipeline lateral).

**Question 2**
Are first-mile/last-mile connections to other types of assets and infrastructural systems identified assets?

**Answer**
Generally, yes. In a manner consistent with the answer to Question 1, ASC 842-10-15-16 indicates that a portion of a larger asset is physically distinct, and thus an identified asset, if it connects a single customer to the larger asset or system. Even when the portion is part of a contiguous asset and is not separable from the larger system, that portion may only serve a single customer and thus is physically distinct.

Portions of assets to which the guidance in ASC 842-10-15-16 may apply include, but are not limited to:

- Train tracks that connect a customer’s facility to the larger rail network.
- Electric distribution lines that run (either overhead or underground) from the street, transformer, etc., to a customer’s home or facility.
- Telephone wires that run (either overhead or underground) from the street to a customer’s home.
- Coaxial and fiber-optic cables (i.e., for cable television and Internet) that run (either overhead or underground) from the street to a customer’s office building.
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In line with the response to Question 1, even if the arrangement depends on an identified asset because the first mile/last mile is considered physically distinct, the customer may not have the right to direct the use of the first mile/last mile (see Q&A 3-13 for detailed discussion).

Connecting the Dots — Arrangements Involving Rights to Use Portions of Larger Assets

We have received a number of questions about so-called secondary-use arrangements in which a customer shares the use of part of a larger asset for a defined period. Examples of such arrangements include advertising placed on the side of a fixed asset and nonutility customers' attachment of distribution wires (e.g., cable wires) to utility poles. Often, we have been asked (1) how to assess economic benefits when two parties contemporaneously use the same asset and (2) what unit of account to use for the evaluation of control (the larger asset or the portion being shared).

ASC 842-10-15-16 provides guidance on evaluating whether a portion of an asset would be considered an “identified asset” and could be subject to ASC 842. Under this guidance, a “capacity or other portion of an asset that is not physically distinct . . . 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” (emphasis added).

Questions sometimes arise regarding physical distinction, particularly in scenarios involving a larger asset, a specific portion of which is shared by one or more parties over a defined period for use in different ways. An example would be a building's exterior wall to which one party is granted the exclusive right for advertising while the occupants of the building continue to use the wall for support of their residence, protection from the elements, and so forth. Unlike situations involving the lease of one floor of a multistory building, which is functionally independent and unique, these scenarios involve simultaneous but different uses of a portion of a larger asset. Other examples include the placement of solar panels on a specific section of rooftop and the attachment of cable wires to a specific spot on a utility pole (in both cases, the owner continues to use the entire asset while allowing another party to use a portion of the asset for a different purpose over a defined period). To the extent that there are substantive substitution rights in these arrangements, a lease will generally not be present. However, we understand that many of the scenarios found in practice do not allow for substitution. (See Section 3.3.3 for a detailed discussion of substitution rights.)

Some considerations that may ultimately be relevant to the determination of whether a lease exists include whether:

- The arrangement involves a shared use of the larger asset, including the portion specified in the arrangement.
- The portion being used by the customer is functionally independent and therefore separable from the larger asset.
- The portion being used by the customer is commercially significant to the asset owner by design.
**Shared Use**

Shared-use arrangements will typically involve the contemporaneous use of the same asset (or the same portion of a larger asset) for different purposes. For example, many advertising scenarios feature shared use (e.g., an ad displayed on top of a baseball dugout, on the side of a bus, or on the floor of a grocery store). On the other hand, if the owner of the asset is not contemporaneously using the asset (or is not contractually allowed to use the asset), shared use may not exist (e.g., a cell tower operator that allows a customer to use a specific hosting site on the tower for a defined period or a satellite owner that allows a customer to use a specific transponder on the satellite for a period of time). Shared-use arrangements are less likely to contain leases, while exclusive-use arrangements (i.e., arrangements in which a customer has exclusive use of a portion of a larger asset) are more likely to contain leases. An entity may need to use judgment in determining whether a particular arrangement features shared or exclusive use of the portion of the larger asset.

**Functional Independence**

It may be useful to evaluate the functional independence of the portion being used by the customer, including the functional use and design of the asset that is subject to the arrangement. To the extent that the portion being used by the customer has a discrete functional use (e.g., a specific floor of a building), it could be more likely that the portion being used is physically distinct and an identified asset. On the other hand, if the portion being used is not functionally distinguishable from the larger asset (e.g., a spot on a utility pole), there may be a reasonable basis for viewing the larger asset as the identified asset in the arrangement.

**Commercial Significance by Design**

It may also be useful to consider commercial significance by design — that is, the commercial objectives of the asset owner when it built or purchased the asset. To the extent that the asset was built or purchased with the commercial objective of leasing a specific portion or portions to others (e.g., specific hosting locations on a cell tower), it could be more likely that the portion being used for these purposes is physically distinct and therefore an identified asset. On the other hand, if the asset was built or purchased without such a commercial objective (e.g., a utility pole), there may be a reasonable basis to view the larger asset as the identified asset in the arrangement.

**Determining Whether a Lease Exists**

The above indicators may help entities assess circumstances in which the use of a portion of an asset might reasonably be viewed as a secondary, or incidental, use of that portion of the asset such that the owner retains substantive economic benefits from the use of the portion. Sometimes, it may be reasonable to view the larger asset as the identified asset in the arrangement and to assess control (including economic benefits) on that basis. Such an approach would generally make it more likely that the arrangement does not contain a lease since the customer does not obtain substantially all of the economic benefits from the use of the larger asset (the customer’s economic benefits are limited to the portion it uses). The right to control the use of an identified asset is discussed in detail in Section 3.4, while the economic-benefits element of control is discussed in Section 3.4.1.
Our current views on this topic are expressed in the examples and table below. The SEC staff has indicated that it would respect an entity's conclusion regarding such arrangements provided that it was based on reasonable judgment. Therefore, arrangements involving rights to use portions of larger assets should be based on a careful assessment that takes into account all relevant facts and circumstances.

### Example 3-5

**Contract for the Use of Space on a Cell Tower**

Customer A enters into a five-year contract with Supplier B to use space on a cell tower. Customer A is assigned a specifically identified hanger (hosting spot) on the cell tower on the basis of its needs to install its antennae and other telecommunications equipment. Each hosting spot is commercially designed to be leased by B’s customers, and each comprises its own functionally independent infrastructure that allows B’s customers to install their equipment at the hosting spots. Accordingly, A is not the only party with equipment installed on the overall tower; rather, A shares the use of the tower with third parties.

Supplier B is not permitted to move A’s equipment to a different hosting spot or cell tower. In addition, A is the only party that may install equipment on its identified hosting spot. Customer A may install whatever antennae or equipment it wants, subject to certain maximum weight and height restrictions.

The arrangement contains an identified asset because (1) the hosting spot is explicitly identified in the contract and is physically distinct from the larger asset (i.e., from the cell tower) and (2) B may not substitute the asset (i.e., it may not move A’s equipment to a different hosting spot or tower). Alternatively, if B had the right to substitute hosting spots or towers, the parties must assess whether that right is a substantive substitution right (see Section 3.3.3).

### Example 3-6

**Contract for the Use of a Portion of a Satellite**

Customer A enters into a five-year contract with Supplier B to use space on a satellite. In a manner similar to the assigning of the hanger on the cell tower in Example 3-5, A is assigned a specifically identified transponder on the satellite. Each transponder is commercially designed to be leased by B’s customers, and each comprises its own functionally independent infrastructure that allows B’s customers to transmit data signals to and from the transponder. Accordingly, A shares the use of the overall satellite with third parties.

Supplier B is not permitted to transfer A to a different transponder or satellite for reasons other than warranty-related considerations. In addition, A is the only party that may transmit data signals to and from its identified transponder. Customer A may transmit whatever data it wants, subject to certain frequency limitations that stem from the nature of the transponder and satellite.

The arrangement contains an identified asset because (1) the transponder is explicitly identified in the contract and is physically distinct from the larger asset (i.e., from the satellite) and (2) B does not have a substantive substitution right (i.e., it may not transfer A to a different transponder or satellite, except for warranty-related considerations).
<table>
<thead>
<tr>
<th>Asset (Use)</th>
<th>Identified Asset?</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wall space (e.g., painting an advertisement on the side of a building)</td>
<td>No</td>
<td>The advertising is a secondary use of the wall. That is, the wall's primary purpose — the reason it was commercially designed — is to hold up the building structure and protect the building's occupants from the elements. In addition, the advertiser is unlikely to obtain substantially all of the capacity (or economic benefits from use) from the wall by using its portion, which indicates that there is not an identified asset with respect to the portion.</td>
</tr>
<tr>
<td>Retail floor advertising space (e.g., painting an advertisement on the floor of a grocery store)</td>
<td>No</td>
<td>Similar to the basis articulated for wall space.</td>
</tr>
<tr>
<td>Side of a bus shelter or commuter train shelter (e.g., placing an advertisement on one wall of the shelter)</td>
<td>No</td>
<td>Similar to the basis articulated for wall space.</td>
</tr>
<tr>
<td>Billboard (e.g., placing an advertisement on a stand-alone billboard or a billboard attached to another structure)</td>
<td>Yes</td>
<td>A billboard is commercially designed to be contracted to customers for displaying advertisements. In addition, billboards attached to other, larger structures (e.g., when hung on the side of a building) are physically distinct from the larger structure.</td>
</tr>
<tr>
<td>Taxi tent (e.g., placing an advertisement on the sides of a removable, magnetic tent on top of a taxi)</td>
<td>Yes</td>
<td>Similar to the basis articulated for a billboard (i.e., a taxi tent is effectively a mobile billboard).</td>
</tr>
<tr>
<td>Pole attachments (e.g., either (1) a utility attaching its lines to a pole owned by a phone company, or (2) a phone company attaching its wires to a pole owned by a utility)</td>
<td>No</td>
<td>All spots on the pole where a customer would hang its wires are functionally dependent on the rest of the structure, and none are physically distinct.</td>
</tr>
</tbody>
</table>
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(Table continued)

<table>
<thead>
<tr>
<th>Asset (Use)</th>
<th>Identified Asset?</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Space on a rooftop to construct a bar or restaurant</td>
<td>Yes</td>
<td>In this case, the rooftop functions independently as a floor in a building would. In accordance with ASC 842-10-15-16, the floor of a building is a physically distinct portion of a larger asset.</td>
</tr>
<tr>
<td>Space on a rooftop for an advertisement (e.g., for when commercial airplanes fly overhead)</td>
<td>No</td>
<td>Similar to the basis articulated for wall space, retail floor advertising space, and the side of a bus shelter or commuter train shelter.</td>
</tr>
<tr>
<td>Space on a rooftop to install solar panels (e.g., that serve tenants of the building or a utility's larger customer base)</td>
<td>It depends</td>
<td>Judgment is required. Space on a rooftop to install solar panels may be similar to (1) space on a rooftop to construct a bar or restaurant, (2) space on a rooftop for an advertisement, or (3) both of these.</td>
</tr>
<tr>
<td>Kiosk in a mall (e.g., used by a customer for retail purposes)</td>
<td>Yes</td>
<td>As long as there are no substitution rights akin to those in Example 2 in ASC 842-10-55-52 through 55-54 (reproduced in Section 3.7.2), the kiosk is physically distinct, functionally independent, and commercially designed to be contracted to customers as retail space.</td>
</tr>
</tbody>
</table>

3.3.3 Substantive Substitution Rights

ASC 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).

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.
Once an entity has determined that PP&E is specified in a contract, it must also evaluate whether the supplier has the right to substitute the underlying asset throughout the period of use and, if so, whether the supplier’s substitution right is substantive. If the supplier has a substantive substitution right, the underlying asset does not represent an identified asset and the contract does not contain a lease. Paragraph BC128 of ASU 2016-02 notes that the FASB’s reason for establishing this requirement was that if a supplier has a substantive right to substitute the asset throughout the period of use, “the supplier (and not the customer) controls the use of the asset . . . , thereby deciding for what purpose the asset is used.”

Accordingly, the FASB developed guidance in ASC 842-10-15-10 through 15-15 to help entities determine whether a substitution right is substantive. The Board explains in paragraph BC129 of ASU 2016-02 that its purpose in establishing this guidance was to differentiate between the following:

a. Substitution rights that result in there being no identified asset because the supplier, rather than the customer, controls the use of an asset

b. Substitution rights that do not change the substance or character of the contract because it is either not practically or economically feasible for the supplier to exercise those rights or not likely the supplier will be able to exercise those rights.

When developing the framework for the identified-asset notion in the 2013 leasing ED, the Board received significant feedback from stakeholders indicating that substitution rights and clauses in contracts could be used to structure arrangements so that they did not meet the definition of a lease (and, thus, so that lessees could avoid recognizing lease assets and lease liabilities on the balance sheet). The Board acknowledged this in paragraph BC105(b) of the 2013 leasing ED, which stated, in part:

The Board has included additional language to help determine when substitution rights are substantive. [Its] intention in doing so is to discourage the insertion of a substitution clause in a contract, which does not change the substance or character of the contract, solely to achieve a particular accounting outcome.

For a substitution right to be considered substantive, the following two conditions must be met:

- The supplier must have the “practical ability” to substitute the identified asset (see Section 3.3.3.1).
- The supplier must economically benefit from the substitution (see Section 3.3.3.2).

**Connecting the Dots — Economically Beneficial Substitution Is a Higher Hurdle Than Under ASC 840**

ASC 840-10-15-10 through 15-14 address substitution rights. Generally, if an arrangement gives the supplier a substitution right and the supplier has the practical ability to exercise that right, the fulfillment of the arrangement does not depend on the specified PP&E. Under ASC 840, “practical ability” takes into account contractual, legal, and economic constraints but does not require that a supplier economically benefit from a substitution.

Accordingly, ASC 842’s requirement that a substitution right be economically beneficial to a supplier is a higher threshold than the requirements in ASC 840. We therefore expect that fewer entities will be able to avoid lease identification as a result of substitution rights in their arrangements. In other words, we expect that more arrangements will be subject to lease accounting under ASC 842.

Sections 3.3.3.1 and 3.3.3.2 address how an entity would assess the two conditions in ASC 842-10-15-10 to conclude that a substitution right is substantive. See also Example 2 in ASC 842-10-55-52 through 55-54 (reproduced in Section 3.7.2), which illustrates the assessment of these conditions in the context of concession space in an airport.
3.3.3.1 Practical Ability to Substitute Alternative Assets

ASC 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.

Common indicators that the supplier has the practical ability to substitute alternative assets throughout the period of use include the following:

- The customer cannot prevent the supplier from substituting an asset (i.e., the customer cannot block the substitution). See Q&A 3-4 below for further discussion.

- Alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period. However, in accordance with ASC 842-10-15-11, the supplier may not consider future events that, at inception, are considered unlikely to occur. If such events are considered unlikely to occur, the supplier may not assume in its assessment that alternative assets will be readily available to the supplier because of circumstances such as future manufacturing economies of scale, future technological developments, or assets otherwise becoming available in the future that are not available at inception.

- There are no contractual restrictions on when a supplier may substitute the asset. ASC 842-10-15-13 states that the supplier does not have the practical ability to substitute the asset when substitution rights are only exercisable on, or after, a particular date or are only exercisable upon the occurrence of a certain event or the resolution of a contingency.

These common indicators are further considered in the Q&A, examples, and several Connecting the Dots below.

Q&A 3-4 Substitution Requires Customer Approval

Certain contracts may specify that the supplier must obtain approval from the customer before substituting the underlying asset.

Question

Does the supplier have a substantive substitution right if it is required to obtain customer approval to substitute the asset?

Answer

No. In such circumstances, because the customer can block the supplier from substituting the underlying asset, the supplier does not have the practical ability to substitute the asset. Therefore, the supplier’s substitution right is not substantive.

To have the practical ability to substitute the asset in accordance with ASC 842-10-15-10(a), the supplier must be able to substitute the asset without the customer’s approval. Customer consent or approval rights may come in different forms. For example, the customer may be contractually granted a right that allows it to block the substitution itself or may be able to prevent the supplier from accessing the customer’s premises to substitute the asset when the underlying asset is located there. An entity should consider the substance and nature of any rights granted in the contract that may give the customer the right to prevent substitution.
Connecting the Dots — Substantive Substitution Rights Less Relevant for Implicitly Specified Assets

We think that the assessment of whether a supplier has a substantive substitution right in contracts that explicitly specify the asset to be used to fulfill the contract is generally more relevant than that in arrangements for which fulfillment depends on the use of an implicitly specified asset. As discussed in Section 3.3.1, an implicitly specified asset typically exists when the supplier has only one asset (or very few assets) that may be used to fulfill the supplier’s obligation under the contract (e.g., a railcar that can carry hazardous commodities, a server farm with specific security features, or a satellite that can transmit a unique signal). If a supplier only has one asset that can be used to fulfill its obligations under the contract, the supplier most likely does not have the practical ability to substitute the underlying asset. For that reason, a supplier generally does not have a substantive substitution right for implicitly identified assets.

Example 3-7

Supplier Does Not Have the Practical Ability to Substitute

Company BC enters into an arrangement with Supplier LP under which LP will provide a customized Model 5000 copier to BC for two years. Supplier LP only has one customized Model 5000 copier. The arrangement allows LP to replace the copier at will. However, LP would need several months to manufacture such a replacement. Accordingly, no alternative assets are available for substitution. Because LP only has one asset that can be used to honor the agreement with BC and does not have the practical ability to substitute it, LP’s substitution right is not substantive.

Connecting the Dots — Evaluating the Period of Use When a Substitution Right Exists

ASC 842-10-15-13 states that when a “supplier has a right or an obligation to substitute [PP&E] 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” (emphasis added). (See Section 3.5 for further discussion of determining the period of use.) Accordingly, in such cases, the substitution right is not substantive because the contract restricts when the supplier can substitute the asset. Therefore, the supplier may not use the substitution right to conclude that the contract is not, or does not contain, a lease because there is no identified asset.

However, questions have arisen regarding the effect of timed substitution rights. The sections below address front-loaded and back-loaded substitution rights.

Front-Loaded Substitution Rights

Assume that a customer enters into a contract with a supplier for the right to use an asset for 10 years. The supplier has a front-loaded substitution right to substitute the asset in years 1 and 2. Although that right expires at the end of year 2, the right is substantive within years 1 and 2. The contract otherwise meets the definition of a lease, and no other contractual terms would prevent a conclusion that there is an identified asset in the contract.
• **View A** — One view is that a contract that would otherwise meet the definition of a lease in ASC 842, but that contains a front-loaded substitution right, is a forward-starting lease. According to this view, both the customer and the supplier have a forward-starting lease that commences at the beginning of year 3 when there is an identified asset.

In performing a lease assessment, an entity must identify whether a contract is, or contains, a lease. In addition, ASC 842-10-15-9 indicates that an asset can be identified once it is made available for the customer’s use. Effectively, in a manner consistent with the definition of “commencement date of the lease” in ASC 842 (see Section 5.1), a lease does not commence until an identified asset is made available for the customer’s use. Therefore, a contract may contain a lease for the period after the expiration of the substitution right.

View A is consistent with ASC 842-10-15-5, which indicates that a contract that gives the customer the right to control the use of an identified asset for only a portion of a contract term contains a lease for that portion of the contract term.

• **View B** — Another view is that there is an identified asset, and thus a lease, at the beginning of year 1.

Proponents of this view subscribe to a literal reading of ASC 842-10-15-13, which requires that, for a supplier to “have the practical ability to substitute alternative assets,” the substitution right must exist throughout the period of use. In a manner consistent with the definition of “period of use” in ASC 842 (see Section 3.5), an asset is used to fulfill the contract — in this case for 10 years. The substitution right does not exist for all 10 years and is therefore not substantive.

**Back-Loaded Substitution Rights**

Assume that a customer enters into a contract with a supplier for the right to use an asset for 10 years. The supplier has a back-loaded substitution right under which it can substitute the asset in years 9 and 10. Although that right does not exist until the beginning of year 9, the right is substantive during years 9 and 10. The contract otherwise meets the definition of a lease, and no other contractual terms would prevent a conclusion that there is an identified asset in the contract.

[Diagram showing substitution right]

• **View A** — One view is that the contract contains an eight-year lease that commences at the beginning of year 1 and expires at the end of year 8.

In a manner similar to the concepts articulated in ASC 842-10-15-23 (reproduced in Section 3.4.2.2), the substitution rights in years 9 and 10 define the scope of the customer’s right to control the use of an identified asset. Accordingly, within that scope, the contract contains an identified asset — and thus a lease — for the first eight years of the contract term.
In addition, View A is consistent with ASC 842-10-15-5, which indicates that a contract that gives the customer the right to control the use of an identified asset for only a portion of a contract term contains a lease for that portion of the contract term.

In this view, substitution rights are approached in a manner consistent with View A on front-loaded substitution rights (articulated above).

- **View B** — Another view is that there is an identified asset, and thus a lease, for all 10 years of the contract.

In this view, substitution rights are approached in a manner consistent with View B on front-loaded substitution rights (articulated above).

In both the front-loaded and back-loaded substitution right scenarios described above, we believe that it would be acceptable for an entity to apply either view. However, since ASC 842 does not provide clear guidance on this topic and we are aware that views on the issue differ, we encourage affected stakeholders to consult with their accounting advisers and auditors.

### 3.3.3.2 Economic Benefit From Exercise of Substitution Rights

In addition to having the practical ability to substitute the asset, a supplier must benefit economically from the substitution for the substitution right to be substantive. ASC 842-10-15-10(b) states that the “supplier would benefit economically [if] the economic benefits associated with substituting the asset are expected to **exceed** the costs associated with substituting the asset” (emphasis added). Accordingly, an entity may need to perform a quantitative analysis of the costs and benefits of substitution before concluding that the supplier would benefit economically from the exercise of its right to substitute the asset.

<table>
<thead>
<tr>
<th>ASC 842-10</th>
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<tbody>
<tr>
<td><strong>15-12</strong> 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.</td>
</tr>
</tbody>
</table>

As indicated in ASC 842-10-15-12, when the underlying PP&E is located “at the customer’s premises or elsewhere,” it is more likely that the costs of substituting the asset will exceed the benefits to the supplier of doing so. This, in effect, creates a presumption that the costs of substitution will exceed the benefits when the asset is not located at the supplier’s premises.

The Q&A and the Connecting the Dots below expand on the guidance in ASC 842-10-15-12 in addition to addressing other concepts relevant to the guidance in ASC 842-10-15-10(b).

**Q&A 3-5  Costs to Include in the Determination of Whether the Supplier Would Economically Benefit From the Substitution**

ASC 842-10-15-10(b) indicates that a quantitative analysis may be needed to conclude that the benefits of exercising a substitution right exceed the costs of exercising the right.

**Question**

What costs should an entity consider when evaluating whether a supplier would economically benefit from substituting an asset and thus whether the supplier’s substitution right is substantive?
Answer

An entity should consider all costs that would be associated with substituting the asset when evaluating whether a supplier would economically benefit from the substitution. Such costs may include, but are not limited to, the following:

- Costs of (1) removing the existing asset and transporting it to a new location or (2) disposing of the asset.
- Costs of gaining access to the customer’s premises when the underlying asset is located there.
- Costs of transporting, installing, and testing the alternative assets.
- Additional costs of configuring and operating the alternative assets, as necessary.
- Customer losses associated with reduced production and increased downtime during the substitution process.

Costs that would have been incurred regardless of the substitution should not be considered in the evaluation of whether the supplier would benefit economically from the substitution.

Connecting the Dots — Economic Benefit Depends on Future Events That Are Not Likely to Occur

ASC 842-10-15-11 states that an entity’s assessment of “whether a supplier’s substitution right is substantive is based on facts and circumstances” that exist as of contract inception and should ignore the effects of future events that “are not considered likely to occur.” Therefore, when evaluating whether a supplier would benefit economically from substituting the asset, entities should not take into account the effects of future events that are not likely to occur. Typically, such future events are outside the supplier’s control or the supplier does not have historical evidence to support that the events will occur. ASC 842-10-15-11 gives the following examples of such future events:

- A new customer agrees to “pay an above-market rate for use of the asset.”
- New technology is introduced.
- There is a “substantial difference between the customer’s use of the asset, or the performance of the asset,” compared with that at contract inception.
- There is a substantial change in the market price of the asset from the market price considered likely at inception.

The examples below illustrate the evaluation of whether a supplier would benefit economically from exercising its right to substitute the underlying asset. In addition, Example 4 in ASC 842 (ASC 842-10-55-63 through 55-71, reproduced in Section 3.7.4) illustrates the evaluation of a substitution right for which the supplier has the practical ability to exercise its right but would not economically benefit from doing so.
Example 3-8

Storage Locker

Company SM owns a storage facility comprising individual storage lockers that it rents to customers for an annual fee. Each storage locker is identified with a unique locker number, and each contract explicitly specifies the locker number that has been assigned to the customer. The contract also states that SM has the right to relocate, at its sole discretion at any point during the annual rental period, the customer's belongings to any other locker that is the same size in the storage facility. Company SM has a large number of available storage lockers within the storage facility to accommodate other customers. Company SM's cost of relocating a customer's belongings are less than the benefits that SM receives by accommodating new customers.

Company SM has a practical ability to relocate each customer's belongings because the customer cannot block the substitution and other storage lockers with the same specifications are readily available. Because the economic benefits of providing storage lockers to new customers outweigh the costs of relocating an existing customer's belongings to another storage locker, SM would also benefit economically from the substitution. Therefore, SM has a substantive substitution right and an identified asset does not exist. Accordingly, the contract does not contain a lease and should be accounted for in accordance with other applicable U.S. GAAP.

Example 3-9

Copier/Printer

Company A enters into an arrangement with Supplier B under which B will provide a Model 5000 copier to A for two years. Company A will use the Model 5000 copier on its own premises throughout the two-year contract term. The contract explicitly specifies the copier that will be provided to A but stipulates that B may replace the copier at will. Supplier B has multiple Model 5000 copiers similar to the copier provided to A. However, if a replacement copier were needed, B would incur significant installation and transportation costs to substitute the copier. In addition, B would incur costs associated with gaining access to A's premises and may be responsible for recouping A's losses associated with downtime. The costs that would be incurred outweigh the related benefits of substitution.

Supplier B has the practical ability to substitute the copier because the customer cannot block the substitution and replacement copiers with similar specifications are readily available to B. Although B has the practical ability to substitute the copier, B would not benefit economically from the substitution because the costs of substitution outweigh the related benefits. Therefore, B does not have a substantive substitution right. Because the copier is explicitly specified in the contract and B does not have a substantive substitution right, an identified asset exists.

3.3.3.3 Warranty or Upgrade Considerations

ASC 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.
Notwithstanding the requirements in ASC 842-10-15-10, certain substitution rights do not preclude the underlying asset from being an identified asset. Specifically, a substitution right is not substantive if a supplier's right (or obligation) to substitute an alternative asset is limited to either operational failure (i.e., a replacement asset must be used while the original asset is undergoing repairs or maintenance) or technical upgrade (i.e., a newer version of the same asset becomes available). Further, paragraph BC131 of ASU 2016-02 states that “if a supplier has the right or obligation to substitute an asset for the purpose of repair or maintenance, . . . those substitution rights . . . are not substantive regardless of whether those circumstances are specified in the contract.” It is thus important for entities to understand both whether the supplier has the right to substitute the asset and the reason for the substitution provision when evaluating whether an identified asset exists.

Entities should also assess whether the supplier has agreed to transfer a good or service (a nonlease component) for the warranty or upgrade provisions. For a detailed discussion of the separation of lease and nonlease components, see Chapter 4 of this Roadmap. Suppliers in such arrangements should also consider Section 5.5 of Deloitte's Revenue Roadmap.

3.3.3.4 Presumption That Substitution Right Is Not Substantive

<table>
<thead>
<tr>
<th>ASC 842-10</th>
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<tr>
<td>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.</td>
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It may be difficult (or nearly impossible, in some circumstances) for the customer to determine whether the supplier's substitution right is substantive. For example, the customer may not know whether the substitution right gives the supplier an economic benefit.

A customer should presume that a substitution right is not substantive if it is impractical to prove otherwise; this determination involves significant judgment. Paragraph BC132 of ASU 2016-02 explains that the FASB's reasoning for including this provision was to provide customers with some practical relief:

[T]he Board decided to add guidance stating that if a customer cannot readily determine whether a supplier has a substantive substitution right, the customer should presume that any substitution right is not substantive. It is intended that a customer should assess whether substitution rights are substantive if it is reasonably able to do so; if substitution rights are substantive, the Board noted that this should be relatively clear from the facts and circumstances. However, the requirement also is intended to clarify that a customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive.

Connecting the Dots — Guidance on Substantive Substitution Rights Is Anti-Abusive and May Result in Accounting Asymmetry

We view the guidance in ASC 842-10-15-15 as anti-abusive. That is, a lessee must clear a high hurdle to conclude that substitution rights in an arrangement are substantive and may need to perform a quantitative analysis in doing so (as discussed in Section 3.3.3.2 and Q&A 3-5).

However, ASC 842-10-15-15 is only anti-abusive from the perspective of the lessee since it is written with only the customer in mind (i.e., the party that would potentially be recognizing an ROU asset and a lease liability). The supplier, on the other hand, is expected to have enough information at its disposal to readily determine whether its substitution rights are substantive.
Therefore, ASC 842’s guidance on substitution rights may result in asymmetry between the supplier’s and customer’s assessments. That is, the supplier may be able to readily determine that its substitution rights are substantive, in which case the contract would (1) not depend on the use of an identified asset and (2) not be identified as a lease. The customer, on the other hand, may not be able to readily determine whether the supplier’s substitution rights are substantive, in which case the guidance in ASC 842-10-15-15 would apply and the contract (1) would depend on the use of an identified asset and (2) could be identified as a lease.

3.3.3.5 **Exercising Substitution Rights**

The following Q&A addresses the accounting for when a supplier exercises a nonsubstantive substitution right:

**Q&A 3-6  Accounting for the Supplier’s Exercise of a Nonsubstantive Substitution Right**

When a supplier’s substitution right is not substantive, an entity does not consider the substitution right in determining whether the contract contains an identified asset. If the customer has a right to control the use of the identified asset (see Section 3.4), the contract contains a lease and is subject to the measurement and recognition guidance in ASC 842.

However, although a supplier’s substitution right may have been deemed nonsubstantive, instances may still arise in which the supplier actually ends up substituting the asset for various reasons.

**Question**

When a nonsubstantive substitution right is exercised, how should the parties to the contract account for the actual substitution of the underlying asset by the supplier, assuming no other rights in the contract are changed as a result of the substitution?

**Answer**

We generally think that there are two approaches to the accounting that may be considered when a supplier exercises its substitution right that was not deemed substantive at inception:

- **Approach A** — The parties to the arrangement should account for the substitution as a termination of the original lease. (Sections 8.6 and 9.3.4 discuss in detail the lessee’s and lessor’s accounting, respectively, for lease modifications and terminations.) For example, under this approach, the lessee would write off the existing lease liability and ROU asset, which may result in the recording of a gain or loss in the lessee’s income statement. Upon substitution of an alternative asset, the parties would evaluate the arrangement as a potentially new lease in accordance with ASC 842’s guidance on lease identification. If the new arrangement contains a lease, the appropriate classification and subsequent accounting for the lease should be considered.

- **Approach B** — The parties to the arrangement should account for the substitution as a lease modification that does not change the lessee’s right of use. In applying Approach B, an entity effectively would treat the actual substitution as a “non-substantive lease modification” for which no gain or loss would be recognized in the lessee’s income statement (i.e., for which there is no accounting whatsoever).
Note that the modification guidance in ASC 842-10-25-11(c) applies to a full termination. Therefore, both approaches technically result in the application of ASC 842’s modification guidance. However, the outcome of applying that guidance under Approach A will differ from that under Approach B.

Generally, we think that the determination of whether to apply Approach A (lease termination) or Approach B (lease modification) to the actual substitution will be based on facts and circumstances and should include consideration of various factors, including whether the original asset and alternative asset are the same (or similar) and whether the parties modify other terms in the contract upon substitution. However, we would expect that if the asset substituted is similar to the previous asset and there are no other changes to the contract, the actual substitution should be considered a “nonsubstantive lease modification” and accounted for under Approach B.

3.4 Right to Control the Use of the Identified Asset

As discussed in Section 3.2.1, the FASB carried forward into ASC 842 the control concepts it had been developing in other areas of U.S. GAAP (e.g., ASC 810 and ASC 606). Accordingly, to have the right to control the use of PP&E in a contract in which the PP&E is an identified asset (see Section 3.3), the customer must have both of the following:

- The right to obtain substantially all of the economic benefits from the use of the PP&E (i.e., the benefits or economics element, discussed in detail in Section 3.4.1).
- The right to direct the use of the PP&E (i.e., the power element, discussed in detail in Section 3.4.2).

Connecting the Dots — Control in ASC 842 Versus That in ASC 606 and ASC 810

ASC 606-10-25-25 states that “[c]ontrol of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.” This guidance is consistent with ASC 842-10-15-4 on the right to control the use of an identified asset. That is, for a lease to exist, the customer must have the right to direct the use of, and obtain substantially all of the economic benefits from, the identified asset during the period of use.

ASC 842 is also consistent with ASC 606 with respect to determining when an arrangement should be accounted for as a sale. When the amount of control that a lessee has over the right to use an asset is so significant that the lessee has, effectively and economically, obtained control of the entire asset (i.e., not just control during the period of use), the lessor would account for that arrangement as a sale (i.e., as a sales-type lease; see Chapter 9 for a detailed discussion of the lessor’s lease classification and accounting).

However, the economics element of control in ASC 842 differs from that under the VIE consolidation guidance (i.e., ASC 810). Specifically, under ASC 842, the customer must have the right to obtain substantially all of the economic benefits from the use of the asset. The threshold of “substantially all the economic benefits” is different from and higher than that in ASC 810, which only requires the primary beneficiary of a VIE to absorb losses or receive benefits, either of which must only potentially be significant. Accordingly, the primary beneficiary in ASC 810 may control a VIE even when it is not exposed to substantially all of the economics of that entity.
The power element in ASC 842 differs from that in the ASC 810 VIE consolidation model as well. ASC 842 does not specifically address the concept of “shared power”; that is, ASC 842 does not address situations in which the most relevant decision-making rights related to how and for what purpose (HAFWP) the asset is used throughout the period of use are shared (see Section 3.4.2.4 for further discussion of shared power). Consolidation principles, on the other hand, do allow for the concept of shared power. Under the ASC 810 VIE consolidation model, when shared power exists, neither of the parties that share in directing the activities that most significantly affect economic performance has control (provided that they are not related parties). However, when multiple, different activities affect the economics, the control concepts in ASC 842 align more closely with those in the consolidation guidance. Specifically, in such circumstances, an entity would need to determine which of those different activities most significantly affects the economics and thus would generally conclude that one party has control under both ASC 842-10-15-20 and ASC 810-10-25-38E.

The effect of design on the control analysis under ASC 842 also differs from that under the ASC 810 VIE consolidation model. That is, under the ASC 810 VIE consolidation model, the design of the entity must be considered to determine the significant activities of the entity and who has the power to control them (and thus controls the entity). However, by itself, design does not give one party control of a legal entity, provided that ongoing operations have an effect on the economics of the legal entity. Under ASC 842, on the other hand, the customer may have power over an identified asset if it was significantly involved in the design of the asset, even if the supplier operates the asset. Design and its role in the lease identification assessment are further discussed in Section 3.4.2.

**Connecting the Dots — Link Between Power and Economics**

The FASB makes an important point when describing the concept of the right to control the use in paragraph BC134 of ASU 2016-02:

> [A] customer must have decision-making rights over the use of the asset that give it the ability to influence the economic benefits derived from use of the asset throughout the period of use. Without any such decision-making rights, the customer would have no more control over the use of the asset than any customer purchasing supplies or services. If that were the case, the customer would not control the use of the asset.

That is, with respect to the power element, the customer is making decisions about the use of the asset so that it may maximize (or minimize) the economic benefits that it will receive. ASC 842-10-15-24 makes this clear in stating that “[d]ecision-making rights are relevant when they affect the economic benefits to be derived from use.” In other words, the customer cannot just have substantially all of the economics and some rights over the use of the asset — the customer’s decision-making rights must influence the economic benefits it has the right to obtain.

**Changing Lanes — Control Over the Output of PP&E Is No Longer Solely Determinative**

Under ASC 840-10-15-6(c) (formerly EITF Issue 01-8), an arrangement may qualify as a lease because (1) the customer takes all (or substantially all) of the output of the PP&E and (2) the contract is priced like a lease. That is, ASC 840 differentiated between a lease contract and a service (or supply) contract on the basis of whether the supplier was pricing the contract to recover, and earn a return on, the cost of either (1) the PP&E (in which case the contract is a lease) or (2) each unit of output (in which case the contract is a service).
However, the pricing of an arrangement is not indicative of whether the customer has “power” under ASC 842. Paragraph BC134 of ASU 2016-02 explains that the pricing condition in ASC 840, which defined control on the basis of only “economics” and who controlled the output of the asset, is no longer indicative of control since the Board decided to align the new control concept with that in the revenue and consolidation guidance:

In previous leases guidance, a customer could have the right to control the use of an asset solely on the basis of obtaining substantially all of the output from that asset, assuming that the contract is priced in a particular way. This defined control on the basis of only a “benefits” element. Topics 606 and 810, however, define control to require both a “power” element and a “benefits” element. The Board decided that, to control the use of an asset, a customer is required to have not only the right to obtain substantially all of the economic benefits from use of an asset throughout the period of use (a “benefits” element), but also the ability to direct the use of that asset (a “power” element). [Emphasis added]

Moreover, the Board noted in paragraph BC105(d) of the 2013 leasing ED that removing the effect of pricing from the control concept would be advantageous because this condition had proved difficult to apply in practice.

Therefore, contracts that are, or contain, leases under ASC 840 solely because the customer controls the output of the underlying asset will no longer meet the definition of a lease under ASC 842. We expect that the contracts most likely to be affected by this change will be off-take and purchase arrangements, such as PPAs and manufacturing supply contracts. Unless those arrangements somehow also grant the customer power through decision-making rights over the use of the asset (e.g., through dispatch rights, under which the customer determines whether, when, and how much the asset is producing), they are unlikely to be leases going forward.

Example 3-10

**Power Purchase Agreement**

Supplier X, a power generation company, executed a five-year PPA with Customer Z, a utility. Customer Z will purchase 100 percent of the electricity produced at X’s natural gas–fired generating facility, to be delivered on an as-available basis, because 100 percent of the facility’s production capacity is not expected to exceed the demand of Z’s end-use customers. Accordingly, Z agrees to accept whatever volume of electricity is produced at the facility.

Pricing under the PPA is a fixed capacity payment of $300,000 per month (which compensates X for reserving the facility to provide energy to Z), plus $25 per unit of electricity produced.

Under ASC 840, the contract contains a lease because (1) facts and circumstances at contract inception indicate that it is remote that parties other than Z will take more than a minor amount of the output (i.e., the electricity) produced by X’s facility during the five-year contract term and (2) the price paid by Z per unit of electricity varies with the volume of production (rather than being contractually fixed or equal to the current market price of the electricity).

However, under ASC 842, the parties will need to assess whether Z has both the power over and the economics of (i.e., whether it has the right to control the use of) the facility. Although Z obtains substantially all of the economic benefits from the facility through its purchase of 100 percent of the electricity, Z may not have the right to direct the use of the facility (i.e., it may not have power over the use of the facility).
## Changing Lanes — Physical Access Is No Longer Solely Determinative

Under ASC 840-10-15-6(b) (formerly EITF Issue 01-8), an arrangement may qualify as a lease because the customer (1) takes more than a minor amount of the output of the PP&E and (2) controls physical access to the PP&E. That is, under ASC 840, the right to control the use of PP&E may be conveyed through the right to control physical access to the PP&E.

However, under ASC 842, control of physical access will not be solely determinative of whether the customer has power over (i.e., whether the customer has the right to direct the use of) the PP&E. The party that controls physical access to the PP&E in an arrangement will generally have at least some (but maybe not all) decision-making rights related to when and how the PP&E is used.

Accordingly, while some contracts that are, or contain, leases under ASC 840 on the basis of the control over physical access may still meet the definition of a lease under ASC 842, others may not. The following example addresses one contract type that may no longer meet the definition of a lease under ASC 842:

### Example 3-11

**Rooftop Solar**

Developer Y executes a 25-year PPA with Resident Z under which Y will install solar panels on the roof of Z's home. In exchange, Z will purchase 100 percent of the electricity produced by the solar panels at a price that is fixed per unit of electricity. The rooftop solar panels are expected to meet 50 percent of Z's demand for electricity.

Developer Y retains ownership of the solar panels and is responsible for any operation and maintenance that is needed throughout the contract term. However, because the panels are installed on Z's home, Z controls physical access to them.

Under ASC 840, the contract is a lease because Z (1) will take more than a minor amount of the output (i.e., the electricity) produced by the solar panels during the 25-year contract term and (2) controls physical access to the solar panels.

However, under ASC 842, the parties will need to assess whether Z has both power and economics (i.e., whether it has the right to control the use of the solar panels). Although Z obtains substantially all of the economic benefits from the use of the solar panels through its purchase of 100 percent of the electricity, Z may not have the right to direct the use of the panels (i.e., it may not have power over the use of the panels). (See Section 3.4.2.3 for additional discussion that would generally be relevant to this example.)

### 3.4.1 Right to Obtain Substantially All of the Economic Benefits

In accordance with the definition of a lease — and the concept of control — in ASC 842, the customer must have the right to obtain substantially all of the economic benefits from the use of the PP&E throughout the period of use. This is the “economics” element of the control concept, as discussed above. It is an important piece of the concept, because a customer would not agree to pay for a right to use PP&E unless it received the benefits resulting from that use.
This analysis is not confined to assets that physically produce outputs, and it will often be relatively simple to determine whether the customer has the right to obtain substantially all of the economic benefits from use of PP&E. For example, in a lease of an office building, it is likely to be clear whether the customer has the right to obtain substantially all of the benefits from using the office building. However, in other situations, the assessment may be more complex. The decision tree below illustrates the process an entity should consider when determining whether the customer has the right to obtain substantially all of the economic benefits from use of the PP&E.

The remainder of Section 3.4.1 walks through this decision tree in greater detail.

3.4.1.1 Economic Benefits That Result From Use of the Asset

<table>
<thead>
<tr>
<th>ASC 842-10</th>
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<tbody>
<tr>
<td><strong>15-17</strong> 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.</td>
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</table>

The concept of “economic benefits” in ASC 842-10-15-4(a) is described very broadly in ASC 842-10-15-17. That is, ASC 842-10-15-17 identifies all of the following as potential economic benefits that may be obtained from the use of PP&E:

- Primary outputs (e.g., physical receipt of the widgets produced by or at a widget factory).
- By-products (e.g., physical receipt of the steam produced as a by-product of the manufacturing process in the widget factory).
- Cash flows derived from primary outputs and by-products (e.g., cash flows derived from the supplier’s selling, on the customer’s behalf, of widgets produced by or at the widget factory).
• Other “economic benefits . . . that could be realized from a commercial transaction with a third party” (e.g., SO2 or other emissions credits granted by the government when the widget factory runs because it is an environmentally efficient factory, provided that those credits can be sold to others).

Economic benefits can also be obtained from nonproductive assets. For example, the economic benefits derived from the use of a warehouse include its storage capacity.

Further, ASC 842-10-15-17 indicates that economic benefits may be obtained either directly or indirectly, such as in the following ways:

• Exclusive use of the asset (e.g., direct operation by the customer of the widget factory).
• Holding the asset (e.g., preventing others from operating the widget factory).
• Subleasing the asset (e.g., the customer subcontracts its rights to the capacity at the widget factory to another counterparty).

Because the concept of economic benefits in ASC 842-10-15-17 is broad, parties to an arrangement should first identify all economic benefits that result from use of the asset. In doing so, the parties are not considering the effects of contract terms (e.g., limitations) but are focusing on the nature of the asset. The parties can thus ensure that they are considering all of the economic benefits before they narrow the analysis to those benefits that are within the scope of the customer’s right to use the asset in the contract (see Section 3.4.1.2).

Q&A 3-7 Whether Economic Benefits Can Be Both Tangible and Intangible

The economic benefits of PP&E often may be physical, tangible outputs. For example, a PPA may give the customer the right to purchase electricity from a particular generating facility, or the customer may have the right to purchase widgets produced at a manufacturing facility.

**Question**

Can economic benefits, in the context of determining whether the customer has the right to obtain substantially all of the economic benefits from use of the asset, be intangible as well as tangible?

**Answer**

Yes. Benefits that result from the use of the asset and that can be realized through a commercial transaction with a third party should be considered economic benefits in the context of ASC 842-10-15-17, regardless of whether they are tangible or intangible.

One example of an intangible economic benefit is renewable energy credits (RECs), which are addressed in two places in ASC 842:

• In Example 9, Case A, in ASC 842-10-55-111(a) (reproduced in Section 3.7.9), RECs are identified as a by-product of the production of electricity by a solar farm (i.e., of the use of a solar farm).
• Paragraph BC135 of ASU 2016-02 states that “a customer should consider benefits relating to the use of the asset (for example, renewable energy credits received from the use of an asset) or by-products resulting from the use of an asset)” (emphasis added).
RECs are used to comply with renewable portfolio standards (RPSs) within a particular jurisdiction (generally, RPSs are established by state). They serve as evidence of the use of “green” electricity that is produced by a renewable generating facility. RECs have no physical substance and are transacted only by electronic transfer among tracking accounts that are specific to each party in the RPS jurisdiction. Although they are therefore intangible, RECs have clear economic value (and sometimes an observable fair market value, depending on the jurisdiction). In addition, they are conveyed and exchanged in commercial transactions on the open market (e.g., as opposed to being claimed in an owner's tax return).

We think that ASC 842’s discussion of RECs as intangible economic benefits demonstrates that the FASB believes intangible benefits (or outputs), which may be realized through a commercial transaction with a third party, should be considered in the analysis of whether a customer has the right to obtain substantially all of the economic benefits from use of the asset. In other words, we do not view RECs to be an “exception” or the **only** intangible form of economic benefit that should be considered in the analysis.

Q&A 3-8  Whether Tax Attributes Represent Economic Benefits

Economic benefits may be obtained directly or indirectly from the asset (e.g., by using, holding, or subleasing the asset) and may include the asset’s primary output and by-products. They may be tangible or intangible (e.g., RECs, as discussed in Q&A 3-7).

Certain types of underlying assets may provide unique tax benefits or tax attributes to the owner. Often, such tax benefits or tax attributes are provided because a government has decided to incentivize investments in the development of the assets. These benefits or attributes may be critical to a buyer's investment decision and often economically justify an investment in an otherwise uneconomic asset or technology.

**Question**

Should an entity consider tax attributes associated with the ownership of the underlying asset when evaluating whether a customer has the right to obtain substantially all of the economic benefits from the use of the asset?

**Answer**

No. An entity should not consider any tax attributes associated with the ownership of the underlying asset — regardless of whether they arise from investment (e.g., investment tax credits) or the asset’s production (production tax credits (PTCs)) — when evaluating whether a customer has the right to obtain substantially all of the economic benefits from the use of the asset.

ASC 842-10-15-17 indicates that economic benefits can be realized from a commercial transaction with a third party. Tax attributes, by nature, cannot be sold separately in a commercial transaction because they are related to the ownership of the asset.
Further, paragraph BC135 of ASU 2016-02 clearly differentiates between economic benefits resulting from use and those resulting from ownership:

[O]nly the economic benefits arising from use of an asset rather than the economic benefits arising from ownership of that asset should be considered when assessing whether a customer has the right to obtain the benefits from use of an asset. A lease does not convey ownership of an underlying asset; it conveys only the right to use that underlying asset . . . . Accordingly, the Board concluded that, when considering whether a contract contains a lease, a customer should not consider economic benefits relating to ownership of an asset (for example, tax benefits as a result of owning an asset). [Emphasis added]

This approach is consistent with how outputs are determined under ASC 840-10-15-6 and therefore is not expected to change practice upon the adoption of ASU 2016-02.

**Connecting the Dots — Identifying Intangible Economic Benefits From Use**

Q&A 3-7 clarifies the view that intangible benefits (or outputs) can be economic benefits from use of the asset as long as the intangible benefits (or outputs) can be realized from a commercial transaction with a third party. Further, Q&A 3-8 clearly differentiates between economic benefits from use of the asset and economic benefits from ownership of the asset. However, in practice, entities in various industries have raised questions about which intangible benefits (outputs) constitute “economic benefits from use of the asset.”

Specifically, in various scenarios, either the supplier or the customer may assert that a contract is not, or does not contain, a lease on the basis that the supplier is obtaining more than an insignificant portion of the economic benefits from use of the asset because it retains certain intangible benefits. As noted in this section, ASC 842-10-15-17 appears to create a broad concept for what may be considered economic benefits from use. Entities in these scenarios rely on that broad concept to include intangible benefits in the analysis and thus to conclude that the customer does not obtain substantially all of the economic benefits from use.

Examples of intangible benefits (or outputs) that we have seen characterized as economic benefits from use include, but are not limited to, the following:

- Advertising rights or benefits that are associated with the display of a brand or image on the asset or are based on the asset’s use (e.g., advertising space on a professional race car).
- Data captured by the asset about how it is used. For instance, data may be sent back to an automaker by using certain smart technology installed in a new car model. Examples of such data may include information about customer demographics, GPS information showing where the customer drives, accident information, frequency of use, or time of use.
- Data generated by the asset regarding the health and function of the larger network of PP&E to which the asset is connected (e.g., data sent back by a utility meter connected to a ratepayer’s home about the speed and quality of electricity moving from the distribution line).
- Remote access capabilities of the supplier so that the supplier may minimize the deployment of field technicians to diagnose and repair the asset (e.g., the supplier can log into a printer remotely, through the Internet, to troubleshoot a printer at a customer site that is not functioning properly).
At this time, stakeholders continue to consider whether certain intangible benefits (or outputs) — including those above — represent economic benefits from use. The more economic benefits from use there are for a particular underlying asset, the greater the likelihood that a supplier or customer may conclude that the customer does not obtain substantially all of the economic benefits from use of that asset. Entities that are involved in these types of arrangements should consult with their accounting advisers and monitor developments on the topic.

We think that it would be helpful for entities to consider the following questions when evaluating whether such intangible benefits (or outputs) are economic benefits from use (i.e., in determining whether such benefits have substance):

- Are the benefits (or outputs) created by — or do they result from — the use of the PP&E? That is, can it be confirmed that they are not benefits solely associated with ownership of the asset?
- Can the benefits (or outputs) from use be realized in a commercial transaction with a third party?
- Is the generation or creation of the benefits (or outputs) passive? That is, if the customer is not actively using the asset, is the benefit still created in such a way that the benefit may not depend on the use of the asset?
- How may the benefit (or output) be realized? If the benefit can only be realized by the supplier in the form of cost savings, the benefit (or output) may not be an economic benefit from use.

If such intangible benefits (or outputs) are determined to be economic benefits from use, an entity will also need to (1) identify which parties obtain the benefit(s) and (2) determine whether the amount of benefits obtained by parties other than the customer is sufficient to conclude that the customer does not obtain substantially all of the economic benefits from use of the asset. In performing the latter assessment, an entity may need to quantify the amount of benefits received by the parties in cases in which intangible benefits (or outputs) are identified. See Section 3.4.1.3 and Q&A 3-10 for detailed discussion.

### 3.4.1.2 Identifying Which Economic Benefits From Use Are Within the Scope of the Customer’s Right to Use the Asset in the Contract

Once the parties to the arrangement identify, on the basis of the nature of the asset, all of the economic benefits from use of the asset, they must identify which of those benefits are within the scope of the customer’s right to use the asset in the contract. These economic benefits are subject to the “substantially all” criterion in ASC 842-10-15-4(a) (see Section 3.4.1.3 for detailed discussion).

<table>
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<th>ASC 842-10</th>
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<tr>
<td>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:</td>
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<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
The graphic to the left illustrates the example in ASC 842-10-15-18(b). In this example, the supplier's and customer's assessments take into account the economic benefits related to only the mileage the contract permits the customer to drive a motor vehicle “during the period of use” (represented by the blue area of the circle to the left) and not the entire mileage that the vehicle may be driven on the basis of the nature of the asset (represented by the entire circle). This makes sense in light of the first paragraph of ASC 842-10-15-18, which indicates that, of the universe of economic benefits derived from the use of the underlying asset — identified in accordance with ASC 842-10-15-17 (and Section 3.4.1.1) — parties to the arrangement should only consider benefits that are within the scope of the customer's right to use the asset in the contract. ASC 842-10-15-18 points readers to ASC 842-10-15-23 (discussed in Section 3.4.2.2) for guidance on determining the scope of the customer's right to use the asset in the contract.

Generally, the scope of the customer's right to use the asset will be limited by the supplier's protective rights. With respect to the example in ASC 842-10-15-18(b), the supplier may limit the number of miles that the customer may drive the leased vehicle during the period of use so that the supplier may better protect its interest in the residual asset. The supplier's protective rights, in this case, help ensure that the supplier can market the residual asset for a minimum value to third parties after the conclusion of the customer's lease.

The supplier's protective rights do not prevent the customer from obtaining substantially all of the economic benefits from use of the asset because the “substantially all” assessment is performed with respect to the economic benefits that are within the scope that is bound by those protective rights. Any economic benefits that can only be realized by going “beyond” the scope of the customer's right to use the asset in the contract are not obtained by any party to the arrangement during the period of use.

### 3.4.1.3 Obtaining Substantially All of the Economic Benefits From Use

Once an entity has identified the economic benefits from use that are within the scope of the contract, the parties to the arrangement must determine whether the customer obtains substantially all of them.

The Q&As, examples, and the Connecting the Dots below further discuss how this determination should be made.

**Q&A 3-9 Definition of “Substantially All” (Economic Benefits)**

ASC 842-10-15-4(a) states that, to have “the right to control the use of an identified asset,” the customer must have the “right to obtain substantially all of the economic benefits from use.”

**Question**

What is the meaning of “substantially all” in the context of determining whether the customer has the right to obtain substantially all the economic benefits from use of the identified asset?
Answer

Although ASC 842 does not define “substantially all,” it uses the term frequently. The term is used, for instance, in the context of (1) whether a capacity portion of a larger asset is an identified asset (see Section 3.3.2 for detailed discussion of portions of assets and whether they are identified assets) and (2) the lease classification test (i.e., determining whether the present value of the lease payments represents substantially all of the fair value of the underlying asset).

Paragraph BC73 of ASU 2016-02 indicates that entities should be allowed to use a 90 percent threshold in determining whether the “substantially all” criterion is met in the lease classification test:

Nevertheless, the Board understands that entities need to ensure the leases guidance is operational in a scalable manner, which often requires the establishment of internal accounting policies and controls. As a result, the Board included implementation guidance in Topic 842 that states that one reasonable application of the lease classification guidance in that Topic is to conclude, consistent with previous GAAP, that . . . 90 percent or greater is “substantially all” the fair value of the underlying asset.

Likewise, we think that 90 percent should generally be used to determine whether the customer has the right to obtain substantially all of the economic benefits from use. Accordingly, if the customer has the right to obtain 90 percent or more of the economic benefits from use of the identified asset, it has met the “substantially all” criterion in ASC 842-10-15-4(a). Companies should consult with their auditors, accounting advisers, or both if they are considering the use of a different percentage threshold for this purpose.

This is consistent with interpretations of the condition in ASC 840-10-15-6(c), under which control is defined on the basis of only economics (see the Changing Lanes discussion in Section 3.4). That is, the language “it is remote that one or more parties other than the purchaser will take more than a minor amount” in ASC 840-10-15-6(c) is generally interpreted as meaning that another party will not take more than 10 percent, which is consistent with the customer’s taking 90 percent.

Example

Outsourcing Arrangement for Basketballs

Customer X enters into a contract with Supplier Y to purchase a particular size, type, quality, and quantity of basketball over a four-year period. Supplier Y has only one factory that can meet X’s needs and is unable to supply the basketballs from another factory or source them from a third-party supplier. Because Y does not have the practical ability to source the basketballs from another facility, the facility is implicitly identified in the contract.

Case A — Capacity of the Factory Exceeds the Output for Which the Customer Has Contracted

Assume that the capacity of the factory exceeds the output for which X has contracted in such a way that X only has rights to 75 percent of the capacity of the factory. In addition, Y can use the factory to manufacture basketballs for other customers. In this case, X does not have the right to obtain substantially all of the economic benefits from the use of the factory because Y can use the factory to fulfill its obligations under contracts with other customers (i.e., thereby retaining 25 percent of the economic benefits). Accordingly, X does not have the right to control the use of the facility and the contract does not contain a lease.
Example (continued)

Case B — Output for Which the Customer Has Contracted Represents Substantially All of the Capacity of the Factory

In this case, assume that the factory was specifically designed to manufacture basketballs for X and that Y is practically limited from using the facility to manufacture any other products for any other customers. Because the factory can only be used to manufacture basketballs for X, X has the right to obtain substantially all of the economic benefits from the use of the factory. To determine whether the contract contains a lease, the parties should evaluate whether X has the right to direct the use of the factory. See Section 3.4.2 for additional information on the right to direct the use of an identified asset.

Q&A 3-10  Quantitative Versus Qualitative Assessment Related to Determining Whether the Customer Has the Right to Obtain Substantially All of the Economic Benefits

In accordance with ASC 842-10-15-4(a) and ASC 842-10-15-17, for a contract to be, or contain, a lease, the customer must have the right to obtain substantially all of the economic benefits from use of the asset. As discussed in Q&A 3-9, “substantially all” in this context is generally interpreted as referring to 90 percent or more of the economic benefits from use.

Question

Does an entity need to perform a quantitative analysis to conclude that the customer has the right to obtain 90 percent or more (i.e., substantially all) of the economic benefits from use?

Answer

It depends. There is no requirement in ASC 842 for an entity to conduct a quantitative analysis of the economic benefits from use and which parties have the rights to obtain them. Accordingly, if the contractual terms and conditions, as well as the related facts and circumstances, are clear on whether the customer has the right to obtain substantially all of the economic benefits from use, a quantitative analysis is not needed.

However, when it is not qualitatively clear whether the customer has the right to obtain substantially all of the economic benefits from use, a quantitative analysis may be required. We think that a quantitative analysis of the economic benefits from use might be necessary in the following situations (not all-inclusive):

- The identified economic benefits from use include intangible benefits (or outputs), and those intangible benefits could be more than insignificant. (See Section 3.4.1 and Q&A 3-7 for more information about intangible economic benefits.) Because of the intangible nature of such benefits, a qualitative assessment alone may be insufficient for determining whether they are more than insignificant.

- The economic benefits from use include by-products or co-products that may be transacted with third parties.

When economic benefits from use, including by-products or co-products, can be transacted in a secondary market with third parties, a quantitative analysis may be easier to perform. In such situations, market pricing may be both (1) readily accessible and (2) used by the parties to the arrangement in their negotiations and economic decision-making to enter into, or not enter into, the arrangement.
Example

Sale of Energy and Renewable Energy Credits Produced by a Solar Facility

Off-Taker U enters into a PPA with Supplier G to purchase 100 percent of the electricity produced by a solar facility for 20 years. Supplier G owns the solar facility. Off-Taker U will pay $40 per unit of electricity produced.

Besides electricity, the solar facility produces one REC for every unit of electricity produced. Supplier G has separately entered into two contracts to sell RECs produced by the solar facility to third parties: 25 percent of the RECs produced are sold to Polluter A for 20 years, and 50 percent of the RECs produced are sold to Polluter B for 20 years. Supplier G retains 25 percent of the RECs produced, either for its own account or to sell in the spot market to other market participants.

Off-Taker U and G determine that if the PPA had also included the purchase of 100 percent of the RECs, G would have charged a bundled price of $50 per unit of electricity produced.

Although U has the right to obtain 100 percent of the electricity produced by the solar facility, a minimum of three additional parties have the right to obtain the RECs produced by the solar facility. As discussed in Q&A 3-7, both the electricity and the RECs are economic benefits from use of the solar facility.

On the basis of the stand-alone value of the RECs and the electricity, U and G determine that the RECs represent more than an insignificant portion of the economic benefits from use of the solar facility. Accordingly, U does not have the right to obtain substantially all of the economic benefits from use. The PPA neither is, nor does it contain, a lease for either party to the arrangement.

Connecting the Dots — Contracts in Which the Customer’s Rights to Economic Benefits Change

It is common in off-take or other supply arrangements for the economic benefits obtained by the customer to change or fluctuate, contractually, throughout the period of use. For example, a customer may obtain 100 percent of the widget-production capacity at a manufacturing facility for the first five years and then 50 percent of the widget-production capacity at that facility for the next five years. Alternatively, for an asset with a primary output and a by-product (both of which are identified as economic benefits from use), a customer may obtain 100 percent of the primary output throughout the period of use but only 50 percent of the by-product in the first five years. Questions have arisen about the period over which economic benefits should be assessed in such situations (e.g., over the full period of use, on a yearly basis, on a monthly basis).

For example, assume that W through Z below are supply arrangements in which the contracts provide for a mix of goods that change over time and result in the customer’s obtaining the following percentage of economic benefits by year of the contract:2

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2 Note that none of the examples W through Z have a contract year in which 0 percent of the economic benefits are conveyed to the customer. In such situations, we think that the arrangement would be indicative of having nonconsecutive periods of use, which are discussed in detail in Section 3.5.
Two views have emerged regarding how to assess the economic benefits in W through Z.

**View A**

**Description**

According to this view, an entity first assesses the period of use (see Section 3.5) and then determines whether the customer has substantially all of the economic benefits from use of the asset on the basis of that period. This view is based on a literal reading of ASC 842-10-15-4, which states, in part:

> To determine whether a contract conveys the right to control the use of an identified asset . . . 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 . . . .

[Emphasis added]

In other words, View A places significant weight on the order in which the words in ASC 842-10-15-4 are written and thus suggests that an assessment of the period of use must come first.

**Outcomes**

View A would result in a conclusion that the customer, in each of W through Z, does not obtain substantially all of the economic benefits from use of the asset. This is because on an aggregate basis over all 10 years, the customer does not obtain at least 90 percent (i.e., substantially all) of the economic benefits from use of the asset during the period of use. The period of use is 10 years according to this view because, as indicated in ASC 842-10-20, that is 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).”

View A is consistent with application of the guidance in ASC 840-10-15-6(c).

**Shortcomings**

View A potentially opens up structuring opportunities for parties to an arrangement to avoid identifying a lease. That is, in applying View A, the parties to an arrangement could avoid lease accounting by tacking on nonsubstantive periods at the end of the contract term so that the customer obtains a low percentage of the economic benefits from use.

However, some proponents of View A acknowledge that the assessment would need to contain an anti-abuse override under which, for example, the parties to an arrangement have a disincentive to structure contracts to look like X in the example above. Depending on the facts and circumstances, some proponents of View A may conclude that if there is an anti-abuse override, the period of use in X is eight years in the assessment of the economic benefits from use.

**View B**

**Description**

According to this view, an entity looks to the assessment of whether the customer has substantially all of the economic benefits from use of the asset to determine what the period of use is. This view is based on the guidance in ASC 842-10-15-5, which states the following:

> 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. [Emphasis added]
View B is also an interpretation of the order in which the assessments should be performed that minimizes (as compared with View A) opportunities for parties to an arrangement to use structuring to avoid identifying a lease (i.e., for lessees to avoid recognizing lease assets and lease liabilities).

**Outcomes**

With respect to identifying the period of use, View B would result in bifurcation of the contract term into the periods during which the customer obtains at least 90 percent (i.e., substantially all) of the economic benefits from use of the asset. Effectively, according to View B, (1) the period of use is more closely aligned with the period during which the customer gets the benefits from use and (2) the period of use, as defined above and in ASC 842-10-20, may include nonconsecutive periods.

On the basis of this view, the customer obtains substantially all of the economic benefits from use during the following periods:

- X: Years 1–8.
- Y: Years 2, 4, 6, 8, and 10.
- Z: Years 1–2, 4–5, and 7–8.

Accordingly, for each of W through Z, the parties to the arrangement would incorporate the periods identified above into the assessment to determine whether the customer has the right to direct the use of the asset during those periods.

**Shortcomings**

View B could create challenges related to applying the lessee and lessor accounting models (e.g., if Y is determined to be an operating lease, it would be more complex to determine how to recognize lease expense or lease income on a straight-line basis over nonconsecutive periods). See Section 8.4.3.4 and Chapter 9 for detailed discussion of lessee and lessor accounting, respectively.

In addition, the examples W through Z above focus on economic-benefit percentages determined annually. However, proponents of View B acknowledge that there is no basis in ASC 842 for saying that the annual level is the correct and lowest level at which the assessment should be performed. For example, if the customer can further break down the percentages of economic benefits on the basis of months, days, or even hours, there could be further bifurcation of the period of use into nonconsecutive periods. Accordingly, if the arrangement is determined to be a lease, the assessment and subsequent accounting would become more complex.

**Next Steps**

The issue, as well as the views, continue to evolve. Companies involved in these types of arrangements should consult with their accounting advisers and monitor developments on the topic.
3.4.1.3.1 Portion of Cash Flows Derived From Use Paid to Supplier or Third Party

ASC 842-10-15-19 clarifies that cash flows derived from the use of the asset are economic benefits from use, even if a portion of those cash flows is paid to the supplier in the form of (variable) lease payments. That is, the cash flow structure in the contract should not dictate which cash flows derived from use are considered economic benefits from use or which party obtains those benefits.

In other words, a supplier generally prices a contract — and charges the customer — to earn a return of and on its investment in the underlying PP&E. It may structure the cash flows it must receive to earn that return in a number of ways. In the example in ASC 842-10-15-19, the supplier structures the cash flows to share in the customer's benefits from using the PP&E (i.e., to share in the upside). Alternatively, it could have forecasted the customer's sales and derived a fixed payment to achieve what is effectively the same result. In either case, the supplier would have designed the payment terms to achieve a necessary return.

Accordingly, whether the consideration in the arrangement is based on the customer's performance in using the asset or on a fixed basis (or some other variable basis) should not affect the assessment of whether the customer obtains substantially all of the economic benefits from use. Example 4 in ASC 842-10 (ASC 842-10-55-63 through 55-71, reproduced in Section 3.7.4) illustrates this notion.

3.4.2 Right to Direct the Use

In accordance with the definition of a lease — and the concept of control — in ASC 842, the customer must have the right to direct the use of the PP&E throughout the period of use. This is the “power” element of the control concept, as discussed in Section 3.4. It is an important piece of the concept because a customer would not agree to pay for a right to use PP&E unless it could actually exercise that right and direct how it uses the PP&E.
A customer has the right to direct the use of an asset if it can determine HAFWP that asset is used throughout the period of use. The extent to which the customer directs HAFWP the asset is used will depend on whether the contract grants the customer decision-making rights over that asset. Therefore, a customer should (1) identify the decision-making rights that most affect HAFWP the asset is used during the period of use (i.e., which decision-making rights most affect the economic benefits from use of the asset) and (2) determine which party controls those rights.

In many cases, it is relatively simple to determine whether the customer has the right to direct the use of the PP&E. For example, in a lease of an office building, it is likely to be clear that the customer has the right to direct HAFWP the office building is used throughout the period of use.

However, in other situations, the assessment may be more complex. When neither party to the arrangement (i.e., neither the supplier nor the customer) controls the decision-making rights that most affect HAFWP the asset is used throughout the period of use, then HAFWP the asset is used throughout the period of use may be predetermined. In those situations, the customer only directs the use of the asset when it either (1) operates the asset throughout the period of use or (2) designed the asset so that HAFWP the asset is used throughout that period is predetermined. Alternatively, when neither party controls the decision-making rights that most affect HAFWP the asset is used throughout the period of use, then power over those rights may be shared between the supplier and the customer.
The decision tree below illustrates the process an entity should consider when determining whether the customer has the right to direct the use of the PP&E.

Identify decision-making rights that most affect HAFWP PP&E is used throughout period of use (excluding predetermined use).

Of those, identify the decision-making rights that are within the scope of the customer's right to use the asset in the contract (i.e., as limited by protective rights).

Who has the decision-making rights over HAFWP PP&E is used throughout period of use?

Neither

HAFWP PP&E is used throughout period of use is either predetermined or shared.³

Yes

Does the customer have the right to operate the PP&E throughout period of use?

No

Did the customer design the PP&E in a manner that predetermines HAFWP PP&E is used throughout period of use?

³ See Section 3.4.2.4 for further discussion of when power over the decision-making rights related to HAFWP PP&E is used throughout the period of use is shared.
As noted in Section 3.2.1, the determination of whether the customer has the right to direct the use of the asset is generally a two-step process:

1. Evaluate whether the customer or the supplier has the right to direct HAFWP the asset is used throughout the period of use.
2. If no party has the right to direct HAFWP the asset is used throughout the period of use, HAFWP the asset is used throughout that period may be predetermined. In such cases, an entity evaluates whether the customer (1) can operate the asset or (2) designed the asset in a manner that predetermined HAFWP the asset is used throughout the period of use. (However, if no party has the right to direct HAFWP the asset is used throughout the period of use, an entity may need to consider whether power over that right is shared.)

The remainder of Section 3.4.2 addresses the above decision tree in greater detail.

### 3.4.2.1 How and for What Purpose the Asset Is Used Throughout the Period of Use

<table>
<thead>
<tr>
<th>ASC 842-10</th>
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<tbody>
<tr>
<td><strong>15-24</strong> 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.</td>
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<td><strong>15-25</strong> 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:</td>
</tr>
<tr>
<td>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)</td>
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<tr>
<td>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)</td>
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<tr>
<td>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)</td>
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<tr>
<td>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).</td>
</tr>
<tr>
<td><strong>15-26</strong> 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)).</td>
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As noted above in ASC 842-10-15-24, a customer can direct HAFWP an asset is used throughout the period of use (and thus meets the criterion in ASC 842-10-15-20(a)) when the customer has “decision-making rights that are most relevant to changing [HAFWP] an asset is used” throughout that period. The most relevant decision-making rights are those that can affect the economic benefits that result from use of the asset (i.e., there is a direct link between the “power” and “economics” elements of the right to control the use of the asset, as discussed in Section 3.4). Paragraph BC137 of ASU 2016-02 clarifies that those are the decision-making rights that are most important to determining whether the customer has the right to control the use of the asset.

Paragraph BC137 of ASU 2016-02 also clarifies that HAFWP is a “single concept.” That is, parties to the arrangement should not assess how an asset is used separately from the asset’s intended purpose in the arrangement. Decision-making rights that affect the economic benefits derived from the use of an asset will differ depending on the nature of the asset. However, ASC 842-10-15-25 gives the following common examples of decision-making rights that affect the economic benefits derived from the use of the asset and, therefore, that govern HAFWP an asset is used:

- The customer’s ability to change what type and amount of output the asset produces (e.g., the type of widget — widget X or widget Y — the PP&E produces and the volume of each).
- The customer’s right to change when the asset is used (e.g., when the PP&E produces widget X).
- The customer’s ability to change where the asset is used (e.g., where a truck delivers goods).
- The customer’s right to change whether the asset is used (e.g., whether PP&E is operating to produce widgets and how many widgets the PP&E produces when it does operate).

In paragraph BC137 of ASU 2016-02, the Board observes that “decisions about how and for what purpose an asset is used can be viewed as similar to considering the decisions made by a board of directors when assessing control of an entity.” Specifically, under the consolidation guidance, the choices made in the execution of — or the actions taken to carry out — the decisions made by a board of directors are subordinate to the decisions themselves. Therefore, the control analysis in the consolidation guidance focuses on the power of the board to direct the most significant activities of the entity, not on who may determine how to execute those significant activities.

Similarly, ASC 842 focuses on which party may make decisions about HAFWP an asset is used throughout the period of use. The execution of (i.e., the operation and maintenance activities related to) a party’s decisions about HAFWP an asset is used is subordinate. Accordingly, ASC 842-10-15-26 clarifies that any rights to determine how the asset will be operated or maintained during the period of use are subordinate to decision-making rights about HAFWP an asset is used throughout the period of use.

Further, paragraph BC137 of ASU 2016-02 notes, for instance, that “a supplier’s operational decisions would have no effect on the economic benefits derived from use of an asset if the customer decides that the asset should not be used.” Therefore, while operation and maintenance decisions are essential to ensuring the efficient use of the asset, they are subject to, and can be overridden by, the rights to change HAFWP the asset is used.
The following graphic illustrates this notion:

![Diagram showing the relationship between decisions about HAFWP the asset is used and rights over operation and maintenance.](image)

**Connecting the Dots — Differentiating Between Rights Over Operation and Decisions About HAFWP an Asset Is Used**

Paragraph BC137 of ASU 2016-02 explains that rights related to the operation and maintenance of an asset are subordinate to decision-making rights associated with HAFWP that asset is used:

> In the Board’s view, the decisions about how and for what purpose an asset is used are more important in determining control of the use of an asset than other decisions to be made about use, including decisions about operating and maintaining the asset. That is because decisions about how and for what purpose an asset is used determine how and what economic benefits are derived from use.

In addition, rights over operation and maintenance are rights that are both (1) essential to the efficient use of the asset and (2) potentially protective if they are held by the supplier (i.e., because they would allow the supplier to ensure operation and maintenance practices that would protect the supplier’s investment in the asset). Therefore, it may be helpful to view rights over operation and maintenance as those that are most likely to have smaller effects on the operating margins (or the net cash flows) derived from using the asset.

By holding operation rights, the supplier may be able to lower the costs of operating the asset on the basis of its experiences in operating that asset and similar types of assets. For example, assume that a supplier knows which route is quickest when driving a delivery truck from Minneapolis to Milwaukee and therefore is able to minimize fuel costs. If the customer in this example holds decision-making rights related to when the route from Minneapolis to Milwaukee will be driven but decides not to exercise that right, no economic benefits (i.e., cash flows) will be derived. That is, the supplier’s right to choose the quickest route and thus lower operating costs is contingent on (subordinate to) the customer’s decisions.

The above example illustrates the difference between (1) the rights to operate an asset and (2) decision-making rights related to HAFWP an asset is used. That is, the latter rights have significantly more influence over the economic benefits to be derived from using the asset and, therefore, the former rights are subordinate to the latter.
Also illustrated above is another way in which the power notion in ASC 842 differs from that in the consolidation guidance in ASC 810. The party that controls operation and maintenance has power under ASC 810 in circumstances in which (1) there are ongoing operation and maintenance decisions to be made for a legal entity and (2) it is determined that those decisions reflect the activities that most significantly affect the economic performance of the legal entity. However, under ASC 842, the supplier's control of operation and maintenance decisions may not prevent the customer from having the right to direct the use of the underlying asset throughout the period of use. Further, ASC 842 requires that when HAFWP the asset is used throughout the period of use is predetermined and the supplier controls operation and maintenance decisions, the analysis must take into account whether the customer designed the asset (see Section 3.4.2.3.2 for further discussion of design).

Q&A 3-11 Dispatch Rights

“Dispatch rights” are rights that may be granted to a customer in an arrangement to direct the asset to be used for its intended purpose. In the power and utilities industry, such rights are common and may be granted to an off-taker (i.e., the customer) in a PPA to allow the off-taker to tell a power plant owner and operator whether to use the plant to produce electricity, when to use the plant to produce electricity, and what amount of electricity to produce.

However, dispatch rights can refer to similar rights associated with any type of asset. For example, an emergency services operator that is outsourcing to a third party can dispatch an ambulance or helicopter owned by the third party to provide the services. In addition, a customer in a manufacturing supply arrangement may have dispatch rights in connection with a widget factory (or a discrete manufacturing line within that factory) such that it can tell the owner and operator of the factory whether to produce widgets and how many widgets to produce.

Question

Do dispatch rights, when granted to the customer in an arrangement, convey the right to direct HAFWP an asset is used?

Answer

Generally, yes. Dispatch rights allow the customer in an arrangement to change whether, when, and to what extent an asset is used, which generally are the decision-making rights that most affect the economic benefits to be derived from the asset's use and thus represent the rights to determine HAFWP the asset is used throughout the period of use. Therefore, in accordance with ASC 842-10-15-24 through 15-26 and the Connecting the Dots, dispatch rights would override any rights of the asset's owner to operate and maintain the asset. Example 9, Case C, in ASC 842-10-55-117 through 55-123 (reproduced in Section 3.7.9) illustrates the use of dispatch rights in a PPA.

In some industries, dispatch rights may be conveyed through another right (e.g., an effective dispatch right). For example, in some markets in the power and utilities industry, dispatch decisions are ultimately made by an independent system operator on the basis of a consideration of bid prices and any transmission system constraints (i.e., if there are no constraints, generating units will be dispatched economically by accepting the lowest bids first); therefore, in such cases, neither the owner nor the off-taker can mandate physical production. While the bid-in process in the power and utilities industry is not entirely the same as a dispatch
right held by a customer as described above, companies should consider whether control over the bidding process in such scenarios conveys to the customer the right to direct HAFWP the asset is used, since that is the right an owner would normally exercise in these markets to influence whether, when, and to what extent the owner’s asset is used.

In a tolling arrangement, the right to provide the inputs the asset needs to produce outputs may also constitute an effective dispatch right. When a customer obtains a tolling right in an arrangement, the asset may generally only produce outputs when the customer provides the inputs that the asset needs to convert those inputs to a refined or finished product (i.e., the asset produces outputs upon the receipt of the necessary inputs). Further, the asset will generally only produce to the extent of the inputs provided; that is, the amount of outputs the asset produces is a function of the amount of inputs provided and the efficiency of the asset in converting those inputs. Therefore, in tolling arrangements, the customer will generally control the rights that most affect the economic benefits to be derived from the asset’s use — and thus the right to direct HAFWP the asset is used — by virtue of the customer’s right to provide the inputs and request conversion to outputs. Tolling arrangements are found not only in the power and utilities industry but also in basic manufacturing as well as in the metal, agriculture, and oil and gas industries.

3.4.2.1.1 Applying the Guidance in ASC 842-10-15-24 Through 15-26

The three examples below illustrate the guidance in ASC 842-10-15-24 through 15-26 and the discussion above.

**Example 3-12**

**Exclusive Limousine Service**

Customer D, a politician, enters into a contract with Company R, a limousine service provider, for transportation during the four-year term of D’s political assignment. The contract explicitly specifies the VIN of the limousine that will be used to transport D, and R is contractually restricted from substituting the limousine for reasons other than repairs or maintenance. Therefore, the parties have determined that the fulfillment of the contract depends on an identified asset.

The limousine in question is stored on R’s premises when not in use, but R may not use the limousine to transport any other customers during the four-year contract term. In addition, R provides a dedicated driver for the entire four-year contract term. The limousine will be used to transport D to various speaking and charity events according to a schedule that D provides to R on a biweekly basis. However, once the schedule is provided, the dedicated driver — an employee of R — plans the routes to and from each scheduled event.

Customer D has the right to obtain substantially all of the economic benefits from the limousine throughout the four-year period of use because it is the only customer that will be transported in the limousine during that period. In addition, although R is responsible for operating the limousine and has some discretion in route planning, D has the right to direct the use of the limousine because it is responsible for determining whether and, if so, when the limousine will operate and where it will travel.

For these reasons, D has the right to control the use of the limousine and the contract contains a lease.
Example 3-13

Refrigerated Storage Unit

Customer A enters into a contract with Company B for the exclusive use of a refrigerated storage unit for a 15-month period. Company B constructed the storage unit and is responsible for operating and maintaining it. The contract explicitly identifies the storage unit via its serial number, and B is contractually restricted from substituting the refrigerated storage facility during the contract term. Therefore, the parties have determined that the fulfillment of the contract depends on an identified asset.

Throughout the 15-month period of use, A has the right to take products out of, or put them into, the storage unit at any time without B's consent. However, B controls physical access to the storage unit and only B's employees are allowed inside; therefore, B is responsible for physically moving the products as A requests.

Customer A has the right to obtain substantially all of the economic benefits from the storage unit throughout the 15-month period of use because of its exclusive use of the storage unit. Although B controls physical access to the storage unit and is responsible for operating it, B does so according to A's decisions about what products will be stored in the storage unit as well as whether and, if so, when they will be stored. Customer A therefore has the right to direct the use of the storage unit.

Because A obtains substantially all of the economic benefits from the storage unit (an identified asset) and has the right to direct its use, the contract contains a lease.

Example 3-14

Natural Gas Processing Facility

Customer U enters into a three-year contract for the exclusive use of Supplier M's processing plant. Supplier M agrees to separate “wet” natural gas that U extracts from shale rock formations into its component products of “dry” natural gas and natural gas liquids (e.g., ethane, butane, propane).

The contract explicitly names M's plant by address. Although M has, at times, contracted to provide varying amounts of capacity to multiple customers simultaneously, U has contracted for 100 percent of the capacity of the plant. This is the only plant M owns that is connected via a pipeline to U's natural gas wellhead gathering system, so M does not have an alternative plant that it could substitute to fulfill its obligations under the contract. Accordingly, the parties have determined that the fulfillment of the contract depends on an identified asset.

During the three-year contract period, M's own employees will operate and maintain the plant. Although U never has physical access to the plant, it may provide the wet gas for processing whenever it chooses and will receive 100 percent of all products yielded (i.e., 100 percent of the dry gas and natural gas liquids produced).

Customer U has the right to obtain substantially all of the economic benefits from the processing plant throughout the three-year period of use because it will receive 100 percent of the outputs (i.e., dry gas and natural gas liquids) produced by the plant. Although M is entirely responsible for operating and maintaining the plant, this contract is, in effect, a tolling agreement. That is, U determines whether and, if so, when the plant is used, as well as what amount of output it will produce, by virtue of its right to provide 100 percent of the plant's inputs. For example, if U does not provide any wet gas, the plant does not produce dry gas and natural gas liquids. Customer U therefore has the right to direct the use of the processing plant.

Because U obtains substantially all of the economic benefits from the processing plant (an identified asset) and has the right to direct its use, the contract contains a lease.

Note that in all three of the above examples, the PP&E is kept on the supplier's premises but the customer has the right to direct HAFWP the asset is used throughout the period of use. These three examples illustrate that the analysis should focus on the parties' decision-making rights rather than on the location of the PP&E.
Importantly, while the customer may have the right to direct the use of the asset throughout the period of use when the asset is kept on the supplier’s premises, the inverse can also be true. That is, as the FASB staff has indicated to us, the supplier may have the right to direct the use of the asset throughout the period of use even when assets dedicated to the customer are kept on the customer’s premises.

Example 10, Case A, in ASC 842-10-55-124 through 55-126 (reproduced in Section 3.7.10) illustrates this notion, and the Connecting the Dots below discusses it in greater detail.

**Connecting the Dots — Assessing Which Party Has the Right to Direct the Use of Dedicated Assets on the Customer’s Premises**

We have received a number of questions regarding the outcome of Example 10, Case A, in ASC 842-10-55-124 through 55-126 (reproduced in Section 3.7.10). That example involves a contract for network services under which a telecommunications company (the supplier) installs and configures multiple servers at a customer site to support the customer’s network needs (primarily the storage and transportation of data). During the term of the arrangement, the supplier makes decisions about how to deploy the fleet of servers to satisfy customer requests. Although the arrangement involves dedicated equipment, some of which is maintained on the customer’s premises, the conclusion reached in the example is that the arrangement does not contain a lease since the customer does not (but the supplier does) have the right to direct the use of the individual servers are used.

Some may find this outcome counterintuitive since the servers are dedicated solely to the customer for the term of the arrangement. However, the conclusion highlights an important change from ASC 840. Specifically, for a lease to exist under ASC 842, the customer must obtain the right to control the use of the asset(s) in the arrangement and the right to control the use is not limited to having the right to all of the asset’s productive output (one of the circumstances in which an entity could conclude that an arrangement is a lease under ASC 840, as discussed in the Changing Lanes discussion in Section 3.4). Rather, the right to control the use under ASC 842 is determined in a two-part test that focuses on (1) economic benefits and (2) the right to direct the use of the identified asset(s). In the example, the second condition is not met; therefore, the arrangement does not contain a lease.

A number of stakeholders have asked about the key factors related to why the customer in the example does not have the right to direct the use of the servers. For instance, questions have been raised regarding why, if the right to dispatch a power plant (i.e., to tell the owner-operator when to produce electricity — see Q&A 3-11) conveys to the customer the right to direct the use of the plant (as illustrated in Example 9, Case C, in ASC 842-10-55-117 through 55-123, reproduced in Section 3.7.9), the right to determine when and which data to store or transport by using the network would not likewise convey to the customer the right to direct the use of the underlying servers.
We understand the following regarding the key factors behind the conclusion in Example 10, Case A:

- The analysis is focusing on whether each individual server, as opposed to the entire network, is a lease. In the example, the supplier is providing a service (a network of a certain capacity and quality) by using dedicated assets. Therefore, the analysis to determine which party has the right to direct the use of the asset(s) should be performed at the asset level (i.e., at the individual server level).
- The consideration of HAFWP the asset is used, as described in ASC 842-10-15-25, likewise focuses on decisions related to each individual server — not the output produced by the overall network.
- The scenario involves multiple assets (multiple individual servers), and the supplier retains the discretion to deploy each individual server in whatever manner the supplier decides will best fulfill the overall network service.
- Since each server on its own can perform different functions (e.g., storing data, transporting data), the supplier has the right to make meaningful decisions about which server(s) should be used to satisfy a particular customer request.
- The customer cannot decide HAFWP each individual server is used and cannot prevent the supplier from making those decisions. The customer's decisions are limited to how the customer uses the network and do not extend to the individual servers.

We think that these key factors, though they are not all-inclusive, help differentiate the conclusion in Example 10, Case A, from the conclusion in Example 10, Case B, in ASC 842-10-55-127 through 55-130 (reproduced in Section 3.7.10). In Case B, the arrangement involves a single server, and the customer makes the critical decisions about which data to store or transport by using that single server as well as about how (or whether) to integrate that single server into its broader operations. Therefore, we believe that Case B is more analogous than Case A to Example 9, Case C, which involves dispatch rights over a power plant (also a single asset).

Understanding the key distinguishing factors in the above examples should help preparers identify leases under ASC 842. However, the illustrative examples represent an application of the framework to certain stated facts and circumstances. An entity must perform a detailed analysis of its own specific facts and circumstances in such scenarios. We recommend that entities that have questions about their arrangements and whether they should be analyzed in a manner similar to the analysis in Example 10, Case A, should discuss those questions with their auditors or accounting advisers.

**Q&A 3-12 Assessing the Right to Direct the Use of Multiple Assets in a Single Arrangement**

**Question 1**

When an arrangement involves the use of multiple assets, at what level (i.e., at the level of the group of assets or the individual asset) should the parties to the arrangement assess whether the customer has the right to direct the use of those assets?
Answer

The analysis to determine which party has the right to direct the use of the assets should be performed at the individual asset level and, as discussed in the Connecting the Dots, should focus on decision-making rights related to each of those assets. Feedback received from the FASB and IASB staffs has indicated that this is a key element of the analysis in Example 10, Case A.

This may seem counterintuitive given the order of operations indicated by ASC 842. That is, in accordance with ASC 842-10-15, an entity should first determine whether a contract is or contains a lease before it breaks that contract into its units of account consisting of separate lease (and nonlease) components. (For additional information about separating components in a contract, see Chapter 4.) However, the guidance in ASC 842-10-15-24 through 15-26 continually uses the singular, referring to the right to direct the use of an asset or HAFWP the asset is used.

In addition, the decisions that affect the economic benefits to be derived from use of an asset are most easily identifiable at the level of the individual asset. We think that this will be especially true when each individual asset has multiple functionalities, as in Example 10, Case A (e.g., the supplier, at its discretion, may individually deploy each server for such tasks as filing, e-mail, or printing to provide the customer with a network of a certain capacity and quality). It would follow, then, that the customer has the right to direct HAFWP an asset is used when it has decision-making rights that affect the economic benefits derived from the use of the individual asset.

The example below illustrates another application — besides Example 10, Case A — of the response in this Q&A.

Example

Contract for Construction-Related Services

Homebuilder B enters into a contract with Vendor GC to provide demolition and construction services for two years. Under the arrangement, GC will use three pieces of heavy construction equipment — an excavator, a crane, and a skid loader — in the razing of real estate purchased by B and the construction of a new suburban housing development at B’s direction.

Assume that it is clear from the contract that the equipment represents identified assets and that B obtains substantially all of the economic benefits from use of each of these assets.

Each piece of equipment has multiple functionalities. For example, the crane can be used to lift heavy materials when a hook is attached or to raze existing structures when a wrecking ball is attached. Vendor GC's own employees are deployed to operate the equipment, and B is contractually precluded from operating the equipment itself or from hiring a third party to do so.

Homebuilder B issues instructions to Vendor GC each week with a stated project. For example, B may instruct GC in the first week to raze an existing structure on a northwest parcel of the purchased land and, in the second week, it may instruct GC to lay the foundation for a new home on the southwest parcel of the purchased land.

Vendor GC retains the discretion to deploy each individual piece of equipment in whatever manner it decides will best fulfill the demolition and construction services it is providing to B. For example, to accomplish the first week’s project, GC may choose not to use the skid loader and instead save its fuel; GC may be able to complete the first week’s project solely by using the demolition-related functions of the crane and the excavator. Because each piece of equipment on its own can perform different functions, GC has the right to make meaningful decisions about which pieces of equipment should be used to satisfy each week’s project. Therefore, GC’s decision-making rights go beyond basic decisions about operating and maintaining the equipment.
Example (continued)

Homebuilder B cannot decide how each individual piece of equipment is used to complete each week's project, and B cannot prevent GC from making those decisions. Homebuilder B's decisions are limited to how it will use the services provided by GC and do not extend to the individual pieces of equipment.

Accordingly, GC retains the right to direct how each piece of equipment is used. The contract does not contain a lease.

Question 2

When an arrangement involves the use of a single asset that is made up of individual component assets (e.g., a power plant with two turbines that is constructed to function as a single asset), should the parties to the arrangement break the single asset into its individual component assets to assess whether the customer has the right to direct the use of those assets (e.g., the individual turbines)?

Answer

No. When a supplier or asset owner builds or constructs a single asset by bringing together a group of individual component assets, the analysis to determine which party has the right to direct the use should be performed with respect to the single asset. In such circumstances, it would be inappropriate to break the asset apart into its component pieces. Because the asset is built or constructed to function as a single asset, the most relevant decision-making rights will be those that affect the economic benefits to be derived from use of the single asset.

For example, it is common in the power and utilities industry for a power plant to contain two or more turbines that produce electricity (in the case of a wind facility, there may be many turbines). Those turbines will generally perform the same function (i.e., producing electricity), and the individual turbines will benefit jointly from the installation of other individual PP&E within the power plant for efficiency purposes (e.g., a single transformer). Because the individual turbines are constructed to be a part of a larger, single asset for the intended use of generating electricity as a single asset, it would be inappropriate to assess the right to direct the use of each individual turbine.

However, if the power plant was constructed to contain two or more turbines, each capable of generating electricity separately, it would be appropriate to assess the right to direct the use of each individual turbine.

These concepts would also apply to a manufacturing facility with multiple manufacturing lines that are constructed to function as a single asset. That is, it would generally be inappropriate to assess the right to direct the use of each manufacturing line separately.

As discussed above, the right to direct how an asset is used can be complex when the use of the asset is heavily influenced by activities the supplier performs (e.g., in Example 10, Case A, reproduced in Section 3.7.10). The analysis can be equally complex when the use of the asset is heavily influenced by, or depends on, infrastructure that is owned, operated, and controlled by the supplier. Q&A 3-13 and the Connecting the Dots below discuss this complexity with respect to pipeline laterals and the first miles and last miles of tangible, integrated infrastructure systems.
Q&A 3-13  Pipeline Laterals (Right to Control the Use)
Pipelines are generally constructed and operated in sprawling and integrated systems that transport natural gas, oil, and refined products from supply regions to demand regions. Some customers are connected to, and receive deliveries of transported commodities through, the pipeline system via dedicated laterals. In addition, a pipeline system must, by its nature, have starting and ending points. Therefore, other customers may be connected to the pipeline system through effective laterals, because they are connected to the first mile or last mile of the larger pipeline system.

Q&A 3-3 explains that laterals and first-mile/last-mile connections are physically distinct portions of the larger pipeline system. Therefore, in transportation agreements, they are identified assets in accordance with ASC 842-10-15-16.

**Question**
Does the customer in a firm transportation agreement have the right to control the use of a pipeline lateral or a first-mile/last-mile connection to the larger pipeline system?

**Answer**
It depends. As noted in Q&A 3-3, the FASB and its staff discussed this issue at the May 10, 2017, Board meeting. Firm transportation agreements are those in which the customer is guaranteed a certain amount of transportation capacity on the pipeline system and is given priority above other customers that do not have firm rights.

While highlighting that the specific facts and circumstances of each arrangement must be considered, the FASB staff discussed two types of pipeline laterals on the basis of information it obtained via outreach to entities in the midstream oil and gas industry sector:

- **Type 1** — These “typically are connected to an integrated pipeline system” and are the most common type of pipeline laterals. While they cannot operate on their own, they share “supply sources with the main line and other customers.” The pipeline owner retains the ability to change the compression in the lateral to manage pressure in the lateral and on the larger system. Pressure moves commodity within the system, so changing the pressure in the lateral can affect the pressure in the larger system, thus affecting the speed at which other customers’ inventory moves through the system (and the speed at which the pipeline owner is able to provide its transportation services to others). Further, the pipeline owner retains the ability to store its own commodity in the lateral (i.e., line pack). Doing so also manages the pressure in the lateral and on the larger system.

Accordingly, the pipeline owner retains both (1) economic benefits from the asset’s use that are more than insignificant through its rights to store commodity in the lateral and to use the compression in the lateral to manage the pressure in the larger system, even though the customer decides when to receive service and at what volumes, and (2) the right to direct the use of the asset throughout the period of use because of its rights to change when, whether, and to what extent the lateral is used to manage the pipeline owner’s larger system. Depending on the significance of retained rights, the Board agreed with the staff’s analysis that Type 1 pipeline lateral contracts do not contain a lease. Type 1 pipeline laterals are expected to be the most common type.

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4 Quoted material in this Q&A is from the Board’s May 10, 2017, meeting handout.
Type 2 — These laterals “are fully capable of operating using their own dedicated assets,” and “the customer has the right to substantially all the pipeline lateral’s capacity.” The customer is able to close off this type of lateral from the remainder of the pipeline system (by closing a valve or a similar mechanism), thus preventing the pipeline owner from directing the use of the asset. In addition, closing the lateral off from the larger system allows the customer to use the lateral independently from the larger system.

The Board agreed with the staff's analysis that a lease exists in this case, since the customer has “the right to obtain substantially all the economic benefits . . . and the right to direct the use of the pipeline lateral throughout the period of use.”

The Board agreed with the staff's analyses, as noted above, and did not believe that any additional standard setting was required at that time.

**Connecting the Dots — Right to Direct the Use of Other First-Mile/Last-Mile Assets**

As indicated in Q&A 3-3, other first-mile/last-mile connections are identified assets in accordance with ASC 842-10-15-16. Therefore, entities must assess whether the customer has the right to control the use of such assets. We think that the FASB's May 10, 2017, meeting discussion regarding pipeline laterals (see Q&A 3-13) is helpful to this assessment.

Q&A 3-13 describes two types of pipeline laterals, one of which — Type 2 — can be functionally and tangibly closed off (e.g., by closing a valve or a similar mechanism) from the remainder of the larger pipeline system even though the lateral is not physically disconnected from the system. The Board generally expects that, for Type 2 laterals, the customer therefore will have the right to use the lateral independently from the larger system. The customer will thus have the right to control the use of the lateral, and the related arrangement will contain a lease.

We think that the same analysis can be applied to other types of first-mile/last-mile connections. That is, unless the customer is able to functionally and tangibly close off the first-mile/last-mile asset from the larger system, the customer will be unable to control the use of this asset. In other words, when there is no such “cut-off point,” or when the cut-off point is so near to the customer's facility that no substantive first-mile/last-mile asset remains after that point, the related arrangement will not contain a lease.

Note that just because an asset is connected to, and requires the use of, a distribution system controlled by the owner of the system, an entity should not automatically conclude that there cannot be a lease. The first-mile/last-mile issues address specific sections or parts of the physical distribution network itself, and we generally do not expect that portions of the larger network will contain leases on the basis of the guidance above. However, arrangements related to assets that are attached to distribution networks (e.g., storage tanks, power plants) may still be identified as leases or as containing leases.
Q&A 3-3 includes a list (not all-inclusive) of examples that would be identified assets under the guidance in ASC 842-10-15-16. Our understanding of the most common facts and circumstances, and how they are related to the lateral framework discussed above and in Q&A 3-13, is as follows:

- **Electric and telecommunications (i.e., wire and cable that deliver telephone, cable television, and Internet services)** — Wires and cables of this nature less commonly function as Type 2 pipeline laterals because (1) they are less likely to have a cut-off point after which the customer has the right to use the wires and cables independently from the larger system and (2) a cut-off point, if one exists, is most likely to be very close to the customer’s facility. While they may not function as Type 1 laterals because the supplier generally cannot use the first-mile/last-mile connection to manage its larger network, the important point is that they rarely function alone, without the assistance of the larger system. Accordingly, we think that it will be rare for the customer to have the right to control the use of first-mile/last-mile connections of electric and telecommunications wires and cables.

- **Rail** — Such first-mile/last-mile connections may more closely function as Type 1 pipeline laterals if the owner of the larger rail network is able to store cars on the first mile/last mile (or miles) that connects to the customer’s facility. However, a rail may also function as a Type 2 lateral if the customer is able to functionally and tangibly close off from the rest of the rail network the portion of track that connects to its facility. In such cases, an entity should carefully consider the relevant facts and circumstances as well as the customer’s and the supplier’s decision-making rights in related arrangements.

### 3.4.2.1.2 Excluding Predetermined Use

ASC 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.

An entity should consider only decisions made during the period of use — and not before — in determining whether the customer has the right to direct HAPWP the asset is used throughout the period of use. For example, if the customer’s only decision-making right related to the use of the asset was to specify the amount, type, and quality of output to be produced by the asset as part of negotiating the contract (i.e., before the period of use), the customer cannot direct HAPWP the asset is used throughout the period of use. Example 8 in ASC 842-10-55-100 through 55-107 (reproduced in Section 3.7.8) illustrates a scenario in which the customer’s only right is to specify the output of an identified manufacturing facility.
When considered in this context, the phrase “throughout the period of use” is meant to create a break in the timeline of the use of the asset between (1) the time before the beginning of the period of use (i.e., predetermination) and (2) the time during the period of use (“period of use” is defined in Section 3.5). That is, “throughout the period of use” is synonymous with “during the period of use” in this respect. The FASB further articulated this notion in paragraph BC140 of ASU 2016-02:

> Topic 842 clarifies that only decisions made during the period of use (and not before the period of use) should be considered in the control assessment, unless the customer designed the asset in a way that predetermines how and for what purpose the asset will be used. In the Board’s view, if a customer specifies the output from an asset at or before the beginning of the period of use (for example, within the terms of the contract) and cannot change those specifications during the period of use, it generally does not control the use of an asset. In that case, it would have no more decision-making rights than any customer in a typical supply or service contract. [Emphasis added]

Some decisions about HAFWP the asset will be used during the period of use may be predetermined by the nature of the asset. For example, in a lease of real estate, the decisions about where the asset may be used during the period of use are predetermined: real estate is affixed permanently to a unique space on the earth and, thus, no party to the arrangement may make such decisions.

However, even when some decisions about HAFWP the asset will be used during the period of use are predetermined, other significant decision-making rights related to HAFWP the asset will be used can most likely still be made during the period of use (e.g., when the asset is used during the period of use to produce an output that the customer specified before the period of use). Those are the decision-making rights that an entity should consider when assessing which party determines HAFWP the asset is used throughout the period of use.

The diagram below illustrates how significant decision-making rights could be granted in an arrangement. According to the diagram, an entity performing the analysis would focus on which party controls the decision-making rights in the green portion of the circle to determine whether the customer can direct HAFWP the asset is used throughout the period of use.

However, if all decisions about HAFWP the asset will be used throughout the period of use are predetermined and, therefore, no other significant decision-making rights about HAFWP the asset is used can be made during the period of use, the parties to the arrangement would consider whether the customer operates the asset throughout the period of use or designed the asset in a manner that predetermined HAFWP the asset will be used throughout the period of use in accordance with ASC 842-10-15-20(b). See Section 3.4.2.3 for a detailed discussion of those circumstances.
3.4.2.2 **Protective Rights Define the Scope of the Contract**

**ASC 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.

Once entities identify the decision-making rights that are most relevant to changing HAFWP the asset is used throughout the period of use (i.e., the decision-making rights that can affect the economic benefits that result from use of the asset), they must identify which of those decision-making rights are within the scope of the contract. The decision-making rights that are within the scope of the contract are the rights that an entity should consider when determining whether the customer or the supplier has the right to direct HAFWP the asset is used throughout the period of use.

This concept is similar to that discussed in Section 3.4.1.2 with respect to the economic benefits that result from use of the asset. In a manner similar to the discussion for economic benefits, the scope of the contract will generally be limited by protective rights, as indicated in ASC 842-10-15-23.

The diagram in Section 3.4.1.2, therefore, is equally applicable to the determination of which party has the right to direct HAFWP the asset is used throughout the period of use. In that diagram, the economic benefits that are within the scope of the contract are bound by the blue portion of the circle. It would follow, then, that only the decision-making rights that affect those economic benefits should be factored into the analysis of which party has the right to direct HAFWP the asset is used.

Accordingly, in line with the example from ASC 842-10-15-18 and Section 3.4.1.2, it would be inappropriate to conclude that the customer is prevented from directing HAFWP the asset is used on the basis of the fact that the customer does not have all possible rights to decide where and to what extent the vehicle is used (i.e., because the customer does not have the rights to decide to drive the vehicle in all territories and for unlimited miles, respectively). Rather, the analysis would include decision-making rights related to when, whether, where, and to what extent the vehicle is driven, as limited by the protective rights in the contract.

The following examples from ASC 842 illustrate the effect of protective rights on the scope of the contract in the determination of whether the customer has the right to direct HAFWP the asset is used throughout the period of use:

- Example 4 in ASC 842-10-55-63 through 55-71 (see Section 3.7.4).
- Example 6, Case B, in ASC 842-10-55-85 through 55-91 (see Section 3.7.6).
- Example 7 in ASC 842-10-55-92 through 55-99 (see Section 3.7.7).
Example 3-15 below further illustrates this notion.

**Example 3-15**

**Truck Rental Subject to Certain Restrictions**

Customer Bucky enters into a contract with Supplier Badger for the use of a specific truck for a two-year period. Supplier Badger is not permitted to substitute the truck during the contract term. Because the truck is explicitly specified in the contract and Badger does not have a substantive substitution right, the truck represents an identified asset in the contract.

The contract stipulates that Bucky decides whether and, if so, what cargo will be transported; when cargo will be transported; and where (e.g., to which cities) the truck will deliver throughout the period of use. Bucky is required to provide a properly licensed driver and is responsible for the safe delivery of the cargo that is carried. Certain restrictions prohibit Bucky's driver from using the truck beyond the maximum hours permitted by law or from carrying hazardous materials as cargo. Moreover, the contract prohibits Bucky from driving the truck out of the United States. Therefore, although Bucky has significant demand for its products in Alaska, it is restricted from driving the truck through Canada to get there.

Customer Bucky has the right to control the use of the identified truck for the following reasons:

- Although contractual restrictions limit to what extent the truck may be driven (i.e., a maximum number of hours allowable by regulation), where the truck may be driven (i.e., only within the continental United States), and what types of cargo may be transported (i.e., no hazardous cargo), these restrictions represent protective rights that define the scope of the contract.

- Because Bucky has exclusive use of the truck, Bucky has the right under the contract to obtain substantially all of the economic benefits from the use of the truck during the period of use.

- Within the scope of the contract, Bucky has the right to direct HAFWP the truck is used because it decides whether the truck will be used to transport cargo, what cargo will be transported, when the truck will be driven, and where the truck will be driven.

Because Bucky has the right to control the use of the identified truck throughout the period of use, the contract contains a lease for the truck despite the existence of certain use restrictions to protect the owner's investment in the truck.

**3.4.2.3 How and for What Purpose the Asset Is Used Throughout the Period of Use Is Predetermined**

HAFWP the asset is used during the period of use is predetermined when there are no decisions that are available to be made, by either the supplier or the customer, during the period of use about HAFWP the asset is used. In these instances, a “tiebreaker” notion applies under ASC 842. That is, under ASC 842-10-15-20(b), the analysis is forced toward a conclusion that one of the parties to the arrangement must have the right to direct the use of the asset.

When HAFWP the asset is used during the period of use is predetermined, the customer has the right to direct the use of the asset when it either (1) has the right to operate (or to direct others to operate) the asset throughout the period of use without the supplier having the right to change those operating instructions or (2) designed the asset (or the relevant aspects of the asset) in a manner that predetermined HAFWP the asset is used during the period of use.
In paragraph BC139 of ASU 2016-02, the FASB explains that the guidance in ASC 842-10-15-20(b) is intended to identify situations in which the customer, even when it does not have the right to direct the use of an asset, still has rights beyond those of a customer in a service arrangement:

The approach to determining whether a customer has the right to direct the use of an identified asset changes if the decisions about how and for what purpose an asset is used are predetermined. Topic 842 clarifies that if decisions about how and for what purpose an asset is used are predetermined, a customer can still direct the use of an asset if it has the right to operate the asset, or if it designed the asset in a way that predetermines how and for what purpose the asset will be used. In either of these cases, the customer controls rights of use that extend beyond the rights of a customer in a typical supply or service contract (that is, the customer has rights that extend beyond solely ordering and receiving output from the asset). In those cases, the customer has the right to make (or has made in the case of design) decisions that affect the economic benefits to be derived from use of the asset throughout the period of use.

Accordingly, even though the decisions that are most relevant to changing how the asset is used may be predetermined, the customer may still be able to make (or may have made) some decisions that affect the economic benefits to be derived from use of the asset. Therefore, it may still obtain control through both the “power” and the “economics” elements.

**ASC 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.

As explained in ASC 842-10-15-21, HAFWP an asset is used during the period of use may be predetermined through the following:

- **Design** — The design of the asset may predetermine where, when, whether, to what extent, and for what type of output the asset is used. In addition, the nature of the asset will often play a role. For example, the design of a wind farm predetermines where (wherever it is installed) and for what type of output (electricity) the asset is used. In addition, because of the nature of the asset (e.g., an electricity-generating asset that depends on the wind blowing), when, whether, and to what extent the asset is used are beyond the control of any party to the arrangement (e.g., they are subject to the weather).

Example 9, Case A, in ASC 842-10-55-108 through 55-111 (reproduced in Section 3.7.9) illustrates this concept with respect to a contract to purchase electricity produced by a solar farm.

- **Contractual restrictions** — Restrictions in the contract may predetermine where, when, whether, to what extent, and for what type of output the asset is used. Such restrictions are most likely to exist when dedicated machinery is used in certain supply arrangements or in situations in which the protective rights enforced by the supplier in the contract (see Section 3.4.2.2) are so severe that no decisions about HAFWP the asset is used can be made during the period of use.

Example 6, Case A, in ASC 842-10-55-79 through 55-84 (reproduced in Section 3.7.6) illustrates this concept with respect to a contract to transport goods via ship.

Further, the FASB discusses a manner of predetermination — predetermination through contractually negotiated terms and conditions — in paragraph BC138 of ASU 2016-02:

Nonetheless, decisions about how and for what purpose an asset is used can be predetermined. In that case, those decisions cannot be made by either the customer or the supplier during the period of use. This could happen if, for example, in negotiating the contract, the customer and supplier agree on all the relevant decisions about how and for what purpose an asset is used and those decisions cannot be changed after the commencement date.
We think that this manner of predetermination differs from the predetermination by contractual restrictions discussed in ASC 842-10-55-21. Predetermination by contractual restrictions implies that the arrangement becomes more like a service arrangement as a result of the supplier's efforts to protect its investment in the asset. That is, the supplier is willing to provide services to the customer but unwilling to give the customer any rights to direct the use of the asset.

On the other hand, predetermination by negotiation implies that both parties agree to the terms and conditions of the arrangement in such a way that the use of the asset is predetermined. In this case, neither party is deemed to control the agreed-upon terms, since the arrangement represents an arm's-length exchange. The following example illustrates this concept:

**Example 3-16**

**Refrigerated Storage Unit**
Assume the same facts as in Example 3-13, except that Customer A and Supplier B, when negotiating and writing the contract, agree that A will only store a certain type of carbonated beverage in the refrigerated storage unit and a specific quantity (e.g., in gallons) of the beverage. Customer A is not allowed to change the type or quantity of beverage to be stored in the storage unit during the 15-month contract term. Further, A and B agree that A will provide the beverages for storage on the commencement date and retrieve them from storage at the end of the contract term.

In this case, the contract predetermines what the storage unit will be used throughout the period of use. That is, A and B contractually agreed to what products will be stored in the storage unit, what amount will be stored, when the products will be stored, and whether anything will be stored. No decisions about how the storage unit is used during the period of use can be made by A or B during this period.

Even though these stipulations meet A's business requirements, A is not deemed to control these aspects during the period of use because they were agreed to up front and cannot be changed. Rather, these decisions are deemed to be contractually predetermined. Therefore, A must determine whether it either (1) has the right to operate the storage unit throughout the period of use or (2) was involved in the design of the storage unit. As stated in Example 3-13, B operates the storage unit. In addition, B had already constructed the storage unit when the contract was executed and A was not involved in the design of the storage unit. Because neither of the “tiebreaker” conditions are met, A does not have the right to direct the use of the storage unit.

Therefore, even though A obtains substantially all of the economic benefits from its exclusive use of the storage unit over the 15-month contract term, A does not have the right to control the use of the storage unit. Accordingly, B controls the use of the storage unit and, as a result, the contract does not contain a lease.

**Connecting the Dots — Predetermination Is Expected in “Relatively Few Cases”**
In the Background Information and Basis for Conclusions of ASU 2016-02, the FASB is careful to explain that it expects the analysis in ASC 842-10-15-20(b) to apply to “relatively few” contracts. Specifically, the Board twice indicates that it expects, in most leases, that either the customer or the supplier will have decision-making rights over how the asset is used during the period of use:

BC138. . . The Board noted that it would expect decisions about how and for what purpose an asset is used to be predetermined in relatively few cases.

BC139 [The Board] expects that, for most leases, the assessment of whether a customer directs the use of an asset will be based on identifying the party that decides how and for what purpose an asset is used.

As a result, we expect that it will be uncommon for an entity to use the tiebreaker tests in ASC 842-10-15-20(b) to determine whether a contract is, or contains, a lease.
3.4.2.3.1 Customer Has the Right to Operate the Asset

Although rights of operation do not factor into the assessment of who directs HAFWP the asset is used, those rights can vest control of the asset to the customer in accordance with ASC 842-10-15-20(b)(1) when HAFWP the asset is used during the period of use is predetermined. The Q&A and examples below provide additional insight into this condition.

**Example 3-17**

**Shipping Charter**

Customer Y enters into an arrangement with Supplier Z for the exclusive use of an explicitly identified ship. Customer Y indirectly chooses the type of ship to be used by selecting a shipping service package. In this case, Y receives the ship at designated Port City A. The ship is predetermined to go from Port City A to Port City B during a specific time frame. Customer Y's own crew will man, steer, and otherwise operate the ship. Customer Y and Supplier Z agree up front on the contents and amount of cargo to be shipped.

The parties conclude that the arrangement constitutes a lease of the ship for the following reasons:

- The ship is explicitly specified in the arrangement, and Z does not have a substantive substitution right.
- Because of its exclusive use of the ship, Y obtains all of the economic benefits from the ship during the period of use.
- Because the output of the ship (i.e., the cargo and transportation capacity) is specified in the contract, the relevant decisions about HAFWP the ship is used are predetermined. However, Y has the right to operate the ship during the period of use (e.g., Y's own operating personnel will man, steer, and otherwise operate the ship) and thus has the right to direct the use.

**Q&A 3-14 Rights to Kick Out the Operator**

**Question**

With respect to the “tiebreaker” conditions, are rights to kick out the operator of an asset sufficient to give the customer the right to direct the use of the asset in accordance with ASC 842-10-15-20(b)?

**Answer**

Yes. If HAFWP the asset is used during the period of use is predetermined and the supplier operates the asset, but the customer has the right to remove the supplier and hire a new operator, the customer has the right to direct others to operate the asset in accordance with ASC 842-10-15-20(b)(1). When the kick-out right is substantive (i.e., when the customer can remove and replace the operator without cause at any time), the customer — not the supplier — is the decision maker with respect to the operation of the asset.

**Example**

**Ship**

Assume the same facts as in Example 6, Case A, in ASC 842-10-55-79 through 55-84 (reproduced in Section 3.7.6). Supplier operates and maintains the ship and is responsible for the safe passage of the onboard cargo. However, in this scenario, Customer may remove Supplier at will and without cause so that it can hire another operator for the ship, or operate the ship itself, during the term of the contract.
Example (continued)

As in ASC 842-10-55-82 and 55-83, the contract depends on the use of an identified asset and Customer has the right to obtain substantially all of the economic benefits from use of the ship, respectively. In addition, HAFWP the ship will be used is predetermined in the contract. However, in this case, Customer has the right to operate the asset throughout the period of use in accordance with ASC 842-10-15-20(b)(1).

Accordingly, the contract contains a lease of the ship.

3.4.2.3.2 Customer Has Designed the Asset

HAFWP an asset is used during the period of use can be predetermined by the design of an asset. If the customer is the party that designed the asset — or is the party that designed aspects with the most influence on HAFWP the entire asset is used — the customer had decision-making rights that extend beyond those of a typical customer in a supply or service arrangement. In those instances, in accordance with ASC 842-10-15-20(b)(2), the customer has the right to direct the use of the asset.

Example 9, Case A, in ASC 842-10-55-108 through 55-111 (reproduced in Section 3.7.9) illustrates an application of the guidance in ASC 842-10-15-20(b)(2). However, as is evident from the discussion and examples below, the complexity of applying ASC 842-10-15-20(b)(2) will often be related to determining how much involvement in the design of the asset is enough to give the customer the right to direct the use of the asset.

Connecting the Dots — Entities Need to Use Significant Judgment in Evaluating Design

We expect that entities in certain industries will need to use significant judgment in evaluating who has the right to direct the use of an asset under ASC 842, especially when HAFWP the asset is used throughout the period of use is predetermined. Although an entity may not have trouble determining whether the customer or supplier has control over the operating decisions related to the asset, the assessment of whether the customer designed the asset will often be more difficult given the different levels of influence a customer may have over the design decisions (e.g., where the asset will reside/operate, determining the technology to be used). Accordingly, we expect that this assessment will be one of the aspects of ASC 842 that will require entities to use the greatest judgment.
The example below illustrates the difficulty in applying judgment in such cases.

Example 3-18

Renewable Power Purchase Agreement

Customer X, a utility company, enters into a 20-year PPA with Supplier Y, a power generation company, to buy all of the electricity produced by a new wind farm that Supplier Y will own. Assume the following:

- The wind farm is explicitly specified in the contract, and Y has no substitution rights.
- The electricity cannot be provided by another asset.
- Customer X hired an expert engineer to help determine the location of the wind farm and its size (i.e., the maximum electricity production capacity).
- Supplier Y is responsible for constructing, operating, and maintaining the wind farm during the contract term.
- All the relevant decisions about where, whether, when, and what amount of electricity will be produced are predetermined as a result of the design decisions and the nature of the asset. That is, the customer cannot change these decisions and, once the asset is constructed, the outputs derived from its use depend largely on weather.
- The wind farm is in a state with an RPS, and X will receive all RECs that accrue from using the wind farm.
- Supplier Y will receive PTCs that result from the operation of the wind farm.

The agreement meets the following conditions to be considered a lease:

- The wind farm is an identified asset because it is explicitly identified and Y does not have substitution rights.
- Customer X has the right to obtain substantially all of the economic benefits from use of the wind farm because it receives 100 percent of the electricity and RECs produced by the wind farm. PTCs do not represent economic benefits because they are an ownership attribute and cannot be monetized by sale to a third party (see Q&A 3-8).

Neither X nor Y may decide how the wind farm is used during the period of use. All relevant decisions about HAPWP the wind farm is used are predetermined by the nature and design of the wind farm. Because Y operates and maintains the wind farm throughout the period of use, X does not meet the condition in ASC 842-10-15-20(b)(1). However, X was involved in the design of the wind farm, so X must also consider whether it has the right to direct the use of the wind farm under ASC 842-10-15-20(b)(2).

We think that more information is needed before the extent of X's involvement in the design of the wind farm can be assessed. For example, the following questions may be considered:

- In determining the maximum capacity of the wind farm, did X also determine how many wind turbines would be installed, or did Y make that design decision?
- How did X select the location? Did X determine that the wind farm should be constructed in Logan County, Oklahoma, within 10 miles of X's interconnection point, or did it determine that the wind farm should be constructed on a specific plot of land in Oklahoma? Who was responsible for ultimately selecting the exact acreage where the wind farm would be constructed?
- Is X's "involvement" in the design only with respect to a competitive request for a proposal that it issued and that Y won?
- Does X decide what technology to use (i.e., manufacturer and model type of turbine blades or drivetrain), and does X configure the wind farm (e.g., determine the placement of the individual turbines within the wind farm)?
Connecting the Dots — Design of a Renewable Generating Asset

As indicated in Example 9, Case A (reproduced in Section 3.7.9), as well as the examples in this section, contracts related to renewable generating assets are expected to often be subject to ASC 842-10-15-20(b)(2). That is, once a weather-dependent renewable generating asset is constructed, generally no HAFWP decisions can be made by any party during the period of use. Certain HAFWP decisions are subject to the weather and are thus outside the control of any party; otherwise, maintenance is essential to the continued operating efficiency of the generating assets once they are installed.

As illustrated in Example 3-18, the evaluation of whether a customer predetermined HAFWP a renewable generating asset is used because of the extent of its involvement in the design of the asset involves significant judgment. A customer may often be involved in some design decisions, but not all. In such cases, the evaluation should focus on whether the customer made the design decisions that most significantly affect the economic benefits to be derived from use of the asset.

The design decisions that most significantly affect the economic benefits from use will differ depending on the nature of the asset (i.e., wind, solar) and may change as these technologies continue to develop. However, we expect that the most significant design decisions will often comprise some combination of the following:

- Selecting the specific generating equipment (e.g., the wind turbines or photovoltaic cells) to be installed.
- Determining the technical design and site layout (e.g., determining whether solar panels will be static or rotate with the sun).
- Determining the specific location of the facility.

We understand that the power and utilities industry is working with stakeholders to develop an interpretive framework for how to assess ASC 842-10-15-20(b)(2) with respect to renewable generating assets. We continue to monitor those developments. In the meantime, we recommend that entities discuss these scenarios with their auditors or accounting advisers.

3.4.2.4 Power Over How and for What Purpose the Asset Is Used Throughout the Period of Use Is Shared

As discussed in Section 3.4, ASC 842 does not address the concept of “shared power.” That is, ASC 842 does not specifically address situations in which the power over decision-making rights related to HAFWP the asset is used throughout the period of use is shared.

Power over HAFWP the asset is used during the period of use is only considered shared when both parties to the arrangement are involved in the decision-making rights that most affect the economic benefits derived from the use of the asset. When power is shared, no single party (i.e., neither the customer nor the supplier) has the right to direct the use of the asset.

For example, assume that the ability to change when and whether an asset is used represents the decision-making rights that most affect the economic benefits derived from the use of that asset. If both the customer and the supplier must approve an order that would call that asset into use for a specific time frame, neither party controls those decision-making rights.
Chapter 3 — Identifying a Lease

Connecting the Dots — Concluding That Power Is Shared

We think that, in practice, there is a high threshold for concluding that power is shared. Such a conclusion can only be reached if the customer and the supplier consent to all the decisions that most affect the economic benefits derived from the use of the asset.

Therefore, in a manner similar to that under the ASC 810 VIE consolidation model (see Section 7.2.7 of Deloitte’s A Roadmap to Consolidation — Identifying a Controlling Financial Interest), it is important to differentiate situations in which power is shared from those in which the supplier and the customer have power over multiple, different activities. As noted in Section 3.4, we think that, in such situations, the guidance in ASC 842 would be aligned with the ASC 810 VIE consolidation model, specifically the provisions in ASC 810-10-25-38E. That is, we think that ASC 842 requires an entity to determine which of the different decision-making rights most affects the economic benefits derived from the use of the asset. The party with the power over that decision-making right has the right to direct HAFWP the asset is used throughout the period of use.

Connecting the Dots — Shared Power Is a Blind Spot

ASC 842-10-15-20 through 15-26 do not specifically address circumstances in which both the customer and supplier must consent to direct HAFWP the asset is used during the period of use. Rather, ASC 842-10-15-20 only focuses on whether the customer has the right to direct the use of the asset. Accordingly, we think it may be reasonable to conclude that, when power is truly shared between the parties, the customer does not have the right to direct the use of the asset and thus there is no lease.

However, we note that when neither the customer nor the supplier has the right to direct HAFWP the asset is used during the period of use, the decision tree in ASC 842-10-55-1 (reproduced in Section 3.2.1) would indicate that HAFWP the asset is used during the period of use is predetermined. That is, the decision tree would point an entity toward applying the tiebreaker test in ASC 842-10-15-20(b) in these situations (see Section 3.4.2.3 for detailed discussion of this guidance).

We therefore think that, when an entity is concluding that power is shared, the entity should consider this path in the decision tree. In these situations, an entity that also performs the analysis in ASC 842-10-15-20(b) can confirm that the entity does not have rights beyond those of a customer in a service arrangement.

3.5 Period of Use

ASC 842-10-20 (reproduced in Appendix A) defines the term “period of use” as 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).”

The term is used throughout this chapter as well as in the Codification examples in Section 3.7. In several places in this chapter, we discuss interpretive issues related to the effect of the term “period of use” on the lease identification assessment, including the following:

- Evaluating the period of use when a substitution right exists in the assessment of whether the supplier has the practical ability to substitute alternative assets (see Section 3.3.3.1).
- Determining whether the customer has the right to obtain substantially all of the economic benefits from use of an asset in contracts in which the customer’s rights to economic benefits change (see Section 3.4.1.3).
“Period of use” is a new term in ASC 842 and clarifies an important concept: a right to use an asset for nonconsecutive periods can be identified as a lease. In these cases, the periods of nonuse should effectively be ignored in the assessment of the right to direct the use and the right to obtain substantially all of the economic benefits from use. The following example illustrates this point:

**Example 3-19**

**Nonconsecutive Periods**

Two unrelated parties, Party X and Party Y, enter into separate arrangements with the owner of an explicitly identified parking garage. The first arrangement gives X the right to use the parking garage from Monday through Friday each week for 10 years. The second arrangement gives Y the right to use the parking garage on Saturday and Sunday each week for the same 10-year period.

Assume that, during the periods stated in the contract, X (for Monday through Friday each week) and Y (for Saturday and Sunday each week) each (1) can obtain substantially all of the economic benefits of the parking garage through their exclusive use and (2) have the right to direct the use of the parking garage. In addition, assume that the owner of the parking garage does not have any substitution rights, so the parking garage is an identified asset.

Although nonconsecutive, the periods of use are as follows:

- **Party X** — 2,600 days in total, calculated as 5 days per week for 52 weeks each year for 10 years.
- **Party Y** — 1,040 days in total, calculated as 2 days per week for 52 weeks each year for 10 years.

Party X would assess whether, throughout the 2,600 days, it has the right to control the use of an identified asset. On the basis of the facts presented above, X has a lease of the parking garage for nonconsecutive periods.

Party Y would perform the same assessment throughout its 1,040 days and, like X, would conclude that it has a lease of the same parking garage for nonconsecutive periods.

Party X and Y, as lessees, would account for the lease in accordance with Section 8.4.3.4. The owner of the parking garage would also account for two leases as a lessor (see Chapter 9 for a discussion of lessor accounting).

### 3.6 Reassessment of Whether a Contract Is or Contains a Lease

**ASC 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.

Lease identification is performed at contract inception in accordance with ASC 842-10-15-2. However, in accordance with ASC 842-10-15-6, the reassessment of “whether a contract is or contains a lease” is not revisited unless “the terms and conditions of the contract are changed.” See Section 8.6.1.1 for additional information.

### 3.7 Codification Examples

**ASC 842-10**

**15-27** See Examples 1 through 10 (paragraphs 842-10-55-41 through 55-130) for illustrations of the requirements for identifying a lease.

**55-41** Examples 1 through 10 illustrate the identification of a lease.
The examples below from ASC 842-10-55-42 through 55-130 reflect implementation considerations related to the guidance in ASC 842-10-15-2 through 15-26 on identifying a lease. Rather than carving up each example and reproducing different pieces throughout this chapter, we have decided to keep them intact in their entirety since we find that approach to be more useful.

Some of the examples may illustrate a specific point with respect to the guidance in ASC 842-10-15-2 through 15-26. Generally, however, each example walks through, at a minimum, the entirety of the analysis of either (1) whether there is an identified asset or (2) whether the customer has the right to control the use of PP&E.

### 3.7.1 Example 1 — Rail Cars

**Example 1 — Rail Cars**

**Case A — Contract Contains a Lease**

**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.

**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).

**55-44** The contract contains leases of rail cars. Customer has the right to use 10 rail cars for 5 years.

**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.

**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.
ASC 842-10 (continued)

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

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.

55-49 The contract does not contain a lease of rail cars or of an engine.

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.

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.

3.7.2 Example 2 — Concession Space

ASC 842-10

Example 2 — Concession Space

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.

55-53 The contract does not contain a lease.
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.

### 3.7.3 Example 3 — Fiber-Optic Cable

**Example 3 — Fiber-Optic Cable**

**Case A — Contract Contains a Lease**

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).

The contract contains a lease of dark fibers. Customer has the right to use the 3 dark fibers for 15 years.

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.

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.

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**

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).
ASC 842-10 (continued)

55-61 The contract does not contain a lease.

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.

3.7.4 Example 4 — Retail Unit

ASC 842-10

Example 4 — Retail Unit

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.

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.

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.

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.

55-67 Supplier provides cleaning and security services as well as advertising services as part of the contract.

55-68 The contract contains a lease of retail space. Customer has the right to use Retail Unit A for five years.

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.
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.

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.

3.7.5 Example 5 — Truck Rental

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 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.

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.

Customer is responsible for driving the truck from New York to San Francisco.

The contract contains a lease of a truck. Customer has the right to use the truck for the duration of the specified trip.

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

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.
3.7.6 Example 6 — Ship

Case A — Contract Does Not Contain a Lease

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.

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.

The contract does not contain a lease.

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.

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.

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

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.

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.

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.

The contract contains a lease. Customer has the right to use the ship for five years.
3.7.7 Example 7 — Aircraft

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.

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.

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.

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.

The contract contains a lease. Customer has the right to use the aircraft for two years.

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.
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.

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.

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.

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).

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.

The contract does not contain a lease.

The factory is an identified asset. The factory is implicitly specified because Supplier can fulfill the contract only through the use of this asset.

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.

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).

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.
3.7.9 Example 9 — Contract for Energy/Power

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Example 9 — Contract for Energy/Power
Case A — Contract Contains a Lease
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.

55-109 The contract contains a lease. Customer has the right to use the solar farm for 20 years.

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.

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
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.

55-113 The contract does not contain a lease.

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.
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.

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

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).

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.

55-119 Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices.

55-120 The contract contains a lease. Customer has the right to use the power plant for 10 years.

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.

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.

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.
3.7.10 Example 10 — Contract for Network Services

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Example 10 — Contract for Network Services
Case A — Contract Does Not Contain a Lease

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.

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.

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

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.

55-128 The contract contains a lease. Customer has the right to use the server for three years.

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.

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.
3.8 Decision Tree for Identifying a Lease

The decision tree below combines those in Sections 3.3, 3.4.1, and 3.4.2. It summarizes, graphically, the analysis for identifying whether a contract is, or contains, a lease.
Chapter 4 — Components of a Contract

4.1 Introduction
4.2 Identify the Separate Lease Components
   4.2.1 Separating Lease Components
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4.4 Determining and Allocating Consideration in the Contract
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4.5 Contract Combinations
4.1 Introduction

The phrase “whether a contract is or contains a lease” (emphasis added) is consistently used throughout ASC 842-10-15 and Chapter 3 of this Roadmap. The reason behind this wording choice is more fully explained in Section 3.2.2 — a lease may be embedded in a larger service arrangement. When that is the case, contracts contain both lease and nonlease components. Generally, the nonlease components are services that the supplier is also performing for the customer. For example, in a single contract, the supplier could be leasing equipment to a customer while also agreeing to provide ongoing maintenance services for the equipment throughout the period of use.

Further, in paragraph BC143 of ASU 2016-02, the FASB acknowledges that contracts may contain multiple lease components. Paragraph BC143 of ASU 2016-02 cites a contract for the right to use a marine port as one example of a contract that may contain several lease components (e.g., leases of land, buildings, and equipment).

Changing Lanes — More Guidance on How to Separate, and Allocate Consideration to, Components of a Contract

ASC 840-10-15-16 through 15-19 (formerly EITF Issue 01-8) require separation of, and allocation of consideration to, lease and nonlease components. However, ASC 840 provides little guidance on how to perform such separation and allocation. Accordingly, the FASB recognized the need for more comprehensive guidance on accounting for contracts that contain multiple components. Specifically, paragraph BC144 of ASU 2016-02 states:

Previous GAAP provided limited guidance on how to separate lease components and nonlease components of a contract, even though it required that separation. Because Topic 842 results in lease components of a contract being accounted for differently from nonlease components (for all leases except short-term leases for which a lessee elects the recognition and measurement exemption), the Board decided to provide expanded guidance on how entities should account for contracts that contain both lease components and nonlease components.

Paragraph BC144 of ASU 2016-02 explains that, because the customer’s accounting for a lease results in balance sheet recognition (except for short-term leases — see Chapter 8 for detailed discussion of lessee accounting) while its accounting for a service generally does not, ASC 842 places additional emphasis on the separation of lease and nonlease components. That is, the Board is increasing the importance of appropriately identifying the components of — and consideration in — a contract that is subject to balance sheet recognition. In addition, since operating leases have different income statement effects than finance leases, separation of multiple lease components remains relevant.

The guidance in ASC 842-10-15 effectively establishes the following process for identifying the contract component(s) (i.e., the units of account) and consideration subject to lease accounting:

1. Considering whether the contract involves the use of PP&E, as covered in ASC 842-10-15-1 (see Chapter 2).
2. Assessing whether that contract is, or contains, a lease, as addressed in ASC 842-10-15-2 through 15-27 (see Chapter 3).
3. Determining which lease component(s) in that contract is (are) subject to the recognition and measurement guidance in ASC 842, as covered in ASC 842-10-15-28 through 15-42 (discussed in the remainder of this chapter).
Chapter 4 — Components of a Contract

The third part of the process is expanded in the graphic below, which outlines steps related to considering how to separate, and allocate consideration to, components in a contract under ASC 842. Each of these steps is discussed in greater detail in the remainder of this chapter.

4.2 Identify the Separate Lease Components

**ASC 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.

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).
Once an entity determines that a contract is, or contains, a lease (i.e., part or all of the contract is a lease — see Chapter 3), the entity (i.e., both the customer and the supplier) must assess whether the contract contains multiple lease components (i.e., when a contract conveys the rights to use multiple underlying assets). ASC 842-10-15-28(a) and (b) prescribe criteria (reproduced above) for identifying whether one lease component is considered separate from other lease components in the contract.

However, land is considered an exception to the guidance in ASC 842-10-15-28. In accordance with ASC 842-10-15-29, a right to use land must be separated from the rights to use other underlying assets (e.g., from the right to use a building that sits on top of the land), unless the effect of separating the land is insignificant to the resulting lease accounting.

**Connecting the Dots — Importance of the Unit of Account**

Paragraph BC145 of ASU 2016-02 stresses that it is important for an entity to identify the appropriate unit of account when applying the lessee or lessor accounting models in ASC 842 (see Chapters 8 and 9, respectively), since the unit of account can affect the allocation of consideration to the components in the contract. Specifically, paragraph BC145 of ASU 2016-02 states, in part:

> By way of example, regarding allocation, the Board noted that the standalone price (observable or estimated) for a bundled offering (for example, the lease of a data center) may be substantially different from the sum of the standalone prices for separate leases of the items within a bundled offering (for example, the lease of each asset in the data center). Given the substantially different accounting for lease and nonlease components in Topic 842, the allocation of contract consideration carries additional importance as compared with previous GAAP. Consequently, the Board concluded that including separate lease components guidance in Topic 842 will result in more accurate accounting that also is more consistent among entities.

ASC 840 does not include guidance on how to identify the unit of account to which lease accounting should be applied. For example, ASC 840 does not specify whether to classify rights to use several underlying assets in a contract individually or as a single right of use. Rather, in practice, interpretive guidance arose that was effective but not necessarily based on GAAP. Accordingly, in the Board’s view, ASC 842 reflects an improvement over ASC 840 in this area.

The decision tree below illustrates how an entity might think about the guidance in ASC 842-10-15-28 and 15-29 for each contract containing a lease.
The contract is, or contains, a lease.

Does the contract convey multiple rights of use (i.e., the rights to use multiple assets)?

Yes

Does the contract convey a right to use land along with the other assets?

No

No

Yes

Would the effect of accounting for the right to use land as a separate lease component be insignificant?

No

No

Yes

Do not separate the right to use land. Include the land when evaluating the rights to use the other assets.

Separate the right to use land from the other rights of use. Continue evaluating the rights to use the other assets.

Evaluate each right of use (or bundle of rights of use) for separation from the other rights of use.

Can the customer benefit from the right of use on its own or together with other readily available resources?

No

Combine two or more rights of use and reevaluate the new bundle.

Yes

Is the right of use highly dependent on, or highly interrelated with, the other rights of use in the contract?

No

Account for the right of use as a separate lease component.

Yes

Assess whether the contract contains any nonlease components (see Section 4.3).
4.2.1 Separating Lease Components

Effectively, the guidance in ASC 842-10-15-28 is intended to help entities evaluate whether the parties are contracting to provide the customer with multiple, individual outputs (i.e., multiple rights of use) or a single output (i.e., a single right of use) that comprises multiple inputs. To accomplish this objective, the FASB uses two criteria:

- The customer can economically benefit from the right of use (1) on its own or (2) together with other, readily available resources. “Readily available resources” could be those that the customer can obtain separately (whether from the supplier in the contract or others) or those that have already been transferred to the customer in the current contract or other, prior contracts. For example, the fact that a right of use is contracted on its own is an indicator that it meets this first criterion.

  This criterion is intended to be effectively the same as the “capable of being distinct” criterion in ASC 606-10-25-19(a) and 25-20 with respect to determining whether a performance obligation is distinct. Accordingly, when evaluating this first criterion for a contract that is, or contains, a lease, an entity may find it helpful to consider the guidance in Section 5.3.2.1 of Deloitte’s Revenue Roadmap.

- The right of use is “neither highly dependent on nor highly interrelated with” other rights of use in the same contract (i.e., the right of use is separately identifiable). The right of use may not be separately identifiable if (1) the supplier integrates it with other rights of use in the contract in such a way that it is only one input in an effort to deliver a combined right of use (i.e., a single output) to the customer or (2) it significantly modifies or affects — or is significantly modified or affected by — the other rights of use in the contract.

  This criterion is intended to be effectively the same as the “distinct within the context of the contract” criterion in ASC 606-10-25-19(b) and ASC 606-10-25-21 with respect to determining whether a performance obligation is distinct. Accordingly, when evaluating this second criterion for a contract that is, or contains, a lease, an entity may find it helpful to consider the guidance in Section 5.3.2.2 of Deloitte’s Revenue Roadmap.

Connecting the Dots — Similarities Between Identifying Separate Lease Components Under ASC 842 and Identifying Separate Performance Obligations Under ASC 606

The concept of separating lease components under ASC 842 is similar to the notion of identifying performance obligations under ASC 606. Specifically, paragraph BC146 of ASU 2016-02 states:

The separate lease components guidance in paragraph 842-10-15-28 is similar to the guidance on identifying performance obligations in Topic 606, and, therefore, the Board expects that it will be applied in a similar manner. . . . Accordingly, rather than developing entirely separate requirements addressing how to identify separate lease components, the Board decided that it is logical to provide requirements similar to those in Topic 606 on the identification of performance obligations to determine whether a lessee is contracting for the right to use multiple underlying assets (for example, five vehicles) or for the right to use a single solution that is comprised of multiple assets (for example, many data centers or manufacturing facilities).
In other words, the Board’s intention was not to create a different set of requirements for separating lease components but to link the concepts from the two standards so that they may be applied consistently. Accordingly, we think that the guidance in ASC 606— as well as Deloitte’s related interpretive guidance in Section 5.3.2 of Deloitte’s Revenue Roadmap — will be helpful to entities applying the guidance in ASC 842-10-15-28. Further, ASC 606’s guidance on identifying performance obligations is more robust and descriptive than ASC 842’s guidance on separating lease components. ASC 606 also contains more examples that address the “distinct” criteria.

The link between the new revenue and leasing standards will be a consistent theme throughout the remainder of this chapter, since the two standards are also similar regarding the allocation and reallocation of the consideration to the components in the contract.

The example below illustrates the guidance in ASC 842-10-15-28. (See Section 4.2.3 for additional examples, including an illustration of a situation in which the right to use land is not separated from other rights of use in the contract.)

**Example 4-1**

**Landscaping Heavy Machinery**

Garden Co., the lessee, leases a dump truck, riding lawn mower, and skid loader from Tools Inc., the lessor. Tools Inc. sells and leases each piece of machinery separately to other customers and lessees, respectively, during its normal course of business.

Although it leased all three pieces of machinery together for use in its landscaping business, Garden Co. determined that the rights to use the machinery represent three separate lease components. This conclusion is based on the following:

- Garden Co. can economically benefit from the use of each piece of machinery on its own or together with other, readily available resources. For example, Garden Co. can lease separately — either from Tools Inc. or from another supplier — an excavator that may be used in conjunction with the dump truck to perform the landscaping services that it provides to its customers.

- Each piece of machinery is neither highly dependent on, nor highly interrelated with, the others. Tools Inc. is not integrating the rights to use the machinery into a single, combined right of use. Further, no piece of machinery is significantly modified or affected by the others — they do not come together, for example, to form a larger, more efficient piece of machinery.

Accordingly, Garden Co. and Tools Inc. would account for each piece of machinery as a separate lease component in accordance with the lessee and lessor accounting models, respectively.

**4.2.2 Land and Other Assets**

ASC 842-10-15-29 requires that land be considered a separate lease component in a contract involving land and other assets, unless the effect of separately accounting for the land portion of the contract is insignificant.

**Connecting the Dots — The Nature of Land**

Paragraph BC147 of ASU 2016-02 states, in part:

Topic 842 also requires an entity to account for a right to use land as a separate lease component, even if the separating lease components criteria are not met, unless the accounting effect of doing so would be insignificant. The Board decided that land, by virtue of its indefinite economic life and nonpredictable nature, is different from other assets, such that it should be assessed separately from other assets regardless of whether the separating lease components criteria are met.
Paragraph BC147 of ASU 2016-02 can be interpreted as meaning that if an entire building were leased, the lessee would implicitly also be leasing the land on which the building sits. Because the underlying land asset is subject to unique risks compared with those of the building, the right to use the land should be accounted for as a separate lease component (unless the accounting effect of doing so would be insignificant).

However, the same may not be true if an entity is leasing only part of a building (e.g., a physically distinct portion of a larger building, such as a single floor in an office building). Entities should consider whether facts and circumstances indicate otherwise, but in these situations, we do not expect that a lessee will have an implicit lease of the underlying land. (See Q&A 4-2 for further discussion.)

ASC 842 does not explicitly define the term “insignificant,” as used in ASC 842-10-15-29. Therefore, management will need to use judgment in applying this term. In determining significance, an entity should separately assess (1) whether separating the land component affects the classification of any lease component, (2) the value of the land component in the context of the overall contract, and (3) whether the right to use the land is coterminous with the rights to use the other assets.

For example, if a lease includes both land and a building component and an entity concludes that both components would be classified as an operating lease over the same lease term if they are accounted for separately, it may be reasonable for the entity to conclude that the difference between accounting for the two lease components together and accounting for the land and building separately would be insignificant.

ASC 842-10-15-29 gives two examples illustrating when the accounting effect of separating the right to use land from other rights of use would be insignificant, both of which are mentioned above. The first of those examples (i.e., the effect on lease classification) is discussed in the preceding paragraph. The Changing Lanes section below and Q&A 4-1 address the second (i.e., the value of the right to use the land). A third example (i.e., the terms of the different rights of use), also mentioned above, is discussed in Example 13 in ASC 842-10-55-146 through 55-149 (reproduced in Section 4.2.3).

**Changing Lanes — Bifurcation of the Land Component May Be More Common**

ASC 842’s approach to accounting for leases of land and other assets is consistent with the historical approach in IAS 17 under IFRS Standards but represents a change from the U.S. GAAP guidance in ASC 840. The guidance in ASC 840 requires a lessee to do the following for land and other assets: (1) when the lease meets either the transfer-of-ownership or bargain-purchase-price classification criteria, account for the land and other assets separately (see ASC 840-10-25-38(a)), or (2) when the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception, classify the land and other assets separately (as discussed in Q&A 4-1 below). The new approach may result in more bifurcation of real estate leases into separate lease components.

**Q&A 4-1 Use of a 25 Percent Threshold to Separate Land**

To determine when the right to use land must be accounted for separately under ASC 840-10-25-38(b), an entity uses a 25 percent threshold to compare the fair value of the land with the fair value of the entire leased property. That is, under ASC 840, if the fair value of the underlying land is less than 25 percent of the fair value of the entire leased property, the land is combined with the other rights of use.
Question
Is it appropriate to use a 25 percent threshold to determine whether land should be separated in accordance with ASC 842-10-15-29?

Answer
No. The concept behind the guidance in ASC 842-10-15-29 (discussed in the Connecting the Dots above) differs from that in ASC 840.

Under ASC 842, the value of the land component in a contract containing the right to use land and other assets may be considered in the determination of whether the accounting effect of separating the land component is insignificant. However, the sole reliance on any bright-line threshold based on the land value, compared with the total property value, would not be appropriate in this assessment.

For example, although the land component in a contract containing the right to use land and a building may represent a fair value that is lower than 25 percent of the entire leased property, the lease classification for the right to use the land could differ from that for the right to use the building. In such situations, an entity should consider all facts and circumstances to determine whether the accounting effect of not separating the components is insignificant.

Entities should also consider arrangements in which lessees are leasing a significant capacity portion of a building (or another asset atop land). Such arrangements may inherently convey a right to use the underlying land and would need to be assessed in accordance with ASC 842-10-15-29. The following Q&A further explains this notion:

Q&A 4-2 Inherent Land Leases When the Capacity Portion of a Building Is Leased

Question
Should a lessee in a multitenant building consider whether there is a right to use the land underlying the building that is a separate lease component?

Answer
It depends. Regardless of the capacity of the building it is leasing, a lessee in a multitenant building inherently has some rights to use the underlying land. However, the land may not represent an identified asset to the lessee in such a way that the lessee would have the right to control the use of an identified asset (i.e., in such a way that the lessee would have a lease of the land, as defined in ASC 842-10-15-3 and 15-4 and further discussed in Chapter 3 of this Roadmap).

A lessee in a multitenant building will have the right to control the use of a physically distinct portion of the building, but its rights related to the underlying land are not over a physically distinct portion of the land unless the lessee is, in effect, leasing the entire building. In such cases, the lessee is also effectively leasing the entire, underlying plot of land. Therefore, we think that when the lessee has the right to control the use of substantially all of the capacity of the building, it also has the right to control the use of substantially all of the capacity of the land. (See Section 3.3.2 for further discussion of when a capacity portion of a larger asset is an identified asset.)
In such arrangements, lessees and lessors should consider whether the lessee’s rights to use the land represent a separate lease component in accordance with ASC 842-10-15-29.

**Q&A 4-2A  Allocation of the Fair Value of Land When a Portion of a Multitenant Building Is Leased**

**Question**

In a lease for a portion of a multitenant building, should an entity take the fair value of the underlying land into account when performing the fair value test for lease classification?

**Answer**

It depends. As discussed in Q&A 4-2, when a lessee leases a portion of a multitenant building, the lessee generally only has the ability to control the use of the underlying land if it has the ability to control the use of substantially all of the capacity of the building that rests on that land. If the lessee is able to control the underlying land, both the lessee and the lessor should account for the lessee’s right to use the land as a separate lease component (unless the accounting effect of doing so would be insignificant as stated in ASC 842-10-15-29). When accounting for the right to use the underlying land as a separate lease component, an entity would allocate lease payments separately between the two lease components (i.e., the lease of land and lease of the building). Accordingly, an entity would separately compare the present value of those allocated lease payments with the fair value of the underlying land and the fair value of the building in assessing the classification of each lease component in accordance with ASC 842-10-25-2(d).

However, if the control assessment reveals that the lessee does not control the land and no other tenant in the building obtains substantially all the use of the land, the land does not represent a separate lease component. In these cases, the lease payments that would otherwise be allocated to the land component instead would be entirely allocated to the lease of the lessee’s portion of the building. We believe that the lessee and the lessor should consider whether some of the lease payments *economically* represent payments to use a portion of the underlying land. If so, in the assessment of the classification of the lease, the fair value of the underlying asset should include both the fair value of the lessee’s portion of the building and a proportional amount of the fair value of the underlying land.

For more information about lease classification and about evaluating whether the present value of lease payments represents substantially all of the fair value of a lease component, see Section 8.3.3.6 for lessee considerations and Section 9.2.1.4 for lessor considerations.

**Example 1**

Lessee and Lessor enter into a lease agreement in which Lessee obtains the right to use multiple floors of a building for a term of 10 years. Lessee is the most significant tenant and occupies a majority of the floors in the building, which represents approximately 95 percent of the building's usable square footage. The building takes up the entire underlying land of the property. Accordingly, no other structures can be built on the land and the tenants of the building collectively are receiving the full economic benefits from the use of the land during the lease term. No individual tenant has the right to use a physically distinguishable portion of the underlying land.

The terms of the lease agreement require that Lessee make lease payments of $30 million annually at the end of each year for the entire 10-year lease term. The fair value of the entire property is $500 million, of which $100 million is related to the land and $400 million is related to the building. The stand-alone prices (lessees) and stand-alone selling prices (lessors) of the right to use the land and building components are $66 million and $264 million, respectively. Lessee has an incremental borrowing rate of 10 percent.
Example 1 (continued)

Both entities (Lessee and Lessor) have concluded that the ability to control 90 percent or more of the building is indicative of substantially all of the building's capacity. Because Lessee has the right to use 95 percent of the building, both entities (Lessee and Lessor) have determined that Lessee has the right to control the use of substantially all of the economic benefits of the building and therefore also has the right to control the use of 100 percent of the underlying land. Lessee and Lessor will account for the building and the land as two separate lease components and will allocate the consideration to be paid over the lease term on the basis of each component's relative stand-alone price (lessees) and stand-alone selling price (lessors).

As illustrated in the table below, Lessee and Lessor will allocate $60 million, or 20 percent, of the total consideration of $300 million to the land and the remaining $240 million to the building. Lessee will use its incremental borrowing rate of 10 percent to calculate the present value of these payments, yielding approximately $37 million and $147 million for the land and building lease components, respectively. Lessee will then compare the present value of these payments with the fair value of $100 million and approximately $380 million (95 percent of the total building fair value) for the land and building lease components, respectively, to determine whether these payments represent substantially all of the fair value of the underlying asset in accordance with ASC 842-10-25-2(d).

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Prices</th>
<th>Percentage of Total Stand-Alone Price</th>
<th>Allocated Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>66</td>
<td>20%</td>
<td>60</td>
</tr>
<tr>
<td>Building</td>
<td>264</td>
<td>80%</td>
<td>240</td>
</tr>
<tr>
<td>Total</td>
<td>330</td>
<td></td>
<td>300</td>
</tr>
</tbody>
</table>

Example 2

Assume the same facts as in Example 1, except that the lessee only controls 80 percent of the capacity of the building. Because Lessee's capacity is less than 90 percent of the building, Lessee does not have the right to control the use of substantially all of the economic benefits of the building and no other tenant obtains substantially all of the economic benefits (i.e., the other 20 percent, regardless of whether it is used by one or more tenants, is not substantially all). As a result, the underlying land would not be accounted for as a separate lease component.

In this example, both entities (Lessee and Lessor) will allocate the entirety of their future lease payments of $300 million to the building, which is the only lease component. Lessee will then compare the present value of these lease payments of approximately $184 million with the fair value of its allocable portion of the property. Because Lessee occupies 80 percent of the capacity of the building, it will allocate approximately 80 percent of the total property value (including land) to the building in this calculation. Thus, Lessee will use a fair value of $400 million (80% of $500 million) in its lease classification test.

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1. Lessor would calculate the present value of the lease payments by using its rate implicit in the lease; however, such a calculation is not included in this example.
2. This balance reflects the present value of the allocated portion of annual lease payments paid over the lease term of 10 years. Thus, the land component represents the present value of lease payments of $6 million (20% × $30 million) per annum and the building component represents the present value of lease payments of $24 million (80% × $30 million) per annum, both paid over the 10-year lease term and discounted at Lessee's 10 percent incremental borrowing rate.
3. Lessor would use its rate implicit in the lease to calculate the present value of lease payments and compare that with the fair value of the allocable portion of the total property associated with the ROU asset ($400 million in this example). This example does not illustrate that approach.
4. This balance reflects the present value of the $30 million of annual lease payments paid for the lease term of 10 years and discounted at Lessee's incremental borrowing rate of 10 percent.
Changing Lanes — Classification of the Land Component Under ASC 840

In addition to the lack of a 25 percent threshold under ASC 842 (discussed in Q&A 4-1), the new guidance diverges from ASC 840 in both how consideration is allocated to the land and building elements of the lease arrangement, as well as the classification of these elements.

ASC 840-10-25-38-2(b)(2) prescribes how consideration is allocated between the land and building elements of a lease arrangement, stating, in part:

The minimum lease payments after deducting executory costs, including any profit thereon, applicable to the land and the building shall be separated by the lessee by determining the fair value of the land and applying the lessee's incremental borrowing rate to it to determine the annual minimum lease payments applicable to the land element; the remaining minimum lease payments shall be attributed to the building element. [Emphasis added]

However, under ASC 842, the land element of the lease arrangement is allocated consideration in the same manner as the other components in the contract (i.e., on the basis of its relative stand-alone price or stand-alone selling price). Further, depending on the entity's determination of whether to separate lease and nonlease components in the contract for that asset class, allocated consideration may or may not include certain costs defined as executory costs under ASC 840.

From a classification perspective, ASC 840-10-25-38(b)(2) states the following, in part:

i. If the building element of the lease meets the lease-term criterion in 840-10-25-1(c) or the minimum-lease-payments criterion in paragraph 840-10-25-1(d), the building element shall be accounted for by the lessee as a capital lease and amortized in accordance with the guidance in paragraph 840-30-35-1(b). The land element of the lease shall be accounted for separately by the lessee as an operating lease. [Emphasis added]

ii. If the building element of the lease meets neither the lease-term criterion in 840-10-25-1(c) nor the minimum-lease-payments criterion in paragraph 840-10-25-1(d), both the building element and the land element shall be accounted for by the lessee as a single operating lease.

ASC 842 diverges from this approach, since both lease components would be subject to the lease classification test in ASC 842-10-25-2. While the land component of a lease would never meet the economic-life criterion in ASC 842-10-25-2(c) as a result of its indefinite life, lease payments allocated to this component may represent substantially all of the fair value of the underlying land. Accordingly, scenarios may exist in which the land component is classified as a finance or sales-type lease by passing the fair value test in ASC 842-10-25-2(d), whereas land is always classified as an operating lease under ASC 840. For more information about the lease classification tests under ASC 842, see Section 8.3.

4.2.3 Applying the Guidance on Separate Lease Components

The examples and Q&A below — the first of which is reproduced from ASC 842-10-55-146 through 55-149 — illustrate the process outlined in the decision tree in Section 4.2.1 and the guidance in ASC 842-10-15-28 and 15-29 (further discussed in Section 4.2.2).
Example 13 — Lease of a Turbine Plant

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.

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).

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.

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.

Example 4-2

City Living Properties, the lessor, rents a fully furnished, newly renovated high-rise apartment building with an elevator to Easy Rentals, the lessee, for a term of 20 years. Easy Rentals will eventually lease the building's fully furnished, individual apartment units to tenants. Easy Rentals pays one fixed monthly rental payment to City Living Properties.

The apartment building, elevator, and apartment furnishings have a 40-, 20-, and 10-year useful life, respectively. The land on which the building sits has an indefinite useful life. Easy Rentals determines that it has the right to use four underlying assets: (1) the apartment building, (2) the elevator, (3) the land, and (4) the apartment furnishings.
Example 4-2 (continued)

Further, Easy Rentals determines that the leases for both the land and the building are operating leases (see Chapter 8 for further discussion of the lessee classification guidance), primarily because the 20-year stated lease term, when compared with the useful life of each underlying asset, will not result in a finance lease classification conclusion for either. Therefore, Easy Rentals reasonably concludes that the accounting effect of separating the land from the building is insignificant.

The combined land and building component and the elevator are not separately identifiable because they are highly dependent and highly interrelated. The rights to use the land, building, and elevator are inputs into the delivery of a single right to use a high-rise apartment building. Therefore, these rights are considered one lease component in the contract. When classifying the lease, Easy Rentals would use the useful life of the predominant asset within the bundle to determine the useful life of the entire lease component (i.e., 40 years, because the apartment building is the predominant asset).

The apartment furnishings are a separate lease component, since they can be used independently of the single lease component for the high-rise apartment building. Easy Rentals can use the apartment furnishings on their own or together with other readily available resources to economically benefit from the right of use. When making this determination, Easy Rentals considers the characteristics of the lease component itself, regardless of contractual limitations (i.e., it does not consider the way in which it may use or be allowed to use the lease component).

In addition, the apartment furnishings are not highly dependent on, or highly interrelated with, the single high-rise apartment building lease component. Rather, they are separately identifiable and are not combined with the high-rise apartment building to deliver a single right of use.

Easy Rentals would therefore allocate the consideration in the contract between (1) the single high-rise apartment building lease component and (2) the apartment furnishings. Allocation to components of a contract is further discussed in Section 4.4.

Q&A 4-2B Identifying Lease Components When the Underlying Asset Is Replaced During the Lease Term

Certain lease arrangements may either require or allow for replacement of the underlying asset by the lessor during the term of the arrangement. That is, in such arrangements, it is expected (or required) at contract inception that the underlying asset will be replaced. The purpose of such replacement may be to ensure that the underlying asset continues to meet agreed-upon performance standards for the lessee.

Example

A lessee enters into a noncancelable contract with a lessor to obtain IT processing services by using a dedicated server for 10 years in exchange for 10 years of fixed periodic payments. Assume that the contract provides the lessee with a right to control an identified asset (the server) is used throughout the 10-year contract term (i.e., the contract contains a lease of the server). The expected useful life of the server is five years.

In this example, the contract stipulates that the lessor must replace the server once during the contract term. Since the original server has a useful life of five years, it is expected to be replaced at the end of year 5. The purpose of the replacement is to maintain a standard level of IT processing services provided to the lessee. The contract pricing is established up front and does not change as a result of the server replacement. The replacement server provides essentially the same benefit and functionality as the original server; however, it is unlikely that the original server would have continued to provide the same level of benefit for the entire 10-year contract term.

The apartment furnishings may need to be separated further (e.g., a couch is separable from a table); however, for illustration purposes, such an evaluation is not performed.
**Question 1**

How should the lessee in the example above determine the lease component(s) and lease term when evaluating lease classification at lease commencement and measuring its ROU asset and lease liability?

**Answer**

The lessee should consider each asset (i.e., the original server and the replacement server) as a separate lease component with separate lease terms — that is, there are two separate lease components in this example. The lease terms of the separate lease components can be determined by considering the expected replacement dates (five years in the above example), but we would not expect the lease term to exceed the estimated useful life of the underlying asset in a scenario in which an asset must be replaced to maintain minimum performance standards.

The lessee should allocate the consideration (e.g., gross lease payments expected to be paid over the course of the lease terms of the lease components) between the two lease components on a relative stand-alone price basis and should record an ROU asset and lease liability for the first asset (i.e., the server provided at commencement) at lease commencement by using the discounted lease payments over the lease term for that asset (five years). (See Section 7.2 for more information about determining the discount rate to be used by a lessee.) The lessee should use the five-year lease terms (and corresponding lease payments) in determining the lease classification.

The example above is analogous to a master lease agreement in which the lessee is committed to using a minimum quantity of assets. A master lease agreement may specify that the lessee will obtain control over the right to use multiple underlying assets (e.g., servers) at various points during the term of the master lease agreement. In these cases, the lessee's accounting depends on whether the master lease agreement commits the lessee to obtaining control over the right to use a minimum quantity (units or dollar value) of assets — see Section 13.4.1 for more information about such master lease agreements.

In the above example, the lessee commits to obtaining control over the right to use two servers (the original server and the replacement server). In accordance with ASC 842-10-55-17, because the lessee is obligated to use a minimum quantity of equipment, the lessee must consider the minimum quantity of equipment (i.e., two servers) when identifying the separate lease components and allocating the consideration in the contract. Further, the server to be provided in year 5 does not qualify as an identified asset at lease commencement of the original server under ASC 842-10-15-9, which indicates that an asset can be identified “at the time that the asset is made available for use by the customer.” In other words, a lease does not commence until an identified asset is made available for the customer’s use.

We would expect the lessee in such an arrangement to disclose the “forward-starting” lease of the server provided in year 5, if material, as required by ASC 842-20-50-3(b), which states that a lessee should disclose “[i]nformation about leases that have not yet commenced but that create significant rights and obligations for the lessee.” The lessee would record an ROU asset and lease liability for the remaining five-year lease term once the lease of the replacement server commences.
**Question 2**

Would the answer to Question 1 differ if the contract required the lessor to continually provide a server that meets certain minimum performance standards (e.g., processing speed and capacity for a server) but did not explicitly require a replacement during the 10-year term (if it is assumed that all other facts remain the same)?

**Answer**

It depends. The lessee should consider the specific facts and circumstances of the arrangement, including the expected useful life of the asset(s), when determining the lease component(s) and lease term(s). If the lessee determines that the expected useful life of the underlying asset is less than the overall lease term (i.e., the underlying asset is not expected to be able to meet certain minimum performance standards over the course of the lease term), the lease arrangement may, in substance, involve the use of two (or more) lease components to fulfill the obligations under the arrangement. This is because the lessor could not satisfy its obligation to the lessee to maintain minimum performance standards without replacing the assets during the lease term.

**Question 3**

Would we expect there to be symmetry between the lessee and lessor in the evaluation of lease components and the lease term in arrangements that include the right or obligation (implicit or implied) to replace the original asset?

**Answer**

Yes. The lessee and lessor in an arrangement that contains the right or obligation (including implied rights or obligations) to replace the original asset would have the same contractual rights and obligations; therefore, the determination of the lease components and lease term should generally be aligned. In the above example, the lessor is delivering two lease components to the lessee (i.e., the original server and the replacement server). The lessor would evaluate lease classification separately for the two identified lease components and account for the lease agreements in accordance with ASC 842-30.

### 4.3 Identify the Separate Nonlease Components

**ASC 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 for lessee allocation guidance and paragraphs 842-10-15-38 through 15-42C 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.
Chapter 4 — Components of a Contract

ASC 842-10 (continued)

Pending Content (Transition Guidance: ASC 842-10-65-1)

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.

Once the separate lease components are identified (see Section 4.2), entities must determine whether there are any nonlease components to be separated. An allocation of the consideration in the contract is required for both lease and nonlease components, since they transfer a good or service to the customer. However, as indicated in ASC 842-10-15-30, such allocation does not extend to activities that do not transfer a good or service to the customer (e.g., administrative tasks and reimbursement or payment of the lessor's costs).

Practical expedients may be available that, upon election, would allow entities not to separate, and thus not allocate consideration in the contract between, lease and nonlease components (see Section 4.3.3 for further discussion).

Q&A 4-3   Payments for Components Besides the Lease

Question

In a contract that contains a lease, how should an entity account for payments for items or activities that transfer a good or service and payments for items or activities that do not?

Answer

An entity would first need to identify the various components of a contract. ASC 842-10-15-30 notes that “[c]omponents of a contract include only those items or activities that transfer a good or service to the lessee.” For example, a contract may include a separate lease component (e.g., the right to use the underlying asset that is the subject of the agreement) as well as additional goods or services that are transferred to the lessee (e.g., maintenance services), which are nonlease components (see Section 4.3.1).
Contracts often include other costs or fees that do not provide a separate good or service to the lessee — for example, costs paid by the lessee, such as (1) the cost of administrative tasks performed to set up a contract or initiate the lease or (2) reimbursement or payment of the lessor’s costs (e.g., property taxes and insurance related to the leased asset). These types of costs do not transfer a good or service to the lessee and would therefore not be considered a component in the contract (see Section 4.3.2).

An entity is required to allocate the total consideration in a contract (including all amounts charged for administrative start-up, property taxes, and some insurance — see Section 4.4.1.1 for lessees and Section 4.4.2.1 for lessors) to its identified separate lease and nonlease component(s). The manner of allocating the consideration depends on whether the entity is the lessee (see Section 4.4.1.2) or lessor (see Section 4.4.2.2) in the arrangement.

The graphic below summarizes the concepts in ASC 842-10-15-30 and Q&A 4-3.

The accounting for lease components differs from that for nonlease components, as articulated in ASC 842-10-15-31.6

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6 In July 2018, the FASB issued ASU 2018-11, which includes a practical expedient that allows lessors, when certain conditions are met, not to separate lease and nonlease components. Lessors availing themselves of this practical expedient would not account for affected nonlease components separately. See Sections 4.3.3.2 and 17.3.1.4.2 for further discussion.
Understanding the difference between lease components, nonlease components, and “noncomponents” (i.e., activities paid for by the customer that do not transfer a good or service to the customer) will be critical throughout the remainder of this chapter. The table below outlines these three types of components in greater detail.

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lease Component</strong></td>
<td>The right to use an underlying asset is considered a separate lease component if (1) a lessee can benefit from the use of the underlying asset either on its own or with other resources that are readily available and (2) the underlying asset is not highly dependent on or highly interrelated with other assets in the arrangement. Separate lease components are discussed in detail in Section 4.2.</td>
</tr>
<tr>
<td><strong>Nonlease Component</strong></td>
<td>An activity that transfers a separate good or service to the customer is a nonlease component. For example, maintenance services consumed by the customer and bundled with the lease component in the contract would be a separate nonlease component because the performance of the maintenance transfers a service to the customer that is separate from the right to use the asset.</td>
</tr>
<tr>
<td><strong>Noncomponent</strong></td>
<td>Any activity in a contract that does not transfer a separate good or service to the lessee is neither a lease component nor a nonlease component; therefore, consideration in the contract would not be allocated to such an activity. For example, payments made by the customer for property taxes or insurance that covers the supplier's interests would not represent a component in the contract.</td>
</tr>
</tbody>
</table>

**Connecting the Dots — Determination of Whether a Lease Exists Precedes Component Identification and Separation**

Before identifying and separating lease and nonlease components, an entity must determine whether a contract is or contains a lease (see Chapter 3). Once it has been determined that a lease exists, the identification of the components does not affect that conclusion. A contract can contain one or more lease and nonlease components or noncomponents without influencing the determination that a contract is or contains a lease.

**Connecting the Dots — Services Generally Should Be Accounted for in the Same Manner Regardless of Whether They Are Included in a Contract With a Lease Component**

Paragraph BC148 of ASU 2016-02 states that the recognition and measurement guidance for leases in ASC 842 should only be applied to the lease components in a contract and that “a nonlease component should not, in general, be subject to different accounting requirements solely because it is included in a contract that contains a lease.” Further, Paragraph BC149 of ASU 2016-02 goes on to say:

The Board also decided that [entities] should account for lease and nonlease (typically, service) components separately . . . Board members observed that to do otherwise could result in different accounting for services solely depending on whether the service is included together with a lease. [T]he accounting for services should be the same, regardless of whether the contract that includes the services also includes a lease.

Accordingly, both lessees and lessors are required to separate lease and nonlease components (unless they elect the practical expedients discussed in Section 4.3.3) so that (1) lease components may be appropriately reflected in accordance with ASC 842 (e.g., to ensure more precise measurement of the lessee's lease assets and lease liabilities) and (2) nonlease components may be appropriately reflected in accordance with other applicable GAAP (e.g., to ensure an appropriate pattern of revenue recognition in accordance with ASC 606 when lessors also provide services to lessees).
Example 12 in ASC 842-10-55-141 through 55-145, reproduced below, constitutes a good introductory illustration of the guidance in ASC 842-10-15-30 and 15-31 (as well as the discussion in Q&A 4-3).

**ASC 842-10**

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

**Case A — Payments for Taxes and Insurance are Variable**

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 by Lessor to Lessee each year.

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 by Lessee in profit or loss in accordance with paragraph 842-20-25-5 or 842-20-25-6. Lessor also recognizes those payments as variable lease payments in accordance with paragraph 842-10-15-40A because the real estate taxes and insurance premiums are paid by Lessor to the taxing jurisdiction and insurance company and reimbursed by Lessee to Lessor. However, if Lessee paid the costs directly to the third parties, those lessor costs would not be recognized by Lessor as variable payments because of the requirement in paragraph 842-10-15-40A.

**Case B — Payment for Taxes and Insurance are Fixed**

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**

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.

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 (unless Lessee elects the practical expedient in paragraph 842-10-15-37 or Lessor elects the practical expedient in paragraph 842-10-15-42A when the conditions in that paragraph are met). The amount allocated to the lease component is the lease payments in accounting for the lease.
Chapter 4 — Components of a Contract

ASC 842-10 (continued)

Pending Content (Transition Guidance: ASC 842-10-65-1)

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.

4.3.1 Nonlease Components

Nonlease components in a contract (i.e., any activity that transfers a good or service to the lessee) will generally represent some sort of service that the lessee is paying for in the contract and that the lessor is providing to the lessee in addition to the lease component. The following are examples of common nonlease components in a contract that contains both lease and nonlease components:

- A contract for the right to use equipment, when the lessor also provides regular maintenance of the equipment throughout the contract.
- A contract for the right to use a transportation vehicle (e.g., airplane, ship, or truck), when the lessor also provides operating personnel to operate the vehicle for the lessee throughout the contract.
- A contract for the right to use an oil, gas, or mining drill rig, when the lessor also provides a crew to man and operate the rig throughout the contract.
- A contract for the right to use a manufacturing facility, when the lessor also provides the materials and labor needed to produce a product for the lessee.
- A contract for the right to use several floors of an office building, when the lessor also provides maintenance services to clean the building lobbies, maintain elevators, etc. (i.e., common-area maintenance (CAM)).

Because ASC 842-10-15-30 describes nonlease components as any “items or activities that transfer a good or service to the lessee,” such components may be something other than the typical services described above. For example, ASC 842-10-55-32 and 55-33 clarify that entities (particularly lessors) may need to consider whether guarantees and indemnifications are nonlease components, which must be accounted for in accordance with other applicable GAAP.

ASC 842-10

55-32 Paragraph 460-10-15-4(c) states that, except as provided in paragraph 460-10-15-7, the provisions of Subtopic 460-10 on guarantees apply to indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party. Paragraph 460-10-55-23A provides related implementation guidance for a tax indemnification provided to a lessor.

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.
The concept of a nonlease component in ASC 842 is effectively the same as that for “promised goods or services” under ASC 606. Section 5.2 of Deloitte’s Revenue Roadmap contains detailed discussion of promises in a contract and may help entities understand whether an activity provided by the lessor (other than the right of use) transfers a good or service to the lessee.

**Connecting the Dots — Nonlease Components Do Not Need to Be Distinct**

Although the concept of nonlease components in ASC 842 is similar to that of promised goods or services in ASC 606, there is one significant difference: nonlease components do not need to be distinct from lease components to be accounted for separately.

Under ASC 606, for revenue recognition purposes, the transaction price is allocated only to distinct performance obligations. (See Section 5.3 of Deloitte’s Revenue Roadmap for detailed discussion of when a promised good or service is a distinct performance obligation.) Under ASC 842, the consideration in the contract is allocated to an item or activity when that item or activity transfers a good or service to the lessee.

When developing ASC 842, the FASB considered whether the “distinct” guidance in ASC 606 should apply to identifying and separating nonlease components. Paragraph BC151(a) of ASU 2016-02 explains that the 2010 leasing ED included guidance that required lessees and lessors to account for a service or other nonlease component separately only if it was distinct in accordance with the guidance that the Board was developing on revenue recognition. However, paragraph BC151(a) of ASU 2016-02 further notes that, in feedback on the 2010 ED, respondents indicated that they “found the proposals confusing, or they disagreed with some aspects of those proposals, in particular, the proposal to account for the entire contract as a lease if nonlease components were not distinct.”

Accordingly, under ASC 842, services or other nonlease components may be accounted for separately from the lease component(s) even if they would not be accounted for separately from other promised goods or services in a revenue contract with a customer. This may be counterintuitive to some lessees and lessors that find nonlease components in a contract not to be distinct from the lease component(s) (e.g., when the asset being leased cannot run or operate without the services provided by the lessor’s operating personnel). In addition, it may be challenging to develop an appropriate stand-alone price (for lessees) or stand-alone selling price (for lessors) — for both the lease component(s) and the nonlease components — with respect to allocating consideration in the contract. (The allocation methods for both lessees and lessors are further discussed in Section 4.4.)

Although nonlease components do not need to be distinct from lease components to be accounted for separately, ASC 842-10-15-31 states that nonlease components are not within the scope of ASC 842 (unless a lessor makes the accounting policy election in accordance with ASC 842-10-15-42A) and therefore must be accounted for in accordance with other applicable GAAP. For lessors, this means that nonlease components (e.g., maintenance services) generally should be accounted for in accordance with the guidance on revenue from contracts with customers in ASC 606. Accordingly, lessors will need to consider whether any of the promised goods or services in the separated nonlease component(s) represent distinct performance obligations. That is, although a bundle of promised goods or services may be separated from the lease component as nonlease components, the lessor will further need to identify distinct performance obligations within that bundle in accordance with step 2 of the revenue model in ASC 606. The guidance on identifying performance obligations in ASC 606 is discussed in detail in Chapter 5 of Deloitte’s Revenue Roadmap. Lessors should consider our interpretive guidance in

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7 See footnote 6.
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assessing any nonlease components that are separated from the lease component(s) in a contract that contains a lease.

Maintenance services are likely to be some of the most commonly identified nonlease components in contracts that contain a lease. It is very common for leases of real estate (e.g., leases of an apartment, space in an office building, dwellings in a retirement home) to include some form of CAM. Lessors of such real estate may also procure and provide to lessees certain utilities (e.g., water, gas, and electricity). The Q&As below address common examples of nonlease components in such contracts.

Q&A 4-4  Common-Area Maintenance
Leases of office or commercial space often contain provisions that require the tenant to reimburse the landlord for CAM costs. Such costs might include an allocated portion of costs for landscaping, janitorial services, repairs, snow removal, and other maintenance of common areas. CAM charges can be based on the actual costs incurred by the landlord. However, such charges also might be negotiated at the inception of the lease as fixed amounts, potentially with scheduled increases over the lease term.

Question
Is CAM a nonlease component?

Answer
Yes. CAM represents the transfer of a good or service to the lessee other than the right to use the underlying asset. Therefore, unless a practical expedient is available and elected (see Section 4.3.3), it is a nonlease component (1) that both the lessee and lessor must separate from the lease component(s) and (2) to which consideration in the contract must be allocated.

Example 12, Case C, in ASC 842-10-55-144 and 55-145 (reproduced above in Section 4.3), supports this conclusion and states, in part:

[T]he 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).

Q&A 4-5  Utilities
Leases of office or commercial space often contain provisions that require the tenant to reimburse the landlord for the cost of providing utilities (e.g., heat, water, gas, and electricity). The cost of such utilities may be charged to the tenant at cost, allocated cost, or either cost or allocated cost plus a margin.

Question
Are utilities considered a nonlease component?
**Answer**

Yes. The lessor transfers a good or service to the lessee that is separate from the right to use the underlying asset when it provides water, gas, electricity, or other utilities. Therefore, unless a practical expedient is available and elected (see Section 4.3.3), utilities reflect a nonlease component (1) that both the lessor and lessee must separate from the lease component(s) and (2) to which consideration in the contract must be allocated.

**Changing Lanes — CAM and Utilities Are No Longer Just Executory Costs**

ASC 840 requires that “substantial services” be accounted for separately from the lease element in a contract that contains both a lease element and such substantial services. Although the phrase “substantial services” is not defined in ASC 840, we expect that any elements that are substantial services and that are thus currently separated from the lease element will also be nonlease components under ASC 842.

However, the treatment of maintenance and utilities under ASC 842 will generally differ from that under ASC 840. Specifically, under ASC 840-10-25-1(d), maintenance and utilities are generally considered executory costs and not substantial services. Therefore, under ASC 840-10-15-17 and ASC 840-10-15-19, maintenance and utilities are considered part of the lease element and are within the scope of ASC 840. Under ASC 842, on the other hand (and as explained in Q&As 4-4 and 4-5), maintenance (including CAM) and utilities will be nonlease components. Accordingly, while the lease payments (i.e., the consideration in the contract) are not separately allocated to both CAM and utilities under ASC 840 for accounting purposes, the lease payments will be allocated in this way under ASC 842 (provided that a practical expedient is not available or is not elected — see Section 4.3.3). Further, under ASC 842, unless a practical expedient is available and elected, both CAM and utilities will be accounted for in accordance with other applicable GAAP rather than being accounted for as part of the lease as they are under ASC 840.

**Q&A 4-6  Major Maintenance**

In leases of equipment and other large assets (e.g., airplanes, power plants), the lessor often provides nonroutine or “major” maintenance on the leased asset. Major maintenance differs from CAM or other routine maintenance described in Q&A 4-4 in that, for major maintenance, the lessor (1) does not regularly provide the services and (2) may need to spend a certain amount of capital to keep the asset available for the lessee’s use.

For example, a lessor may need to provide major maintenance for an airplane that it leases to a lessee — and remove the airplane from the lessee's rotational use — at the earlier of (1) the time when a maximum number of miles is flown or (2) a federally regulated time since the last major maintenance was performed.

**Question**

Is nonroutine or major maintenance considered a nonlease component?

**Answer**

Yes. The performance of major maintenance represents the transfer of a good or service to the lessee other than the right to use the underlying asset. Therefore, unless a practical expedient is available and elected (see Section 4.3.3), it is a nonlease component (1) that both the lessor and lessee must separate from the lease component(s) and (2) to which consideration in the contract must be allocated.
Generally, major maintenance is considered a “substantial service” under ASC 840. Therefore, we would expect major maintenance to be separated from the lease component as a nonlease component in a manner consistent with that described in the Changing Lanes. In addition, given the distinct characteristics and separable risks of major maintenance, compared with other services that the lessor may provide more regularly, such maintenance may represent a distinct performance obligation for the lessor in accordance with ASC 606.

**Connecting the Dots — Real Estate Lessors’ Identification of Distinct Performance Obligations Within CAM**

As discussed above, lessors will need to consider the guidance in ASC 606 to identify distinct performance obligations within the nonlease component(s) that are separated from the lease component(s). Similarly, to recognize revenue in accordance with ASC 606, real estate lessors will need to consider whether CAM is a single performance obligation or comprises multiple performance obligations.

We think that CAM will often represent a single performance obligation. Although CAM comprises multiple different activities that the lessor may perform on a day-to-day basis (e.g., cleaning the lobbies and bathrooms daily, buffing the lobby floors weekly), the nature of the lessor’s promise is to maintain the common areas of the real estate being leased. In promising to deliver CAM, the lessor agrees that it will undertake various activities to fulfill its overall promise to the lessee of providing a well-maintained building and common areas.

This view is consistent with that articulated by the FASB in ASC 606-10-55-157B through 55-157E (added to ASC 606 by ASU 2016-10), which illustrate an arrangement involving hotel management services. That is, in this example, the Board concludes that “[t]he service comprises various activities that may vary each day (for example, cleaning services, reservation services, and property maintenance) [but] those tasks are activities to fulfill the hotel management service and are not separate promises in the contract.” Accordingly, each increment (e.g., each day of the management services) of the promised service is distinct, but together the overall promise represents a series of distinct goods or services that are accounted for as a single performance obligation in accordance with ASC 606-10-25-14 and 25-15.

However, real estate lessors should carefully consider the promised goods or services within the overall CAM promise. For example, we do not think that it would be appropriate for utilities (discussed in Q&A 4-5) or major maintenance (discussed in Q&A 4-6) to be considered part of a single performance obligation with CAM just because those items may be billed together or expressed together in the contract with the lessee. That is, just because an activity is characterized as part of CAM does not mean that it should be bundled together as part of a single performance obligation with CAM.

Although an activity (e.g., a good or service) may be distinct from CAM, it may be reasonable to account for it together with the CAM if the pattern of transfer and the outcome of accounting for them together is the same, as indicated in paragraph BC116 of ASU 2014-09.
4.3.2 Noncomponents

While lease components and nonlease components transfer a good or service to the lessee, noncomponents do not transfer anything to the lessee. Rather, they are incurred by the asset owner (i.e., the lessor) regardless of whether the asset is out on lease. As indicated in ASC 842-10-15-30, noncomponents are generally payments for either of the following:

- Administrative tasks performed by the lessor that are necessary “to set up a contract or initiate the lease.”
- Reimbursements (or direct payments) of the lessor’s costs that the lessor requires the lessee to pay as part of earning a return of (and on) the lessor’s costs to deliver the contract.

Payments made by the lessee for the following are considered noncomponents to which the consideration in the contract is not separately allocated:

- Real estate or property taxes related to the leased asset.
- Insurance that covers the lessor’s interest in the asset.
- Commitment fees.
- Other administrative charges.

In addition, payments for the items described above would be considered noncomponents regardless of whether the payments are fixed or variable.

In a manner similar to the guidance in ASC 606 on setup activities, the consideration in the contract is not allocated to noncomponents because they do not transfer a good or service to the lessee. Rather, fixed amounts paid for noncomponents are included in the consideration in the contract and allocated to the lease and nonlease components.9 (See Section 4.4 for detailed discussion of measuring and allocating consideration in the contract.) The Board explains this consistency in paragraph BC159 of ASU 2016-02:

The guidance in Topic 842 in this respect is consistent with the revenue recognition guidance in Topic 606, which states that promised goods or services do not include set up or other activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to the customer. Those activities, therefore, do not get an allocation of the transaction price.

However, these costs are also often variable and paid on the basis of the actual costs and are not considered part of the consideration in the contract. For lessees, the accounting and reporting requirements for these costs are the same regardless of whether the lessee is reimbursing the lessor or paying a third party directly on the lessor’s behalf (e.g., paying real estate taxes directly to the relevant tax authority). However, the accounting and reporting requirements for lessors differ when the noncomponent is a lessor cost. Specifically, lessor costs that a lessee pays directly to a third party on behalf of the lessor are excluded from variable payments, and thus from lease revenue, while lessor costs that the lessor pays directly to a third party, and that the lessee then reimburses, must be accounted for as variable payments and therefore as lease revenue. For detailed discussion of the measurement of the consideration in the contract (and whether or when variable payments are included in that measurement), see Section 4.4.1 (for lessees) and Section 4.4.2 (for lessors).

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9 As discussed in Section 4.3.3.1, lessees can elect a practical expedient by asset class to combine lease and nonlease components into a single component. A similar practical expedient is available to lessors by asset class as long as certain criteria are met (see Section 4.3.3.2). When this practical expedient is elected, any consideration that would otherwise be allocated to the nonlease components, such as payments for noncomponents described in this section, will instead be accounted for as part of the related lease component or the predominant revenue component for lessors. In other words, if the practical expedient is elected, no allocation between lease and nonlease components is necessary.
The following Q&As discuss in greater detail two of the most common noncomponents, property taxes and insurance:

**Q&A 4-7 Property Taxes**

Depending on the relevant tax authority, the asset owner (i.e., the lessor) generally owes property taxes on the asset regardless of whether or to whom the asset is out on lease. Accordingly, the relevant tax authority has recourse only to the lessor for property taxes owed. This is the case even when a lessor requires a lessee in the contract to pay property taxes directly to the tax authority — although the lessor may have recourse to the lessee, the tax authority ultimately holds the lessor responsible for such amounts.

The FASB discusses property taxes in paragraph BC157 of ASU 2016-02:

[I]t is common practice for one party to the contract to pay certain costs directly to a third party, although the counterparty to the contract is principally liable to make those payments (for example, a lessee may make property tax payments directly to the taxing authority although the lessor is principally liable for those payments).

**Question**

Are property taxes paid by the lessee considered a component in the contract?

**Answer**

No. The lessee receives no good or service in return for its payment of property taxes, regardless of whether it reimburses the lessor or pays the tax authority directly. In many cases, the lessee is ultimately reimbursing the lessor for its costs, for which the lessor is the primary obligor to the tax authority. Therefore, both the lessee and lessor consider property taxes noncomponents in a contract and no consideration in the contract is allocated to the property taxes.

Example 12, Case A, in ASC 842-10-55-141 and 55-142 (reproduced above in Section 4.3), supports the conclusion that property taxes are noncomponents. In that example, the lessor and lessee conclude that property taxes are not a component in the contract because the “real estate taxes would be owed by Lessor regardless of whether it leased the building and who the lessee is.” Paragraph BC158 of ASU 2016-02 also addresses the Board’s conclusions regarding property taxes:

For example, an entity would not account for a portion of the consideration in the contract that is attributable to paying the lessor’s property taxes . . . as a component if the lessor is the primary obligor for those taxes . . . and the amounts paid are not for a service (for example, maintenance or operations services) provided by the lessor to the lessee.

For lessees and lessors, any amounts paid for property taxes that are included in the consideration in the contract (i.e., the costs are fixed in the contract) are allocated to the separate lease and nonlease components. However, the lessee and lessor requirements differ when the amounts paid for property taxes are excluded from the consideration in the contract (i.e., the costs are variable). For lessees, the variable payment is allocated on the same basis as the fixed consideration. For lessors, the requirements for lessee-paid costs differ from those for lessee-reimbursed costs. Any amounts that a lessee directly pays to a third party on behalf of the lessor for property taxes should be excluded from variable payments and thus from lease revenue. Any amounts that the lessee reimburses and the lessor pays to the third party should be included in variable payments and therefore in lease revenue. (See Section 4.4 for detailed discussion of measuring and allocating consideration in the contract.)
Q&A 4-8  Insurer

In real estate and automobile leases, the lessor commonly requires the lessee to pay for insurance coverage to protect the lessor’s interest in the leased asset (e.g., insurance to cover the physical structure of an office building). Generally, the lessor would seek to obtain equivalent insurance coverage regardless of whether or to whom it was leasing the asset. The contract may require the lessee to pay the lessor (e.g., to reimburse the lessor’s premium) or to obtain the insurance coverage directly from, and pay the premium directly to, a third-party insurance provider.

It is also common for real estate and automobile leases to require — or for the lessee to decide on its own to obtain — insurance coverage to protect the lessee’s interests in the leased asset (e.g., to cover the contents of the physical structure that the lessee owns, such as with renter’s insurance). In such cases, the lessee would generally obtain the insurance directly from a third-party insurance provider.

**Question 1**

Are insurance premiums that the lessee pays for insurance coverage to protect the lessor’s interest in the asset considered a component in the contract?

**Answer**

No. The lessee receives no good or service in return for its payment of the insurance premium, regardless of whether the lessee reimburses the lessor or the lessee pays the insurance provider directly. The lessee is ultimately reimbursing the lessor for its costs, and when the policy covers the lessor’s interest in the asset as the named insured, the lessor is the primary beneficiary of the policy. Therefore, both the lessor and the lessee consider such insurance a noncomponent in the contract and no consideration in the contract is allocated to the insurance.

Example 12, Case A, in ASC 842-10-55-141 and 55-142 (reproduced above in Section 4.3), supports the conclusion that payments for insurance coverage are noncomponents. In that example, the lessor and lessee conclude that insurance is not a component in the contract because “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).”

For lessees and lessors, any amounts paid for such insurance coverage that are included in the consideration in the contract (i.e., the costs are fixed in the contract) are allocated to the separate lease and nonlease components. However, the lessee and lessor requirements differ when amounts paid for insurance coverage are excluded from the consideration in the contract (i.e., the costs are variable). For lessees, the variable payment is allocated on the same basis as the fixed consideration. For lessors, the requirements for lessee-paid costs differ from those for lessee-reimbursed costs. Any amounts that a lessee directly pays to a third party on behalf of the lessor for insurance coverage should be excluded from variable payments and thus from lease revenue. Any amounts that the lessee reimburses and the lessor pays to the third party should be included in variable payments and therefore in lease revenue. (See Section 4.4 for detailed discussion of measuring and allocating consideration in the contract.)
**Question 2**

Are insurance premiums that the lessee pays for insurance coverage to protect its own interest in the leased asset considered a component in the contract?

**Answer**

No. The lessee receives a good or service in return for its payment of the insurance premium; however, that good or service does not result from the contract that contains the lease but from the contract between the lessee and the third-party insurance provider. The lessee is ultimately protecting its own interest in the leased asset by covering its own property within that leased asset; thus, the lessee is the named insured and primary beneficiary of the policy. In addition, the lessee is not reimbursing the lessor for any costs.

Therefore, both the lessee and the lessor consider such insurance separate from the contract that contains the lease. No consideration in the contract that contains the lease is allocated to the insurance. Rather, the lessee accounts for any amounts it paid for such insurance coverage in accordance with other applicable GAAP. The lessor would not account for the insurance coverage (i.e., the payments are not a lessor cost).

**Question 3**

If the lessee pays insurance premiums for an umbrella insurance policy that covers both the lessor's and the lessee's interest in the leased asset, are the lessee and lessor required to allocate these premiums?

**Answer**

It depends. This situation is common in automobile leases in which the lessor requires the lessee to purchase collision insurance (for which the lessor is the primary beneficiary) and the lessee also obtains liability (and potentially other) insurance under the same policy (for which the lessee is the primary beneficiary).

As explained in Question 1 above, and in accordance with ASC 842-10-15-30, an entity should consider whether any amounts paid for insurance that covers the lessor’s interest in the asset should be included in the consideration in the contract and allocated to the separate lease and nonlease components. (See Section 4.4 for detailed discussion of measuring and allocating consideration in the contract.)

Lessees should allocate the insurance premium amount between (1) the portion that is compensation for the insurance coverage over the lessor’s interest in the asset, when the lessor is the insured party, so that an appropriate amount of the premium can be considered for inclusion in the consideration in the contract (or for allocation of variable payments) and (2) the portion that is compensation for the insurance coverage over the lessee’s interest in the asset, when the lessee is the insured party, so that the lessee can account for an appropriate amount of the premium in accordance with other applicable GAAP.
In this example, lessors are most likely not aware of the actual amount of the policy premium since a lessee would typically pay a third party directly. Any amount that a lessee directly pays to a third party on behalf of the lessor for insurance coverage should be excluded from variable payments. Further, any amount that a lessee directly pays to a third party on behalf of itself for insurance coverage would not be a lessor cost; thus, lessors should never account for such an amount. Accordingly, lessors should exclude from variable payments, and thus from lease revenue, the entire insurance premium (provided that the lessee pays this premium directly to a third party).

Changing Lanes — Lessors Record Revenues and Expenses on a Gross Basis for Property Taxes and Insurance When Reimbursed by a Lessee

As discussed above, under ASC 842, property taxes and insurance (which covers the lessor’s interest in the asset) do not transfer a good or service to the lessee and are thus noncomponents of a contract. The consideration in the contract is not allocated to noncomponents; rather, both the lessee and the lessor allocate payments for noncomponents to the lease and nonlease components.

Under ASC 840, lessors often record payments for executory costs (including property taxes and insurance) net in the income statement, especially when the lessee makes these payments directly to a third party (e.g., the tax authority), such as in a triple net lease. That is, lessors do not record gross revenues for the amounts paid by the lessee and an expense for the amount of costs they incur. Often, the inflow (revenue) and outflow (expense) are equal and are thus “netted” down to zero for presentation in the income statement.

However, under ASC 842, to the extent that the lessee is reimbursing the lessor’s costs and the lessor is ultimately paying the third party (as discussed in Q&As 4-7 and 4-8), the lessor should recognize its costs on a gross basis in the income statement, as it would for any other costs that it incurs. This is consistent with how an entity would recognize and present cost recovery amounts billed to customers in accordance with ASC 606. (See Q&A 13-8 in, and Section D.4.1 of, Deloitte’s Revenue Roadmap for detailed discussion of TRG Agenda Paper 2, which addresses the gross or net presentation of amounts billed to customers.)

This may result in a change from practice under ASC 840 for many lessors, especially real estate lessors. As a result, lessors may end up with higher revenues and expenses than were previously recorded.

That said, under ASC 842, if the lessee is paying a third party directly on behalf of the lessor, the lessor should recognize its costs on a net basis in the income statement (i.e., exclude lessee-paid costs from variable payments and therefore from lease revenue).

Changing Lanes — Property Taxes and Insurance May Inflated the Measurement of the Lease Liability and ROU Asset

On the basis of the lease accounting guidance in ASC 840-10-25-1(d), both property taxes and insurance are considered executory costs. ASC 840-10-15-17 and ASC 840-10-15-19 state that such costs are considered part of the lease element and are therefore within the scope of ASC 840. However, executory costs for property taxes and insurance, and profits thereon, are excluded from minimum lease payments for purposes of lease classification (i.e., excluded from the 90 percent test) and the measurement of capital lease obligations and capital lease assets.
As explained above in Q&A 4-7 and Questions 1 and 3 of Q&A 4-8, property taxes and insurance, respectively, will be noncomponents under ASC 842. Although these costs are often variable, any fixed amounts paid by the lessee for property taxes and insurance will be included in the consideration in the contract and allocated to the lease and nonlease components (to the extent that there are nonlease components in the contract), whereas they are not under ASC 840 guidance. This could potentially result in the following:

- Increased likelihood that an entity will classify the lease component in the contract as a finance lease when considering the criterion in ASC 842-10-25-2(d), since there would be at least some allocation, to the lease component, of fixed amounts paid for property taxes and insurance. (The lessee’s classification is discussed in detail in Chapter 8.)
- Higher lease liabilities and ROU assets, regardless of whether the lease is classified as an operating or finance lease, since there would be at least some allocation, to the lease component, of fixed amounts paid for property taxes and insurance to be included in the initial measurement of the lease.

Q&A 4-8A  Sales Taxes

In certain tax jurisdictions, lessees are subject to sales, use, and value-added taxes, etc., in connection with the use of an asset in a contract that contains a lease. The lessee may pay the taxes directly to the tax authority, or the contract may state that the lessor will collect the taxes from the customer and remit the funds to the tax authority.

Question 1
Do sales taxes paid by the lessee represent payments associated with the contract that contains a lease?

Answer
It depends. To determine whether the sales taxes represent payments associated with the contract that contains a lease, a lessee should assess whether the legal obligation (rather than the stated contract terms indicating an obligation for the lessee to make a payment) to the tax authority for the sales taxes resides with the lessee or the lessor.

Lessee Obligation
If the obligation resides with the lessee, the lessee and lessor should consider such sales tax payments to be separate and apart from the contract that contains a lease. In this case, sales tax payments would not represent lease payments to the lessor or a reimbursement of lessor costs. See Questions 3 and 4 below for considerations related to a lessee’s initial and subsequent accounting for sales tax payments that are a lessee obligation.

Lessor Obligation
If the obligation for the sales taxes resides with the lessor, the sales taxes paid by the lessee as part of the contract are considered to be payments associated with the contract that contains a lease. In this case, the lessee is reimbursing a lessor cost since the tax obligation resides with the lessor. Like property taxes and insurance, the sales taxes represent noncomponents under ASC 842, as explained in Q&A 4-7 and Questions 1 and 3 of Q&A 4-8. Although these costs are

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10 While this discussion focuses on lessees, in December 2018, the FASB issued ASU 2018-20, which makes narrow-scope improvements to the accounting for lessors. Under the ASU’s amendments, lessors are allowed to elect, as an accounting policy, to analogize to the guidance in ASC 606 on presenting sales taxes collected from lessees on a net basis. See Section 4.4.2.1.2 for more information about the ASU.
often variable payments, any fixed amounts paid by the lessee for sales taxes will be included in the consideration in the contract and allocated to the lease and nonlease components (to the extent that there are nonlease components in the contract). Fixed sales tax payments may be less common since a lessee often will reimburse a lessor’s actual sales tax as incurred (e.g., a pass-through from the lessor to the lessee).

**Question 2**

When sales tax is determined by applying the sales tax rate to the gross lease payment (i.e., the rate does not depend on the lessee’s use of the leased asset), is sales tax a variable payment akin to an index or rate?\(^{11}\)

**Answer**

No. Sales tax is akin to real estate or property tax and therefore is treated as a variable payment that does not depend on an index or rate (in a manner similar to sales tax imposed on the basis of a lessee’s usage of the leased asset). Property tax is not deemed to depend on an index or rate because the tax itself is based on a number of factors, some of which are not dictated by market conditions. Taxes generally are subject to governmental policy considerations, and the tax rate is ultimately a function of the tax base and the revenue needs of the governing body. Since the revenue needs may change over time (and can increase or decrease), the tax payments of the lessee do not represent a present obligation until they are calculated and assessed. Sales taxes are no different in this regard.

**Question 3**

When the sales tax obligation resides with the lessee, as discussed in Question 1, is the lessee required to accrue a sales tax liability before payment?

**Answer**

It depends. A lessee should accrue a sales tax liability (separate from the lease liability) if it has an unavoidable obligation to pay sales tax (whether the payment is currently due or is payable as of a future date). For example, if a lessee, upon signing a contract to lease a new vehicle for five years, is legally obligated to make a sales tax payment of $2,500 that is due at lease commencement, the lessee has incurred a liability (which must be recognized) as of the date of contract execution. However, to the extent that there is potential variability in the amount of sales tax owed, or if the lessee is not presently obligated to make a payment, the lessee would not have an unavoidable obligation and therefore would not recognize a liability.

**Question 4**

To the extent that a lessee is required to accrue a sales tax liability (see Question 3 above), may the lessee treat the sales tax payments as a capitalizable cost in accordance with ASC 360?

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\(^{11}\) Note that sales tax imposed on the basis of a lessee’s usage of a leased asset would also be deemed a variable lease payment that does not depend on an index or rate.

\(^{12}\) Question 2 is only applicable if sales tax is determined to be an obligation of the lessor.
**Answer**

Yes. We believe that a lessee may treat sales tax payments as a capitalizable cost (separate from the ROU asset) in accordance with ASC 360. We would expect the costs to be capitalized and expensed over the term to which the sales taxes are related. In the example from Question 3 above, the $2,500 due to the tax authority would be capitalized as an asset and expensed on a straight-line basis over five years, beginning at lease commencement.

### 4.3.3 Practical Expedients

Although the default model in ASC 842 requires separation of lease and nonlease components, certain practical expedients may be available to entities. Entities electing the practical expedient(s) would not separate lease and nonlease components. Rather, they would account for each lease component and the related nonlease component(s) together as a single component.

#### 4.3.3.1 Lessees

<table>
<thead>
<tr>
<th>ASC 842-10</th>
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<tbody>
<tr>
<td>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.</td>
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ASC 842 affords lessees a practical expedient related to separating (and allocating consideration to) lease and nonlease components. That is, lessees may elect to account for the nonlease components in a contract as part of the single lease component to which they are related. The practical expedient is an accounting policy election that must be made by class of underlying asset (e.g., vehicles, IT equipment — see the Connecting the Dots discussion below).

Accordingly, when a lessee elects the practical expedient, any portion of the consideration in the contract that would otherwise be allocated to the nonlease components will instead be accounted for as part of the related lease component for classification, recognition, and measurement purposes (lessee accounting is discussed in detail in Chapter 8). In addition, any payments related to noncomponents would be accounted for as part of the related lease component (i.e., the associated payments would not be allocated between the lease and nonlease components).

**Connecting the Dots — Magnitude of the Nonlease Components Does Not Matter**

The practical expedient in ASC 842-10-15-37 is available to lessees regardless of the extent or significance of the nonlease components in the contract. However, in paragraph BC150 of ASU 2016-02, the FASB acknowledges that it would not expect lessees (even though it is allowed) to elect the practical expedient when the nonlease components in the contract are significant:

The availability of the practical expedient to a lessee is not affected by the relative size of the lease and the nonlease components. However, given that the result of electing this practical expedient is to record additional lease liabilities, the Board concluded that lessees will, in general, only elect this expedient in arrangements with less significant service components.
Paragraph BC150 of ASU 2016-02 further cites the following basis for providing the expedient:

- “[T]he costs and administrative burden of allocating consideration to separate lease and nonlease components may not be justified by the benefit of more precisely reflecting the right-of-use asset and the lease liability,” especially when nonlease components in contracts for which the expedient is elected are not expected to be significant.

- Because nonlease components in contracts for which the expedient is elected are not expected to be significant, “comparability should not be significantly affected as a result of providing this practical expedient.”

Example 11, Case B, in ASC 842-10-55-138 through 55-140 (reproduced in Section 4.4.3) illustrates an application of the practical expedient in ASC 842-10-15-37 to a contract that contains multiple lease components. Accordingly, Example 11, Case B, also emphasizes an important part of the expedient in ASC 842-10-15-37: lessees may “account for each separate lease component and the nonlease components associated with that lease component as a single lease component” (emphasis added). That is, the practical expedient does not allow lessees to not separate lease components from other lease components in the contract, and the guidance in ASC 842-10-15-28 and 15-29 (see Section 4.2) must still be applied when a lessee makes the accounting policy election in ASC 842-10-15-37.

**Connecting the Dots — Meaning of “Class of Underlying Asset”**

ASC 842 provides lessees with two practical expedients that may be elected as an accounting policy by “class of underlying asset”:

- ASC 842-10-15-37 allows lessees not to separate lease and nonlease components.
- ASC 842-20-25-2 allows lessees not to recognize lease liabilities and ROU assets for short-term leases. (The short-term lease recognition exemption is discussed in detail in Section 8.2.1.)

However, ASC 842 does not address what is meant by the phrase “class of underlying asset.” We have received a number of questions about this topic from various stakeholders, and two views have emerged:

- **View 1** — The class of underlying asset is determined on the basis of the physical nature and characteristics of the asset. For example, real estate, manufacturing equipment, and vehicles would all be reasonable classes of underlying assets given their differences in physical nature. Therefore, irrespective of whether there are different types of similar assets (e.g., within the real estate class, there may be retail stores, warehouses, and distribution centers), the class of underlying asset would be limited to the physical nature as described above.

- **View 2** — The class of underlying asset is determined on the basis of the risks associated with the asset. While an asset’s physical nature may be similar to that of other assets (e.g., retail stores, warehouses, and distribution centers are all real estate, as discussed above), each has a different purpose and use to the lessee and would therefore have a separate risk profile. Therefore, for example, it could be appropriate for the lessee to disaggregate real estate assets into separate asset classes by “type” of real estate — to the extent that the different types are subject to different risks — when applying the practical expedients in ASC 842-10-15-37 and ASC 842-20-25-2.
To support their position, proponents of View 2 refer to paragraph BC341 of ASU 2016-02, which states:

The Board decided that a lessor should treat assets subject to operating leases as a major class of depreciable assets, further distinguished by significant class of underlying asset. Accordingly, a lessor should provide the required property, plant, and equipment disclosures for assets subject to operating leases separately from owned assets held and used by the lessor. In the Board's view, leased assets often are subject to different risks than owned assets that are held and used (for example, the decrease in the value of the underlying asset in a lease could be due to several factors that are not within the control of the lessor), and, therefore, users will benefit from lessors segregating their disclosures related to assets subject to operating leases from disclosures related to other owned property, plant, and equipment. The Board further considered that to provide useful information to users, the lessor should disaggregate its disclosures in this regard by significant class of underlying asset subject to lease because the risk related to one class of underlying asset (for example, airplanes) may be very different from another (for example, land or buildings). [Emphasis added]

Views on these questions are still developing. Therefore, we recommend that entities with concerns about such matters discuss them with their accounting advisers.

Irrespective of the views noted above, we do not think that it would be appropriate to determine the “class of underlying asset” on the basis of the lease contract with which it is associated. For example, we believe that it would be inappropriate to break real estate assets into different classes on the basis of whether they are related to gross leases or triple net leases. In that situation, the asset underlying the contract could be exactly the same while the contract differs. We do not think that approach is consistent with the intent of the guidance in ASC 842-10-15-37 or ASC 842-20-25-2.

4.3.3.2 Lessors

<table>
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| 15-42A As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not 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 component if the nonlease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers and both of the following are met:
  a. The timing and pattern of transfer for the lease component and nonlease components associated with that lease component are the same.
  b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3. |
A lessor that elects the practical expedient in paragraph 842-10-15-42A shall account for the combined component:

a. As a single performance obligation entirely in accordance with Topic 606 if the nonlease component or components are the predominant component(s) of the combined component. In applying Topic 606, the entity shall do both of the following:
   1. Use the same measure of progress as used for applying paragraph 842-10-15-42A(a)
   2. Account for all variable payments related to any good or service, including the lease, that is part of the combined component in accordance with the guidance on variable consideration in Topic 606.

b. Otherwise, as an operating lease entirely in accordance with this Topic. In applying this Topic, the entity shall account for all variable payments related to any good or service that is part of the combined component as variable lease payments.

In determining whether a nonlease component or components are the predominant component(s) of a combined component, a lessor shall consider whether the lessee would be reasonably expected to ascribe more value to the nonlease component(s) than to the lease component.

A lessor that elects the practical expedient in paragraph 842-10-15-42A shall combine all nonlease components that qualify for the practical expedient with the associated lease component and shall account for the combined component in accordance with paragraph 842-10-15-42B. A lessor shall separately account for nonlease components that do not qualify for the practical expedient. Accordingly, a lessor shall apply paragraphs 842-10-15-38 through 15-42 to account for nonlease components that do not qualify for the practical expedient.

The practical expedient in ASC 842-10-15-37, under which lessees can elect not to separate lease and nonlease components (see Section 4.3.3.1), was not initially available to lessors. ASC 842, as initially issued by way of ASU 2016-02, required lessors to separate lease and nonlease components in all circumstances. Accordingly, lessors were required to look to the guidance in step 4 of the revenue model in ASC 606 to allocate the consideration in the contract to the separated components. After the consideration is allocated, ASC 842 (including its presentation and disclosure guidance) applies to the lease component and ASC 606 (including its presentation and disclosure guidance) generally applies to the nonlease component. See Section 4.4.2 for further discussion of the guidance on allocating consideration in the contract to lease and nonlease components.

Such separation was required regardless of whether the pattern of transfer to the customer would be the same (i.e., a straight-line pattern of transfer to the customer over the same period) when the lease and nonlease components are separated (see Q&A 4-12). Accordingly, if the patterns of transfer are the same, separation and allocation may only affect presentation and disclosure. For example, this often may be the case when real estate lessors enter into operating leases of real estate and provide CAM services to the customer. However, the FASB received stakeholder feedback indicating that the costs of complying with ASC 842’s separation and allocation requirements for arrangements in which the pattern of transfer is the same outweigh the benefits (i.e., when the separation and allocation guidance only affects presentation and disclosure).

As a result, in July 2018, the FASB issued ASU 2018-11, which provides a practical expedient under which lessors can elect, by class of underlying asset, not to separate lease and nonlease components when certain criteria are met. Therefore, this practical expedient only affects lessors whose lease contracts also include nonlease components that are within the scope of ASC 606 and meet certain criteria (discussed below). If a lessor elects the practical expedient to combine lease and eligible nonlease components, it must evaluate whether the nonlease components in the combined component are predominant to determine whether the combined component should be accounted for under ASC 606 or ASC 842.
Unlike lessors, lessees have always been able, under ASC 842, to elect a practical expedient under which they can choose not to separate (and allocate consideration to) lease and nonlease components (see ASC 842-10-15-37). ASU 2018-11 aligns the lessor’s accounting for the separation of lease and nonlease components with that for lessees. Both lessors (when certain conditions are met) and lessees may now elect to account for each lease component and the associated nonlease components in a contract as part of a single component. Note that this election is an accounting policy election that must be made by class of underlying asset. (For more information, see the Connecting the Dots in Section 4.3.3.1.) However, lessees do not have the option of accounting for the combined component under other U.S. GAAP. Instead, a lessee’s combined component must always be accounted for under ASC 842.

4.3.3.2.1 Criteria for Combining Lease and Nonlease Components

A lessor that elects the practical expedient would not be required to separate lease and nonlease components (i.e., it would account for the lease and nonlease components as a combined, single unit of account), provided that the nonlease component(s) otherwise would be accounted for under the revenue guidance in ASC 606 and both of the following conditions are met:

- **Criterion A** — The timing and pattern of transfer for the lease component are the same as those for the nonlease components associated with that lease component.\(^{13}\)
- **Criterion B** — The lease component, if accounted for separately, would be classified as an operating lease.

ASC 842-10-15-42C also clarifies that the presence of a nonlease component that is ineligible for the practical expedient does not preclude a lessor from electing the expedient for the lease component and nonlease component(s) that meet the criteria. Rather, the lessor would account for the nonlease components that do not qualify for the practical expedient separately from the combined lease and nonlease components that do qualify.

Connecting the Dots — Assessing Timing and Pattern of Transfer

In ASU 2018-11, the Board amended Criterion A to focus on the timing and pattern of transfer (i.e., a “straight-line pattern of transfer . . . to the customer over the same time period”) rather than on the timing and pattern of revenue recognition (as was originally proposed). The purpose of this amendment was to address concerns that the originally proposed practical expedient was unnecessarily restrictive and excluded contracts with variable consideration from its scope, since variable payments are accounted for differently under ASC 606 than they are under ASC 842. That is, the pattern of revenue recognition under ASC 606 could differ because estimates of variable consideration are recognized as revenue under ASC 606 while recognition of revenue for variable consideration under ASC 842 is restricted until the variability or contingency is resolved.

\(^{13}\) Importantly, not all over-time performance obligations will qualify for the practical expedient. Lessors should consider the measure of progress used to recognize revenue related to the nonlease component when assessing the condition in ASC 842-10-15-42A(a).
Q&A 4-8B  Noncoterminous Lease and Nonlease Components

As noted above, ASC 842-10-15-42A allows lessors to elect, as a practical expedient by class of underlying asset, an accounting policy of not separating nonlease components from lease components if (1) the timing and pattern of transfer for the lease component are the same as those for the nonlease components associated with that lease component and (2) “the lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3.”

In some arrangements, a lessee may commit to purchasing a service (that would be considered a nonlease component) for only part of the lease term. The lessee may have the option of renewing the service for an incremental fee over the lease term but is not contractually committed to do so. Therefore, the period over which a lessor is contractually required to provide services to a lessee (that would be a nonlease component) may not span the entire lease term. That is, in such circumstances, the lease term and the contractual service period would not be coterminous.

Question

If a nonlease component's timing of transfer to a lessee is not coterminous with the associated lease component, can a lessor elect the practical expedient in ASC 842-10-15-42A to combine the nonlease component with the associated lease component?

Answer

It depends. We believe that, in some circumstances, this practical expedient can be applied even if the nonlease component is not coterminous with the lease component. Specifically, we think that if the separation of the lease component from the nonlease component would only affect presentation and disclosure (i.e., the pattern and timing of revenue recognition would not differ if the nonlease component were accounted for separately), the lessor can elect the practical expedient to combine the lease and nonlease component even if the timing of transfer of the nonlease component is not coterminous with the lease component. This would generally be the case when the lease and optional nonlease component(s) are each priced at their stand-alone selling price and an allocation between components would therefore not be necessary (i.e., they are not priced at a significant discount in such a way that a material right within the scope of ASC 606 might need to be identified) and the timing and pattern of transfer of the nonlease component are the same as those for the lease component for the period over which the nonlease component will be transferred to the lessee.

This view is supported by paragraph BC31 of ASU 2018-11, which states, in part, “The Board noted that its objective in providing the practical expedient was to align the accounting by lessors under the new leases standard more closely with the revenue guidance.” Further, paragraph BC116 of ASU 2014-09 notes that “Topic 606 would not need to specify the accounting for concurrently delivered distinct goods or services that have the same pattern of transfer. This is because, in those cases, an entity is not precluded from accounting for the goods or services as if they were a single performance obligation, if the outcome is the same as accounting for the goods and services as individual performance obligations.”
On the basis of the Board’s stated objective, we believe that the practical expedient in ASC 842-10-15-42A can be applied when the only impact is on presentation and disclosure of amounts recognized as part of the arrangement (i.e., the pattern and timing of recognition are the same), provided that the lease component, if accounted for separately, would be classified as an operating lease.

**Example**

Lessor X enters into a lease arrangement with Lessee Y for the use of kitchen space (which is identified as a lease component) for a noncancelable one-year term. The lease component, if accounted for separately, would be classified as an operating lease. The lease arrangement also includes optional cleaning and inventory receiving services (nonlease components) that the lessee can elect to receive from the lessor on a month-by-month basis. When elected, the optional services provide the same benefit to Y each day and will be transferred to the lessee by using a time-based measure of progress (i.e., ratably) over the period in which the services are made available. Both the lease component and the optional services (the nonlease component) are priced at their stand-alone selling price. Therefore, there is no requirement to reallocate contractually stated consideration from the lease component to the nonlease component or vice versa and the right to purchase the optional services does not give rise to a material right, as discussed in ASC 606-10-55-42, that would require allocation of consideration separately between the lease and optional nonlease components under ASC 606-10-55-44 and 55-45.

If and when these optional services are purchased, X would use a time-based measure of progress to determine the amount of revenue to recognize from the cleaning and inventory receiving services because the services are transferred to the customer ratably over the elected service term(s). Accordingly, the pattern and timing of transfer of the optional services for the monthly period elected are the same as those for the kitchen space (the lease component).

Although the lessor is not contractually required to provide optional services over the entire lease term (i.e., the noncancelable one-year term of the lease arrangement), the pattern of transfer for the services will be the same as that for the lease component for the periods in which they are provided. Also, as mentioned above, the optional services are priced at their stand-alone selling prices and do not give rise to a material right that would require separate allocation of consideration to the lease and nonlease components. Consequently, X concludes that the separation of the nonlease component from the lease component would only affect presentation of revenue recorded and disclosure (i.e., the timing and pattern of revenue recognized would not differ if the nonlease component were accounted for separately). Therefore, X can apply the practical expedient in ASC 842-10-15-42A to combine the lease component and nonlease component for the periods in which Y exercises its right to receive the optional cleaning and inventory receiving services.

Once an entity has determined whether an arrangement would qualify for the lessor practical expedient, the entity must assess whether the lease component or nonlease component is the predominant element in the arrangement (see Section 4.3.3.2.2 for more information).

### 4.3.3.2.1.1 Effects of the Practical Expedient on Supplier (Lessor) Accounting

The practical expedient will most likely provide significant relief to certain lessors that are implementing ASC 842. When discussing the expedient at the FASB's November 29, 2017, meeting, several Board members pointed out that certain real estate lessors would be allowed to apply ASC 842 in a manner consistent with how entities are permitted to apply ASC 606 when distinct goods or services are delivered concurrently and have the same pattern of transfer to the customer. Paragraph BC116 of ASU 2014-09 clarifies that, in such cases, entities are not precluded from accounting for, and recognizing revenue from, the goods and services as if they were a single performance obligation.
The examples below illustrate situations in which the practical expedient may provide relief to certain lessors implementing ASC 842. In these examples, assume that the nonlease component would otherwise be accounted for in accordance with ASC 606 and that the lease component, if accounted for separately, would be an operating lease.

**Example 4-2A**

In a common real estate lease arrangement (e.g., a lease of floors in an office building), a lessor may also provide CAM services to the lessee. That is, in such an arrangement, the contract between the seller-lessor and the customer-lessee may include two separate components: (1) the right to use space (the lease component) and (2) maintenance services (the nonlease component). The lessor may perform the CAM services on an as-needed basis (e.g., cleaning the building lobbies, performing minor repairs, maintaining elevators); therefore, the maintenance services would be recognized as revenue ratably over the same period as that in which the leased floors are used. When elected, the practical expedient would allow the lessor to account for such a contract — which provides a lease and related CAM services — as containing a single component, as would be permitted for any other revenue-generating activity (e.g., two concurrently delivered services, each of which a purchaser could elect to buy, with or without the other). This alignment with ASC 606 is consistent with how the Board describes the leasing activities of lessors (i.e., as revenue-generating activities) in paragraphs BC92 and BC153 of ASU 2016-02.

**Example 4-2B**

In a common vehicle lease arrangement, a lessor may agree to offer the customer, in addition to the lease, roadside assistance services on a stand-ready basis as well as participation in a loyalty program. As members of the loyalty program, customers earn points for each purchase and can thereby obtain future discounts or free car rentals. In such an arrangement, the seller-lessor is providing the customer-lessee with three things: (1) the right to use the car (the lease component), (2) roadside assistance as a stand-ready service (a nonlease component), and (3) a material right representing the future discounts offered as part of the loyalty program (a nonlease component). In this scenario, it may be reasonable to conclude that the timing and pattern of transfer for the vehicle lease are the same as those for the roadside assistance services; however, the timing and pattern of transfer associated with the loyalty program are unlikely to be the same as those for the others. Under ASU 2018-11, the lessor would be allowed to apply the practical expedient to combine the lease component and nonlease component for the roadside assistance (i.e., the eligible nonlease component) while separating the nonlease component for the loyalty program that is ineligible for the practical expedient and accounting for it in accordance with ASC 606.

**Example 4-2C**

In certain arrangements, customers are provided with a monitoring service (i.e., a nonlease component) and a connected monitoring device (i.e., a lease component) for delivering the service. The lease and nonlease component may have the same timing and patterns of transfer (e.g., when the lease component is an operating lease and the nonlease component represents a continuous monitoring service). A lessor may apply the practical expedient to combine the components into a single component accounted for under ASC 842 or ASC 606, depending on whether the lease or nonlease component is predominant (see Section 4.3.3.2.2).
Note that unlike the lessee practical expedient, which is available for all contracts, the lessor practical expedient related to combining lease and nonlease components can only be elected when certain conditions are met. For example, the practical expedient cannot be applied to arrangements in which the patterns of transfer for the lease and nonlease components would not be the same. Therefore, lessors that enter into lease arrangements with revenue components that are transferred at a point in time (e.g., sales of equipment or other goods) will not be eligible for the relief from allocation between the lease and revenue component(s). Although constituents raised some concerns about allocation in these ineligible contracts, the Board did not address allocation by lessors that may be struggling to determine the appropriate stand-alone selling prices for the lease and nonlease components in such arrangements. Therefore, such entities will need to continue developing processes for estimating stand-alone selling prices in accordance with ASC 606 so that the consideration in the contract can be allocated to lease and nonlease components.

4.3.3.2.2 Determining Which Component Is Predominant

- Is the nonlease component(s) the predominant component(s) in the combined component?
  - Yes
    - Account for the combined component in accordance with ASC 606, as a performance obligation satisfied over time and by using a time-based method to measure progress.
  - No
    - Account for the combined component as an operating lease in accordance with ASC 842.
As with the lessee practical expedient, the FASB originally proposed that a lessor should always be required to account for the combined component as a lease under ASC 842. However, on the basis of feedback it received, the Board revised the final ASU to require an entity to perform another evaluation to determine whether the combined unit of account is accounted for as a lease under ASC 842 or as a revenue component under ASC 606. Specifically, an entity should determine whether the nonlease component (or components) associated with the lease component is the predominant component of the combined component. If so, the entity is required to account for the single, combined component in accordance with ASC 606. Otherwise, the entity must account for the single, combined component as an operating lease in accordance with ASC 842.

**Connecting the Dots — An Entity Will Need to Use Judgment to Determine the Predominant Component**

As indicated in the Background Information and Basis for Conclusions of ASU 2018-11, the FASB decided not to include a separate definition or threshold for determining whether “the nonlease component is the predominant component in the combined component.” Rather, the Board noted that an entity should consider whether the lessee would “ascribe more value to the nonlease component(s) than to the lease component.” Further, the Board acknowledged that the term “predominant” is used elsewhere in U.S. GAAP, including ASC 842\(^{14}\) and ASC 606.\(^{15}\)

The Board also explained that it does not expect that an entity will need to perform a quantitative analysis or allocation to determine whether the nonlease component is predominant. Rather, it is sufficient if an entity can reasonably determine, on a qualitative basis, whether to apply ASC 842 or ASC 606. Therefore, we expect that entities will need to use judgment in making this determination.

At its March 28, 2018, meeting, the Board discussed a scenario in which the components were evenly split (e.g., a 50/50 split of value) and suggested that, in such circumstances, the combined component should be accounted for under ASC 842 because the nonlease component is not predominant. That is, the entity would need to demonstrate that the predominant element is the nonlease component; otherwise, the combined unit of account would be accounted for as a lease under ASC 842.

We believe that the final language in the ASU is intended to indicate that an entity would need to determine whether the lease or nonlease component (or components) is larger (i.e., has more value); only when the nonlease component is larger should the combined component be accounted for under ASC 606.

In discussions with the FASB staff, we confirmed that an entity needs to look at which component has more value, not significantly more value. In a quantitative analysis, “more value” would constitute more than 50 percent. For example, when the value of the nonlease component is 51 percent and the value of the lease component is 49 percent, the nonlease component would be the predominant component. However, the FASB staff indicated that it generally expects that entities will be able to make this determination qualitatively. We also confirmed that the language “ascribe more value to the nonlease component(s) than to the lease component” intentionally excludes the wording “ascribe significantly more value to the license” from ASC 606-10-55-65. Accordingly, we believe that, to be predominant, the nonlease component only needs to be larger (not significantly larger) than the lease component.

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\(^{14}\) ASC 842-10-25-5 states that “an entity shall consider the remaining economic life of the predominant asset in the lease component” to determine the classification when multiple underlying assets comprise a single lease component.

\(^{15}\) ASC 606-10-55-65A allows entities to use the sales-based and usage-based royalty exception to estimating variable consideration when “a license of intellectual property is the predominant item to which the royalty relates (for example, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).”
The examples below illustrate the determination of the predominant component in a contract. In these examples, assume that the arrangement would qualify for the lessor practical expedient on the basis of the criteria in ASC 842-10-15-42A (outlined above).

**Example 4-2D**

**Real Estate Lease With CAM**

A lessor leases three floors of an office building to a lessee for a fixed annual lease payment that includes payment for CAM activities performed by the lessor (e.g., cleaning the building lobbies, maintaining elevators). The three floors represent a lease component (see Section 4.2), and the CAM is a nonlease component (see Q&A 4-4). The CAM (nonlease component) represents approximately 10 percent, and the lease component approximately 90 percent, of the contract value. In addition, the maintenance services are not specialized or customized and the lessee entered into the lease primarily because of the location of the office space. Therefore, the lease component would be considered the predominant component, since the lessee would be expected to ascribe more value to the lease component. As a result, if the practical expedient is elected for this class of underlying asset, the entire arrangement would be accounted for as an operating lease in accordance with ASC 842.

**Example 4-2E**

**Monitoring Service With Hardware (Connected Device)**

An entity enters into an arrangement to provide a monitoring service that requires the use of a monitoring device (hardware) that tracks data and remits the data back to the service provider. In this example, assume that the arrangement for the monitoring service has been identified as containing a lease. The connected device provided to the customer is considered a lease component, and the monitoring service is a nonlease component. The connected device (hardware) represents 2 percent of the contract value, and the service (nonlease component) represents 98 percent of the contract value. Further, the outputs of the service (i.e., security alerts and monitoring reports obtained from the data provided by the monitoring device) were what the customer intended to obtain by entering into the arrangement. Therefore, the nonlease component would be considered the predominant component, since a lessee (customer) would be expected to ascribe more value to the nonlease component. In this case, if the seller (lessor) elects the practical expedient, the entire arrangement would be accounted for as a revenue arrangement in accordance with ASC 606.

**Example 4-2F**

**Health Care or Retirement Community Accommodations and Service**

An entity may enter into an arrangement to provide tenants with accommodations (i.e., the lease component) in a health care or retirement community as well as health care services (i.e., the nonlease component). These arrangements vary (e.g., skilled nursing facilities), and the service component in certain arrangements may provide more value to the customer-lessee than it does in other arrangements (e.g., independent living facilities that may function more as apartment complexes). Therefore, it may not be clear whether the lessee would ascribe more value to the lease or nonlease component(s). An entity would be required to use judgment in making this determination. If the entity determines that the nonlease component represents a larger portion of the value of the contract (i.e., more than 50 percent), the nonlease component (i.e., the health care services) would be considered the predominant component and, if the practical expedient is elected, the entire arrangement would be accounted for in accordance with ASC 606. Alternatively, if the lessor determines that a lessee would ascribe more value to the lease component (i.e., the accommodations), the lease component would be the predominant component and, if the practical expedient is elected, the entire arrangement would be accounted for as an operating lease in accordance with ASC 842.
Connecting the Dots — Accounting for Variable Payments Should Be Consistent With That for the Combined Component

ASU 2018-11 includes language related to the interaction between the practical expedient and the guidance in (1) ASC 842-10-15-39 on consideration in the contract and (2) ASC 842-10-15-40 on the recognition of variable payments. Specifically, ASC 842-10-15-42B(a)(2) clarifies the Board’s intent that the accounting for variable payments should be consistent with that for the combined component. That is, when the combined component is accounted for as a lease under ASC 842, there are no longer any nonlease (revenue) variable payments; rather, there are only variable payments related to the combined lease component, and that variability should be accounted for in accordance with ASC 842. Conversely, if the combined component is accounted for as a service under ASC 606, all variable payments related to the combined component should be accounted for in accordance with the guidance in ASC 606 on variable consideration. That is, an entity would be required to estimate the variable consideration and constrain such estimates in accordance with the guidance in ASC 606-10-32-11.

The flowchart below summarizes when a lessor may apply the practical expedient related to not separating lease and nonlease components in a contract as well as the required accounting for the combined component when the election is made.
Chapter 4 — Components of a Contract

Although an entity must apply the practical expedient to all eligible nonlease components, the presence of a nonlease component (or components) that is ineligible for the practical expedient does not preclude a lessor from applying the practical expedient to the eligible components.

---

16 Although an entity must apply the practical expedient to all eligible nonlease components, the presence of a nonlease component (or components) that is ineligible for the practical expedient does not preclude a lessor from applying the practical expedient to the eligible components.
See Sections 15.3.2.4 and 16.4.6 for further discussion of the disclosure and transition requirements, respectively, related to the lessor practical expedient.

### 4.4 Determining and Allocating Consideration in the Contract

At this point, entities have identified their separate lease and nonlease components to which consideration in the contract will be allocated. Noncomponents have also been identified to ensure that the consideration in the contract is not allocated to them.

Next, entities must:
- Determine the consideration in the contract.
- Allocate the consideration in the contract to the separate lease and nonlease components.

The remainder of this section will discuss the requirements related to measuring and allocating the consideration in the contract for lessees (Section 4.4.1) and lessors (Section 4.4.2). The following matrix summarizes those requirements.

<table>
<thead>
<tr>
<th>Lessee</th>
<th>Lessor</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Determining the consideration in the contract</strong></td>
<td><strong>Includes:</strong></td>
</tr>
<tr>
<td></td>
<td>• Lease payments (see Chapter 6).</td>
</tr>
<tr>
<td></td>
<td>• Any other fixed payments.</td>
</tr>
<tr>
<td></td>
<td>• Any other variable payments based on index or rate.</td>
</tr>
<tr>
<td></td>
<td><strong>Includes:</strong></td>
</tr>
<tr>
<td></td>
<td>• Lessee consideration in the contract (i.e., everything in the column at left).</td>
</tr>
<tr>
<td></td>
<td>• Estimate of variable consideration (determined under ASC 606) when it is related only to the nonlease component(s).</td>
</tr>
</tbody>
</table>

| Allocating the consideration in the contract to lease and nonlease components | **When practical expedient is elected, no allocation is performed (see Section 4.3.3.1).** |
| When practical expedient is not elected, allocate on the basis of: |
| | • Observable stand-alone price, if readily available. |
| | • Otherwise, estimated stand-alone price (maximizing use of observable inputs). |
| **When practical expedient is elected for eligible nonlease components, no allocation is performed (see Section 4.3.3.2).** |
| **When practical expedient is not elected, allocate on the basis of stand-alone selling price in accordance with ASC 606 (see Chapter 7 of Deloitte’s Revenue Roadmap).** |
Q&A 4-9 Allocating Zero to a Component

**Question**

Is it ever appropriate for a lessee or lessor to allocate none of the consideration in the contract to a component in a contract (i.e., on the basis of a stand-alone price of zero)?

**Answer**

It depends. As discussed in the Connecting the Dots in Section 4.3.1, nonlease components do not need to be “distinct” (i.e., in accordance with ASC 606) to be separated from the lease component. The first criterion in ASC 606 that a promised good or service must meet to be distinct is that it must be capable of being distinct — that is, it must have stand-alone value (see Section 5.3.2.1 of Deloitte’s Revenue Roadmap). Therefore, because a nonlease component is separated from a lease component if it transfers a good or service to the lessee (as opposed to a good or service that is distinct and thus must have stand-alone value), it could be reasonable to conclude that the lease component or nonlease component does not have value on its own and thus has a stand-alone price of zero.

However, we think that these situations will be rare and that any such conclusions will be met with skepticism. We encourage entities that identify such situations to consult with their accounting advisers.

### 4.4.1 Lessee

ASC 842 contains all of the guidance for lessees on determining and allocating the consideration in the contract. That is, unlike the requirements for lessors, the guidance for lessees does not refer to ASC 606 or any other GAAP. Paragraph BC156 of ASU 2016-02 addresses the FASB’s reasoning behind its construction of the guidance with respect to allocation:

> The allocation guidance for lessees in Topic 842 does not reference other Topics; the Board decided that it will be less complex and more intuitive for lessees to include the allocation guidance within the leases Topic. The Board also decided that having lessees apply the revenue recognition guidance in Topic 606 (as is the case for lessors) does not make conceptual sense because a lessee is the customer in a lease rather than the supplier.

The sections below further lay out the guidance for lessees on determining and allocating the consideration in the contract.

**Connecting the Dots — Timing of Measurement and Allocation of the Consideration in the Contract**

ASC 842 does not provide guidance for lessees on the timing of measurement of the consideration in the contract when a nonlease component begins before the commencement date of the lease.

For example, assume that a lessee enters into a contract commencing on December 1, 202X, in which the lessor provides (1) the right to use a warehouse and land and (2) landscaping services to the property. The lease also contains a renewal option. The landscaping services are set to begin one month before the lease commencement date. Accordingly, the lessee should begin recognizing expense associated with the nonlease component for the landscaping services on November 1, 202X.
However, under ASC 842, it is not clear what amount the lessee in this case should recognize as expense for the landscaping services. This is because payments under the contract begin on lease commencement, the lease component(s) is (are) not measured until the commencement date of the lease, and the determination of whether the lessee is reasonably certain to exercise the renewal option would not take place until the commencement date of the lease.

Generally, we think that the lessee in this case should make a preliminary estimate and allocation of the consideration in the contract at the time at which the entity should begin to recognize expense for the nonlease component (i.e., on November 1, 202X). Accordingly, at that time, the lessee should also assess, on a preliminary basis, the likelihood of exercising the renewal option.

On the commencement date of the lease, the lessee's initial estimate and allocation of the consideration in the contract as of November 1, 202X, should be trued up to the actual measurement and allocation of the consideration in the contract as of December 1, 202X.

### 4.4.1.1 Determining the Consideration in the Contract

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-35</strong> 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:</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>b. Any other variable payments that depend on an index or a rate, initially measured using the index or rate at the commencement.</td>
</tr>
</tbody>
</table>

The consideration in the contract measured by a lessee will largely comprise the lease payments determined in accordance with ASC 842-10-30-5. (The determination of lease payments is discussed in detail in Chapter 6.) These are the payments made by the lessee for the right to use the underlying asset (i.e., for the lease component).

However, to reflect all fixed payments and ensure an appropriate allocation between the lease and nonlease components, a lessee must also do the following in measuring the consideration in the contract:

- Add any fixed or in-substance fixed payments made during the lease term that are related to a nonlease component (in-substance fixed payments should be considered the same as when the lease payments are determined in accordance with ASC 842-10-30-5 — see Section 6.2.1).
- Add any variable payments related to a nonlease component that are based on an index or rate by using the index or rate as of lease commencement.
- Subtract any incentives paid or payable to the lessee that are related to a nonlease component (i.e., other than incentives reflected in the lease payments, in accordance with ASC 842-10-30-5).
The lessee does not include variable payments that are not based on an index or rate (i.e., that are based on performance or usage), regardless of whether they are related to the lease or nonlease component, in the measurement of the consideration in the contract. Paragraph BC162 of ASU 2016-02 explains that such variable payments are excluded from the consideration in the contract for the following reasons:

- Doing so “aligns the accounting for variable payments for nonlease components with the Board’s decision on the accounting for variable lease payments.”
- “[I]t would be costly and complex to require lessees to estimate variable payments for nonlease components included in a contract that contains a lease,” especially when customers “generally are not required to estimate variable payments for similar nonlease components that do not include a lease.”

The following graphic summarizes the guidance in ASC 842-10-15-35:

The example below illustrates how a lessee would apply the guidance in ASC 842-10-15-35. (Note that the lessor’s determination of the consideration in the contract for the example below is illustrated in Example 4-8.)

**Example 4-3**

**Case A**

Lessee and Lessor enter into a five-year vehicle lease of an open-wheel race car in which Lessor will also perform maintenance and repair services on the race car. Accordingly, Lessee concludes that there are two components in the contract:

1. A lease component for the right to use the underlying asset.
2. A nonlease component for the maintenance and repair services.

Lessee will pay a fixed monthly payment of $2,000 over the five-year lease. Lessee will pay an additional $500 for each month in which the vehicle is driven the minimum mileage.

Lessee determines that the consideration in the contract is $120,000 (i.e., $2,000 per month \( \times \) 12 months per year \( \times \) 5 years). The additional $500 monthly fee is variable: it does not depend on an index or rate and is based on usage or performance. Therefore, this fee is excluded from the consideration in the contract.

Lessee will allocate the $120,000 to the components in the contract.
Example 4-3 (continued)

Case B
Assume the same facts as in Case A, except that the additional fee is the greater of (1) $500 for each month in which the vehicle is driven the minimum mileage or (2) $15,000 total. Also, once Lessee has driven the minimum mileage for nine months within a single calendar year, Lessor agrees to pay Lessee $100 for each additional month of the year in which Lessee drives the minimum mileage (i.e., for a maximum possible incentive of $300 each year).

Lessee determines that the consideration in the contract is $135,000 (i.e., $120,000, determined in the same manner as in Case A, plus an in-substance fixed payment of $15,000). The incentive is variable: it does not depend on an index or rate and is based on usage or performance. Therefore, the incentive is excluded from the measurement of the consideration in the contract.

Lessee will allocate the $135,000 to the components in the contract.

Common arrangements for which lessees will need to determine (and allocate) the consideration in the contract include gross and triple net leases of real estate. In a typical gross lease, the lessee pays a single fixed payment that covers rent, property taxes, insurance, and CAM. Alternatively, in a typical triple net lease, the lessee pays a single fixed payment for rent but reimburses (or pays directly to a third party on behalf of) the lessor for the lessee’s share of property taxes, insurance, and CAM. That is, in a triple net lease, payments for property taxes, insurance, and CAM are generally variable.

The example below illustrates how a lessee would determine the consideration in the contract in both a gross and a triple net lease of real estate. (Note that the allocation of the consideration in the contract determined in the example below is illustrated in Example 4-5.)

Example 4-4

Case A — Gross Lease of Real Estate
Lessees enters into a lease to rent a building from Lessor. The contract has the following terms:

- Lease term: 5 years.
- Fixed annual lease payment: $85,000.
- Property taxes and insurance on Lessor’s interest in the building: included in the fixed annual lease payment.
- CAM: included in the fixed annual lease payment.

Lessee determines that the contract contains the following components:

- A lease component for the right to use the building.
- A nonlease component for the CAM.

In addition, Lessee determines that the consideration in the contract is $425,000 ($85,000 annual lease payment × 5 years).
Example 4-4 (continued)

Case B — Triple Net Lease of Real Estate
Lessee enters into a lease to rent a building from Lessor. The contract has the following terms:

- Lease term: 5 years.
- Fixed annual lease payment: $60,000.
- Property taxes and insurance on Lessor’s interest in the building: reimbursed costs, estimated to be $5,000 annually.
- CAM: estimated to be $20,000 annually.

Lessee agrees to reimburse Lessor for actual property taxes, insurance, and CAM and determines that the contract contains the following components:

- A lease component for the right to use the building.
- A nonlease component for the CAM.

In addition, Lessee determines that the consideration in the contract is $300,000 ($60,000 annual lease payment × 5 years).

Note that in both Case A and Case B in Example 4-4 and in a manner consistent with Q&As 4-7 and 4-8, the property taxes and the insurance that protects the lessor’s interest in the asset will be (1) noncomponents, (2) part of the consideration in the contract, and (3) allocated to the components in the contract.

4.4.1.2 Allocating the Consideration in the Contract

ASC 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.

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.
 ASC 842-10-15-33 requires lessees to allocate the consideration in the contract to the lease and nonlease components (and initial direct costs to the separate lease components) on the basis of the relative stand-alone price. The notion of the relative stand-alone price in ASC 842-10-15-33 thus creates a hierarchy for determining the basis of allocation:

1. If observable stand-alone prices are readily available for the lease and nonlease components, they must be used.
2. If observable stand-alone prices are not readily available for some or all of the lease and nonlease components, such prices may be estimated. However, estimates of the stand-alone prices must maximize the use of observable inputs.
3. If observable stand-alone prices are not readily available for some of the lease and nonlease components, those prices are highly variable or highly uncertain, and some lease and nonlease components have observable stand-alone prices, a residual estimation approach may be used. However, a residual estimation method should still maximize the use of observable inputs.

In addition, if the lessee uses an estimation method to establish the stand-alone price of a lease or nonlease component, it should use that approach consistently in similar circumstances (e.g., in all similar cases in which the lessee is determining the stand-alone price of CAM in a certain market).

**Connecting the Dots — Lessee Allocation Guidance Is Similar to Step 4 of the Revenue Recognition Model**

In developing the hierarchy in ASC 842-10-15-33(a) for determining the relative stand-alone price, the FASB created an allocation method for lessees that is broadly consistent with the concepts entities use to allocate the transaction price to performance obligations under ASC 606. The Board acknowledges this in paragraph BC156 of ASU 2016-02, which states, in part:

*The allocation guidance for lessees is similar to that for lessors and also is broadly consistent with that in previous GAAP, although some additional rigor has been added to the process for determining the standalone price of a lease or nonlease component. That is, the Board decided that in determining the standalone price of lease and nonlease components of the contract, a lessee is required to use observable standalone prices, if available, before using an estimated standalone price. [Emphasis added]*

ASC 842-10-20 defines the stand-alone price as the “price at which a customer would purchase a component of a contract separately.” ASC 842-10-15-34 clarifies that a stand-alone price is observable if the lessor or similar suppliers would charge this price to sell the lease or nonlease component separately.

**Connecting the Dots — Considerations Related to Estimating the Stand-Alone Price of the Lease Component and Inputs to Be Used**

A lessee that cannot find an observable stand-alone price for a lease component will need to use judgment in estimating this price. Management should consider similar leased assets available in the marketplace and refer to the terms of similar lease contracts as well as the purchase price of comparable assets. Comparable assets do not need to be identical to the underlying asset in the lease component, provided that the lease component is not of a specialized nature. Products or services available from comparable suppliers with similar inputs into the lease contract, such as price, payment structure, lease term, renewal options, and purchase options, can be useful data points.

If no observable information is available for a leased asset (e.g., when an asset is unique to a supplier), a lessee may want to obtain information from the supplier on how prices are established in such arrangements.
The examples below illustrate the guidance in ASC 842-10-15-33 and 15-34 on the lessee’s allocation of the consideration in the contract. Note that, in these examples, it is assumed that the lessee has not elected the practical expedient in ASC 842-10-15-37 (see Section 4.3.3.1).

### Example 4-5

#### Case A — Gross Lease of Real Estate

*The facts below are consistent with Example 4-4, Case A.*

Lessee enters into a lease to rent a building from Lessor. The contract has the following terms:

- **Lease term**: 5 years.
- **Fixed annual lease payment**: $85,000.
- **Property taxes and insurance**: included in the fixed annual lease payment.
- **CAM**: included in the fixed annual lease payment.

Lessee determines that the contract contains the following components and consideration:

- **A lease component** for the right to use the building.
- **A nonlease component** for the CAM.
- **Consideration in the contract** of $425,000 ($85,000 annual lease payment × 5 years).

*The facts below are unique to Example 4-5, Case A.*

Lessee determines that the stand-alone prices of the lease and nonlease components are as follows:

- **Lease component**, in which the lessee includes an estimate of property taxes and insurance: $325,000 ($65,000 annual payment × 5 years).
- **Nonlease component**: $100,000 ($20,000 annual payment × 5 years).

The lessee allocates the consideration in the contract ($425,000) to the lease and nonlease components as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Prices</th>
<th>Percentage of Total Stand-Alone Price</th>
<th>Relative Stand-Alone Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right to use the building (lease component)</td>
<td>$325,000</td>
<td>($325,000 ÷ $425,000) = 76.47%</td>
<td>$325,000</td>
</tr>
<tr>
<td>CAM (nonlease component)</td>
<td>100,000</td>
<td>($100,000 ÷ $425,000) = 23.53%</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>$425,000</td>
<td></td>
<td>$425,000</td>
</tr>
</tbody>
</table>

#### Case B — Triple Net Lease of Real Estate

*The facts below are consistent with Example 4-4, Case B.*

Lessee enters into a lease to rent a building from Lessor. The contract has the following terms:

- **Lease term**: 5 years.
- **Fixed annual lease payment**: $60,000.
- **Property taxes and insurance**: estimated to be $5,000 annually.
- **CAM**: estimated to be $20,000 annually.

Lessee contractually agrees to reimburse Lessor for Lessee’s share of actual property taxes, insurance, and CAM.

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17 Examples 11 and 14 in ASC 842-10-55-132 through 55-140 and ASC 842-10-55-150 through 55-158, respectively, also illustrate such allocation. Both examples are reproduced in Section 4.4.3.
Example 4-5 (continued)

Lessee determines that the contract contains the following components and consideration:

- A lease component for the right to use the building.
- A nonlease component for the CAM.
- Consideration in the contract of $300,000 ($60,000 annual lease payment × 5 years).

The facts below are unique to Example 4-5, Case B.

Lessee determines that the stand-alone prices of the lease and nonlease components are as follows:

- Lease component, in which the lessee includes an estimate of property taxes and insurance: $325,000 ($65,000 annual payment × 5 years).
- Nonlease component: $100,000 ($20,000 annual payment × 5 years).

The lessee allocates the consideration in the contract ($300,000) to the lease and nonlease components as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Prices</th>
<th>Percentage of Total Stand-Alone Price</th>
<th>Relative Stand-Alone Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right to use the building (lease component)</td>
<td>$325,000</td>
<td>($325,000 ÷ $425,000) = 76.47%</td>
<td>$229,412</td>
</tr>
<tr>
<td>CAM (nonlease component)</td>
<td>100,000</td>
<td>($100,000 ÷ $425,000) = 23.53%</td>
<td>70,588</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$425,000</strong></td>
<td></td>
<td><strong>$300,000</strong></td>
</tr>
</tbody>
</table>

While the CAM is estimated to be $20,000 annually, payments for CAM are variable and are therefore not included in the consideration in the contract. The same can be said for the estimated property taxes and insurance of $5,000 annually.

A portion of the fixed consideration in the lease is allocated up front to the nonlease component on the basis of the stand-alone price of the CAM. Thereafter, as variable payments for CAM, property taxes, and insurance are incurred, they will be allocated to the lease and nonlease components on the same basis as the fixed consideration (i.e., 76.47 percent to the lease component as variable lease payments and 23.53 percent to the nonlease component as variable payments for CAM) when they are recognized in the income statement (see Chapter 8 for discussion of a lessee's recognition of variable lease payments). If the lessee's estimates of the stand-alone prices for the lease and nonlease components turn out to be accurate, then by the end of the lease, a total of $325,000 will be allocated to the lease component and a total of $100,000 will be allocated to the nonlease component. However, unlike ASC 606's variable consideration allocation guidance in ASC 606-10-32-39 through 32-41 (which the lessor may consider — see Section 4.4.2.2), ASC 842 does not establish a basis for the lessee to allocate variable consideration entirely to one or more, but not all, components in a contract.

Note that in Example 4-5, the lessee’s estimates of the stand-alone price are consistent with the pricing in the contract, most evidently in Case A. This indicates that the contracts in Example 4-5 are effectively priced at fair value, with no discount on either the lease or nonlease component. Example 4-6 illustrates a different scenario:
Example 4-6

Lessee enters into a five-year lease (a gross lease) of a building from Lessor under which Lessee must make a fixed annual lease payment of $35,000 (payments total $175,000 over the five-year term). In accordance with the terms of the contract, the $35,000 annual payment comprises $20,000 for building rent, $7,000 for CAM, $5,000 for property taxes, and $3,000 for insurance that protects Lessor’s interest in the building. From Lessee’s perspective, the estimated stand-alone price of the right to use the building (including an estimate for taxes and insurance) is $30,000 per year, and the estimated stand-alone price of the CAM is $8,000 per year.

In evaluating the separate components in the contract, Lessee would need to determine what goods and services are being provided in the contract, which may include both lease and nonlease components. In this contract, the primary good or service is the right to use the building and is considered a lease component. In addition, the contract requires Lessor to provide CAM, which represents a nonlease component.

As part of the $35,000 fixed annual lease payment, Lessee also pays Lessor consideration attributable to property taxes and insurance. However, in accordance with ASC 842-10-15-30, those payments would not be considered separate components (either lease components or nonlease components), since each fee is a reimbursement of Lessor’s costs. Therefore, despite requiring the payment of four separately described fees in the contract, the arrangement includes only two components. The total fees of $35,000 must be allocated between the two identified goods and services representing the lease component and the nonlease component.

As a result, Lessee allocates the consideration in the contract ($175,000) as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Prices</th>
<th>Percentage of Total Stand-Alone Price</th>
<th>Relative Stand-Alone Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right to use the building (lease component)</td>
<td>$150,000*</td>
<td>($150,000 ÷ $190,000) = 78.95%</td>
<td>$138,158</td>
</tr>
<tr>
<td>CAM (nonlease component)</td>
<td>40,000**</td>
<td>($40,000 ÷ $190,000) = 21.05%</td>
<td>36,842</td>
</tr>
<tr>
<td></td>
<td>$190,000</td>
<td></td>
<td>$175,000</td>
</tr>
</tbody>
</table>

* $30,000 annual payment × 5 years.
** $8,000 annual payment × 5 years.

On the basis of Lessee’s estimate of the stand-alone prices for the lease and nonlease components, the contract contains a discount of $15,000 ($190,000 total stand-alone price – $175,000 total consideration). The lessee allocation method in ASC 842-10-15-33 therefore results in the allocation of that discount between both the lease component, the building (i.e., $15,000 ÷ 78.95% = $19,182), and the nonlease component, the CAM (i.e., $15,000 × 21.05% = $3,158). Unlike ASC 606’s discount allocation guidance in ASC 606-10-32-36 through 32-38 (which the lessor would consider when allocating a discount — see Section 4.4.2.2), ASC 842 does not establish a basis for the lessee to allocate a discount in a contract entirely to one or more, but not all, components in a contract.

4.4.1.3 Remeasure and Reallocate the Consideration in the Contract

ASC 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).
Certain events trigger the need for a lessee to remeasure and reallocate the consideration in a contract to the various lease and nonlease components:

- **Remeasurement of the lease liability** — The lease liability must be remeasured when the lease payments change. This could be due to changes in (1) the lease term, (2) information about whether a lessee will exercise a purchase option, (3) amounts that it is probable the lessee will owe under a residual value guarantee, or (4) the resolution of a contingency in such a way that some (or all) of the variable lease payments that will be paid over the remainder of the lease term become fixed. Remeasurement of lease payments is discussed in detail in Section 6.10, while the lessee's accounting for a remeasurement of its lease liability is addressed in Section 8.5.

- **Lease modifications not accounted for as a separate contract** — For lease modifications that do not meet the criteria to be accounted for as a separate contract, the remaining consideration in the contract must be remeasured and reallocated upon the effective date of the modification. A modification that is not accounted for as a separate contract may (1) grant the lessee an additional right of use, (2) extend the term of the lease, (2) reduce the term of the lease, (3) fully or partially terminate the lease, or (4) change the consideration in the contract. A lessee's accounting for lease modifications is discussed in detail in Section 8.6.

### 4.4.2 Lessor

The requirements under which a lessor determines and allocates the consideration in the contract are housed partially in ASC 842 and partially in ASC 606:

- **Determining the consideration in the contract** — A lessor measures the consideration in the contract in the same manner as a lessee (i.e., in accordance with ASC 842-10-15-35 — see Section 4.4.1.1). A lessor must also measure certain variable consideration in accordance with the guidance in step 3 of the revenue recognition model in ASC 606. (See Section 4.4.2.1.)

- **Allocating the consideration in the contract** — A lessor allocates the consideration in the contract in accordance with the guidance in step 4 of the revenue recognition model in ASC 606. (See Section 4.4.2.2.)

The sections below further elaborate on these requirements.

#### 4.4.2.1 Determining the Consideration in the Contract

<table>
<thead>
<tr>
<th>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 relate to either of the following:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. The lessor's efforts to transfer one or more goods or services that are not leases</td>
</tr>
<tr>
<td>b. An outcome from transferring one or more goods or services that are not leases. . . .</td>
</tr>
</tbody>
</table>

| 15-39A A lessor may make an accounting policy election to exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee (for example, sales, use, value added, and some excise taxes). Taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset shall be excluded from the scope of this election. A lessor that makes this election shall exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes within the scope of the election and shall comply with the disclosure requirements in paragraph 842-30-50-14. |
Initially, a lessor’s measurement of consideration in the contract is the same as a lessee's. (See Section 4.4.1.1.) However, a lessor must perform a few additional steps related to variable consideration in the contract. A lessee only includes consideration in the contract if it is fixed (or in-substance fixed) or if there are variable payments that depend on an index or a rate. For a lessor, ASC 842-10-15-39 provides additional criteria for variable payments that must be included in the consideration in the contract. That is, a lessor will measure variable consideration in accordance with step 3 of the revenue recognition model in ASC 606, and include it in the consideration in the contract, if the variable payment is specifically related to either or both of the following:

- The lessor's efforts to transfer goods or services (i.e., nonlease components) other than the right to use the underlying asset (i.e., the lease component).
- An outcome of the lessor’s performance in transferring goods or services (i.e., nonlease components) other than the right to use the underlying asset (i.e., the lease component).

If variable payments are fully, or even partially, related to the lease component, the lessor does not include such payments in the consideration in the contract. The following flowchart summarizes the variable consideration requirements in ASC 842-10-15-39:

As a result of this guidance, lessors will often measure more variable consideration as part of the consideration in the contract than lessees will. In addition, lessors will need to familiarize themselves with and use the guidance in ASC 606 on determining the transaction price. Section 6.2 of Deloitte’s Revenue Roadmap discusses the relevant guidance in ASC 606 in detail, and we encourage lessors to consider this guidance when determining their consideration in a contract that contains variable payments related to the nonlease component(s).

**Connecting the Dots — Split Model for Variable Consideration**

The flowchart above effectively depicts a split model for a lessor’s measurement of variable consideration. That is, if the variable consideration is entirely related to a nonlease item, it should be measured in a manner consistent with ASC 606. Otherwise, the variable consideration is in some way related to the lease component and therefore should be treated in a manner consistent with the guidance on variable lease payments in ASC 842.
The FASB further explains this split model in paragraph BC163 of ASU 2016-02:

The Board decided that providing guidance on consideration in the contract was necessary to ensure consistent application of the allocation guidance in Topic 842, particularly for lessors because of the differences between how the Board decided a lessor should account for variable lease payments and how an entity accounts for variable consideration in Topic 606. The Board concluded that accounting for a variable payment that relates partially to a lease component (for example, a performance bonus that relates to the leased asset and the lessor’s operation of that asset) in the same manner as a variable lease payment (that is, with respect to recognition and measurement) will be less costly and complex than accounting for that variable payment in accordance with the variable consideration guidance in Topic 606. In addition, the Board decided that a lessor should not account for a single variable payment in accordance with two accounting models (for example, partially as a variable lease payment and partially as variable consideration in the scope of Topic 606). [Emphasis added]

Ultimately, the split model for measuring variable consideration resulted from a desire to provide relief from the potential cost and complexity of applying the ASC 606 guidance on determining the transaction price (i.e., on estimating variable consideration) to variable payments that are related, even partially, to the lease component. However, we think that a split model introduces certain complexities of its own — namely, such a model could require lessors to use judgment in assessing whether a variable payment is related to a nonlease (i.e., revenue) or lease component in a contract.
The following decision tree summarizes the full requirements in ASC 842-10-15-39 with respect to a lessor’s determination of the consideration in the contract:

1. Start with lessee consideration in the contract (see Section 4.4.1.1)
   - Are there any other variable payments?
     - No: There is no adjustment by the lessor for variable consideration.
     - Yes:
       - Do those variable payments relate fully, or partially, to the lease component?
         - No: In accordance with ASC 606, estimate the amount of variable consideration relating to the nonlease component(s) using the most likely amount method or the expected value method.
         - Yes: In accordance with ASC 606, constrain the estimate of variable consideration to an amount that is not probable of a significant revenue reversal.

Include in the lessor’s measurement of the consideration in the contract.
Connecting the Dots — Determining the Factors Governing Variable Payment Terms May Help Entities Determine the Lease or Nonlease Component to Which the Payments Are Related

Lessors should analyze variable payment terms in a contract to determine the lease or nonlease components to which those payments are related. Whether a variable payment is related to a lease or nonlease component will govern whether that payment is included in the lessor’s measurement of the consideration in the contract.

Determining the factors governing the variability in a payment will be helpful in the assessment of whether the payment is fully or partially related to a lease component. Payments in an arrangement that contains a lease may vary as a result of many different factors, including, but not limited to:

- Usage of the underlying asset (e.g., machine hours, number of units produced).
- Performance measures (e.g., revenues earned, profit margin achieved, costs incurred).
- Occurrence or nonoccurrence of certain events (e.g., inclement weather).
- Market conditions (e.g., market index price of electricity).

In addition, a factor governing variability can be within the control of:

- The lessee (e.g., miles that an automobile is driven).
- The lessor (e.g., costs incurred for delivering maintenance services).
- Neither party (e.g., weather).

Once an entity determines the factors governing variability, they can be tagged to the lease or nonlease component. For example, if payments vary on the basis of the number of miles that the lessee drives a leased automobile, that factor (i.e., miles driven) is related to the lease component (i.e., the right to use the automobile). On the other hand, if payments vary on the basis of the costs the lessor incurs in delivering CAM to the lessee, that factor (i.e., costs incurred) is related to the nonlease component (i.e., CAM).

An entity will sometimes need to use judgment in performing this assessment, since it is not always clear whether the factor governing variability is related to a nonlease or lease component. In some cases, the variability may be related to both.

Example 14, Cases A and B, in ASC 842-10-55-150 through 55-156 (reproduced in Section 4.4.3), illustrates the guidance in ASC 842-10-15-39 on the lessor’s measurement of variable consideration in the contract. The following examples also illustrate the guidance in ASC 842-10-15-39:
Example 4-7

Customer X, which manufactures and sells complex battery systems to electric car manufacturers, enters into a contract with Lessor Y to lease a piece of machinery for use in creating the specialized batteries. According to the terms of the contract, Y will provide (1) the machinery at a fixed rate of $220,000 per year for a noncancelable period of five years and (2) marketing services over that same period to make electric car manufacturers more aware of X’s product. In consideration for the marketing services, X will pay an additional fixed fee of $30,000 per year.

Lessor Y determines that there are two components in the contract:

- A lease component for the right to use the piece of machinery.
- A nonlease component for the marketing services.

Lessor Y identifies fixed consideration in the contract of $250,000 per year ($220,000 for use of machinery + $30,000 for marketing services), or $1,250,000 in total over the five-year contract term.

Lessor Y includes the $1,250,000 of fixed consideration in its measurement of the consideration in the contract in accordance with ASC 842-10-15-35 and ASC 842-10-15-39.

Case A — Variable Consideration Is Partially Related to the Lease Component

Assume that the contract also stipulates that X will pay Y a commission of 2 percent of sales per year for each year for which sales have increased by 10 percent or more over the prior year. Therefore, Y also identifies variable consideration in the form of the 2 percent revenue-sharing commission. Lessor Y determines whether the consideration in the contract includes the variable consideration as follows:

<table>
<thead>
<tr>
<th>Determine the factors governing the variability in the payments.</th>
<th>The variability in the payments is governed by a performance measure — sales.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determine whether the identified factors governing the variability are related to the lease or nonlease component(s).</td>
<td>The 2 percent commission, resulting from increased sales, is at least partially related to the lease component, because X's ability to meet its customers' demand depends at least partially on X's use of the leased piece of machinery to manufacture the batteries.</td>
</tr>
<tr>
<td>Determine the variable consideration to be included in the consideration in the contract.</td>
<td>Because the variable consideration is partially related to the lease component, the variable consideration will be excluded from Y’s initial measurement of the consideration in the contract.</td>
</tr>
</tbody>
</table>
Example 4-7 (continued)

Case B — Variable Consideration Is Related Specifically to the Nonlease Component

Assume instead that the contract also stipulates that X will pay Y a fee of $25 for every customer (or potential customer) of X that clicks on Internet advertisements that Y places on behalf of X as part of providing the marketing services in the contract. Therefore, Y also identifies variable consideration in the form of the $25 fee per click. Lessor Y determines whether the consideration in the contract includes the variable consideration as follows:

**Determine the factors governing the variability in the payments.**

The variability in the payments is governed by a performance measure — advertising clicks, a measure of the effectiveness of the marketing campaign that Y executes on behalf of X.

**Determine whether the identified factors governing the variability are related to the lease or nonlease component(s).**

The fee per click is solely a measure of the effectiveness of Y's marketing services. That is, if Y is effective in the type, style, and location of advertisements it places on X's behalf, those advertisements will receive a greater number of clicks. Customers (or potential customers) of X that click on an Internet advertisement do so without considering X's right to use the leased piece of machinery. The $25 fee per click is therefore specifically related to the outcome of Y's performance of marketing services for X. Therefore, the variable consideration is related specifically to the nonlease component.

**Determine the variable consideration to be included in the consideration in the contract.**

Because the variable consideration is related specifically to the nonlease component, this consideration must be estimated (and potentially constrained) in accordance with ASC 606 and included in Y's initial measurement of the consideration in the contract. Using the expected value method, Y estimates that the amount of consideration to which it will be entitled in exchange for transferring the marketing services to X is $250,000. Lessor Y determines that it is probable that there will not be a significant reversal in the amount of cumulative revenue recognized with respect to its $250,000 estimate.

Example 4-8

This example represents a continuation of Example 4-3. Lessee and Lessor enter into a five-year vehicle lease of an open-wheel race car in which Lessor will also perform maintenance and repair services on the race car. Assume the following facts:  
- Lessee will pay a fixed monthly amount of $2,000.  
- Lessee will also make a variable payment in accordance with Cases A and B below.  
- There are two components in the contract:  
  - A lease component for the right to use the underlying asset.  
  - A nonlease component for the maintenance and repair services.

**Case A**

In Case A, Lessee will pay $500 for each month in which the vehicle is driven the minimum mileage (i.e., variable consideration).
Example 4-8 (continued)

Lessor concludes that the variable consideration should not be included in the consideration in the contract. That is because the variable payment each month is not solely related to performance of the nonlease maintenance and repair services; Lessee's use of the race car (i.e., the lease component) substantively governs whether, and to what extent, Lessor will receive the additional fees. Therefore, Lessor's initial measurement of the consideration in the contract is $120,000 (i.e., $2,000 per month in fixed consideration × 12 months per year × 5 years), which is the same as Lessee's.

Case B

In Case B, the additional fee is the greater of (1) $500 for each month in which the vehicle is driven the minimum mileage or (2) $15,000 total. Lessor agrees that once Lessee has driven the minimum mileage for 9 months within a single calendar year, it will pay Lessee $100 for each additional month of the year in which the minimum mileage is driven (i.e., for a maximum possible incentive of $300 each year).

Lessor's initial measurement of the consideration in the contract must include, at a minimum, $135,000 (i.e., $120,000 in fixed consideration, plus an in-substance fixed payment of $15,000). However, Lessor must also consider whether (1) any amounts above the in-substance fixed amount of $15,000 (i.e., a minimum) are entirely related to the nonlease component and (2) the incentive is entirely related to the nonlease component.

As in Case A, the variable payment each month is not solely related to performance of the nonlease maintenance and repair services; Lessee's use of the race car (i.e., the lease component) substantively governs whether and to what extent Lessor will receive the additional fees (or be required to pay the incentive). Therefore, Lessor concludes that the variable consideration should not be included in the consideration in the contract. Lessor's consideration in the contract is the same as Lessee's — $135,000.

In Cases A and B, Lessor determines that its initial measurement of the consideration in the contract is the same as Lessee's.

Q&A 4-10 Variable Amounts for CAM

As discussed in Q&A 4-4, leases for office or commercial space often contain provisions that require the tenant to reimburse the landlord for CAM costs. Such costs might include an allocated portion of landscaping, janitorial services, repairs, snow removal, and other maintenance of common areas. CAM charges can be based on the actual costs (with or without margin) incurred by the landlord. That is, payments for CAM are often variable.

Question

Are variable payments for CAM entirely related to a nonlease component?

Answer

Yes. CAM charges — whether they are direct reimbursements of actual costs or represent an allocated portion of total CAM performed for a property — are related to the lessor's efforts to transfer, or an outcome from transferring, maintenance and other services that are not leases. Because they are related to a nonlease component (i.e., CAM is a nonlease component, as discussed in Q&A 4-4), variable payments for CAM should be included in the lessor's initial measurement of the consideration in the contract in accordance with the guidance in ASC 606 on determining the transaction price (i.e., they should be estimated by using the “expected value” or “most likely amount” method and potentially constrained).
However, lessors that provide CAM should carefully consider whether there are any other variable amounts that are not related entirely to a nonlease component and, if so, ensure that their estimates for CAM do not incorporate those amounts. As discussed in the Connecting the Dots at the end of Section 4.3.1, other amounts (e.g., utilities, property taxes, and insurance) periodically may be billed together with CAM. Lessors should ensure that, although those amounts may be characterized together in the contract or on an invoice, their estimate of variable CAM charges does not include variable amounts for property taxes or insurance. Both property taxes and insurance are noncomponents (as discussed in Section 4.3.2) and are not entirely related to a nonlease component.

4.4.2.1.1 Certain Lessor Costs Paid Directly by Lessees

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-40A</strong> The guidance in paragraph 842-10-15-40 notwithstanding, a lessor shall exclude from variable payments lessor costs paid by a lessee directly to a third party. However, costs excluded from the consideration in the contract that are paid by a lessor directly to a third party and are reimbursed by a lessee are considered lessor costs that shall be accounted for by the lessor as variable payments (this requirement does not preclude a lessor from making the accounting policy election in paragraph 842-10-15-39A).</td>
</tr>
</tbody>
</table>

ASC 842-10-15-30(b) states that an entity “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 [on behalf of the lessor] 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.” A common example of such a cost is an insurance premium under which, according to the lease contract, the lessee must carry insurance to cover the underlying asset and the insurance policy names the lessor as the primary beneficiary of that policy. Before the guidance in ASC 842-10-15-40A, the new leasing standard required a lessor to report these amounts as revenue and expenses even though the lessee may not be required to provide payment amount information to the lessor. Further, the payment amount may be affected by a number of lessee-specific factors (e.g., discounts due to other policies the lessee has with the issuer that are unrelated to the leased asset). Accordingly, the lessor would not be able to present the lessee’s payments and the associated cost on a gross basis without either obtaining more information from the lessee or estimating the premium.

However, with the amendment in ASC 842-10-15-40A, the FASB achieved both of the following:

- Addressed stakeholders’ concerns about the challenges related to determining costs paid by the lessee directly to a third party on behalf of the lessor by requiring lessors to exclude such costs from variable payments and thus from revenue and expenses.18
- Clarified that costs excluded from the consideration in a contract that are paid directly to a third party by the lessor and then reimbursed by the lessee must be accounted for as variable payments and therefore as revenue and expenses.

**Connecting the Dots — Background on Lessor Costs as Addressed Under ASU 2018-20**

In December 2018, the FASB issued ASU 2018-20, which addresses certain requests made by stakeholders regarding lessor implementation issues associated with ASU 2016-02, including an issue related to certain lessor costs paid directly by lessees to an unrelated third party (e.g., a governmental agency for property taxes or an insurance provider for insurance coverage). ASU 2016-02, as initially issued, required a lessor to report those amounts as revenue and expenses.

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18 IFRS 16 does not contain a similar requirement that lessor costs paid directly to a third party by a lessee should be excluded from variable payments. See Appendix B for a summary of differences between ASC 842 and IFRS 16.
ASU 2018-20 requires lessors to “exclude from variable payments lessor costs paid by a lessee directly to a third party.” Lessor costs are considered costs that are not a component in the contract. That is, lessor costs (e.g., property taxes and insurance) are neither lease components nor nonlease components.

Importantly, under ASU 2018-20, a lessor must exclude from variable payments all lessee payments made directly to a third party for lessor costs, even if the lessor knows the exact dollar amount of those payments. However, at the February 13, 2019, Board meeting, the FASB staff clarified that payments a lessee makes directly to third parties for other lease-related payments (i.e., other than for lessor costs) are not within the scope of this amendment. For example, lease payments made by a sublessee directly to a head lessor typically do not represent lessee payments for sublessor costs, since those payments are generally for a lease component rather than for lessor costs.

This amendment made by ASU 2018-20 did not necessitate any updated disclosure requirements. See Section 17.3.1.5 for a detailed discussion of ASU 2018-20, including the transition requirements.

### 4.4.2.1.2 Practical Expedient Related to Sales Taxes and Other Similar Taxes Collected From Lessees

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-39A</strong> A lessor may make an accounting policy election to exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee (for example, sales, use, value added, and some excise taxes). Taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset shall be excluded from the scope of this election. A lessor that makes this election shall exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes within the scope of the election and shall comply with the disclosure requirements in paragraph 842-30-50-14.</td>
</tr>
</tbody>
</table>

Under ASU 2018-20, lessors can elect, as an accounting policy, to exclude from revenue and expenses sales taxes and other similar taxes assessed by a governmental authority and collected by the lessor from a lessee. This is an entity-wide accounting policy election.

This accounting policy election was requested by lessors and offered by the FASB in an effort to align the leasing guidance with ASC 606, as amended by ASU 2016-12, which allows entities to elect an accounting policy of presenting sales taxes collected from customers on a net basis. Specifically, ASC 606-10-32-2A states, in part:

> An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes).

Although lessors are not within the scope of ASC 606, they are performing a revenue-generating activity in a manner similar to a service accounted for under ASC 606. Accordingly, the FASB provides a similar practical expedient under which lessors can present sales taxes collected from lessees on a net basis.

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19 IFRS 16 does not contain a similar practical expedient allowing lessors to present sales taxes collected from lessees on a net basis. See Appendix B for a summary of differences between ASC 842 and IFRS 16.
Connecting the Dots — Background on Sales Taxes Practical Expedient as Addressed Under ASU 2018-20

In December 2018, the FASB issued ASU 2018-20, which addresses certain requests made by stakeholders regarding implementation issues associated with ASU 2016-02, including an issue related to sales taxes and other similar taxes collected from lessees.

The EITF addressed a similar topic in Issue 06-3, which formed the basis of the guidance on the topic in ASC 606. Therefore, we believe that this guidance is important to understanding the basis for the scope of the accounting policy election under ASC 842-10-15-39A. Issue 06-3 indicates that its scope includes all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction between a seller and a customer. However, the scope does not include taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process. Similarly, taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset are outside the scope of the accounting policy election under ASC 842-10-15-39A. The Board clarified the reason for this exclusion in paragraph BC12 of ASU 2018-20, which states, in part, that such taxes “are levied on a lessor's gross revenue and not a specific lease-producing revenue transaction, [so] the Board concluded that a lessor likely would not be acting as an agent for a lessee with respect to those taxes.”

Moreover, during the deliberation of ASU 2018-20, stakeholders requested that the scope of this election be expanded to include property taxes but the FASB did not grant this request. That is, property taxes should not be considered to be within the narrow scope of this election; rather, an entity should consider property taxes when applying the guidance in ASC 842-10-15-40A, as discussed in Section 4.4.2.1.1.

We expect that entities will often align their accounting policy elections under ASC 606-10-32-2A with those under ASC 842-10-15-39A; however, we note that such consistency is not required.

See Section 17.3.1.5 for a detailed discussion of ASU 2018-20, including the transition and disclosure requirements.

4.4.2.2 Allocating the Consideration in the Contract

ASC 842-10

15-38 A lessor shall allocate (unless the lessor makes the accounting policy election in accordance with paragraph 842-10-15-42A) 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 (unless the lessor makes the accounting policy election in accordance with paragraph 842-10-15-42A) 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.

15-39 . . . 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.
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 not recognize those payments before 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). When the changes in facts and circumstances on which the variable payment is based occur, the lessor shall allocate those payments to the lease and nonlease components of the contract. The allocation shall be on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component(s). Variable payment amounts allocated to the lease component(s) shall be recognized as income in profit or loss in accordance with this Topic, while variable payment amounts allocated to nonlease component(s) shall be recognized in accordance with other Topics (for example, Topic 606 on revenue from contracts with customers).

15-40A The guidance in paragraph 842-10-15-40 notwithstanding, a lessor shall exclude from variable payments lessor costs paid by a lessee directly to a third party. However, costs excluded from the consideration in the contract that are paid by a lessor directly to a third party and are reimbursed by a lessee are considered lessor costs that shall be accounted for by the lessor as variable payments (this requirement does not preclude a lessor from making the accounting policy election in paragraph 842-10-15-39A).

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.

15-42A As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not 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 component if the nonlease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers and both of the following are met:

a. The timing and pattern of transfer for the lease component and nonlease components associated with that lease component are the same.

b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3.

15-42B A lessor that elects the practical expedient in paragraph 842-10-15-42A shall account for the combined component:

a. As a single performance obligation entirely in accordance with Topic 606 if the nonlease component or components are the predominant component(s) of the combined component. In applying Topic 606, the entity shall do both of the following:
   1. Use the same measure of progress as used for applying paragraph 842-10-15-42A(a)
   2. Account for all variable payments related to any good or service, including the lease, that is part of the combined component in accordance with the guidance on variable consideration in Topic 606.

b. Otherwise, as an operating lease entirely in accordance with this Topic. In applying this Topic, the entity shall account for all variable payments related to any good or service that is part of the combined component as variable lease payments.

In determining whether a nonlease component or components are the predominant component(s) of a combined component, a lessor shall consider whether the lessee would be reasonably expected to ascribe more value to the nonlease component(s) than to the lease component.

15-42C A lessor that elects the practical expedient in paragraph 842-10-15-42A shall combine all nonlease components that qualify for the practical expedient with the associated lease component and shall account for the combined component in accordance with paragraph 842-10-15-42B. A lessor shall separately account for nonlease components that do not qualify for the practical expedient. Accordingly, a lessor shall apply paragraphs 842-10-15-38 through 15-42 to account for nonlease components that do not qualify for the practical expedient.
Lessors are required (unless the lessor makes the accounting policy election in ASC 842-10-15-42A — see Section 4.3.3.2) to allocate the consideration in the contract to separate lease and nonlease components in accordance with step 4 of the revenue recognition model in ASC 606-10-32-28 through 32-41. That is, they will generally allocate the consideration in the contract on the basis of the relative stand-alone selling price. Accordingly, when allocating the consideration in the contract, lessors should consider the guidance in Chapter 7 of Deloitte’s Revenue Roadmap.

The allocation guidance in ASC 606 can be summarized as follows:

- The objective for lessors that are allocating the consideration in the contract to lease and nonlease components is the same as that for entities allocating the transaction price to distinct performance obligations in a contract with a customer. That is, in accordance with ASC 606-10-32-28, the objective is for a lessor to allocate the consideration in the contract to each separate lease and nonlease component “in an amount that depicts the amount of consideration to which the entity expects to be entitled for transferring the promised goods or services” to the lessee.

- Generally, to meet the allocation objective, lessors will allocate the consideration in the contract to each component proportionately on the basis of the relative stand-alone selling price. (See Section 7.1 of Deloitte’s Revenue Roadmap.)

- The stand-alone selling price, in accordance with ASC 606-10-32-32, is “the price at which an entity would sell a promised good or service separately to a customer.” The best evidence of a stand-alone selling price for a good or service is the observable price of that good or service when the entity sells it separately to similar customers and in similar circumstances. (See Section 7.2.1 of Deloitte’s Revenue Roadmap.)

- When the stand-alone selling price is not observable, it should be estimated in a manner that (1) results in an allocation of the consideration in the contract that meets the allocation objective discussed above and (2) maximizes the use of observable inputs. (See Section 7.2.2 of Deloitte’s Revenue Roadmap.) In accordance with ASC 606-10-32-34, the following are acceptable methods of estimating the stand-alone selling price: (1) an adjusted market assessment approach; (2) an expected-cost-plus-a-margin approach; and (3) a residual approach, but only when certain criteria are met.

- Proportionate allocation does not affect how profit margins are allocated between the lease and nonlease components. Accordingly, margins for the lease and nonlease components may not be the same when the consideration in the contract is allocated on a relative stand-alone selling price basis. In fact, there may be situations in which the allocation objective is not met by allocating the consideration in the contract proportionately across all components in a contract — for example, when the consideration in the contract includes (1) a discount or (2) variable consideration.

- In accordance with ASC 606-10-32-37, a discount should be allocated entirely to one or more, but not all, components in a contract if certain criteria are met. (See Section 7.3 of Deloitte’s Revenue Roadmap.)

- In accordance with ASC 606-10-32-40, variable consideration should be allocated entirely to one or more, but not all, components in a contract if certain criteria are met. (See Section 7.4 of Deloitte’s Revenue Roadmap.) ASC 842-10-25-39 emphasizes this notion as well.
Chapter 4 — Components of a Contract

- The stand-alone selling prices of the components in the contract are determined at inception. In accordance with ASC 606-10-32-43, “an entity shall not reallocate . . . to reflect changes in standalone selling prices after contract inception.” Accordingly, subsequent changes in the consideration in the contract that are not due to a modification (e.g., when a contingency upon which some or all of the variable payments are based is resolved in such a way that those payments become fixed over the remainder of the contract term) are allocated between the lease and nonlease components in the same proportion as the initial allocation. (See Section 7.5 of Deloitte’s Revenue Roadmap.)

The guidance in ASC 842-10-15-40 addresses payments that are not included in the lessor’s initial determination of the consideration in the contract — variable payments that are fully or partially related to the lease component. Because those payments are not measured at inception and allocated to the lease and nonlease components as part of the consideration in the contract, they should be allocated between the lease and nonlease components in the same proportion as the initial allocation when the changes in facts and circumstances on which the variable payment is based occur. For example, if the lessor’s initial allocation of the consideration in the contract results in the allocation of 80 percent to the lease component and 20 percent to the nonlease component, a variable payment that is partially related to the lease component should also be allocated in those same percentages in the period in which the changes in facts and circumstances on which the variable payment is based occur. The portion of the payment allocated to the lease component should be recognized in profit or loss at that time, and the portion allocated to the nonlease component should be recognized in profit or loss in accordance with ASC 606 (or other applicable GAAP). Example 14, Case A, in ASC 842-10-55-152 (reproduced in Section 4.4.3) further illustrates this guidance.

Connecting the Dots — Background on Recognition of Variable Payments for Contracts With Lease and Nonlease Components as Addressed Under ASU 2018-20

ASU 2016-02 initially required lessors to recognize variable payments “in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur,” regardless of whether the variable payment is related to the lease or nonlease component in the contract.

Stakeholders observed that the guidance, as issued, may lead a lessor to recognize as revenue a variable payment related to a nonlease component before control of the nonlease component is transferred to the customer. That is, as issued, ASC 842-10-15-40, read literally, implied that as soon as an uncertainty that created variability in the consideration is resolved, that amount should be recognized as revenue regardless of whether the item to which it is related has been delivered to the customer/lessee.

To clarify the Board’s intent, ASU 2018-20 amended ASC 842 to require a lessor to allocate (rather than recognize) certain variable payments to the lease and nonlease components when the changes in facts and circumstances on which the variable payment is based occur. After the allocation, the amount of variable payments allocated to the lease component would be “recognized as income in profit or loss in accordance with this Topic [ASC 842], while variable payment amounts allocated to nonlease component(s) [would] be recognized in accordance with other Topics (for example, Topic 606 . . . ).”

This amendment made by ASU 2018-20 did not necessitate any updated disclosure requirements. See Section 17.3.1.5 for a detailed discussion of ASU 2018-20, including transition requirements.
Q&A 4-11 Recognizing Variable Payments in Accordance With ASC 842-10-15-40 When a Portion Is Attributable to the Nonlease Component(s)

ASC 842-10-15-40 includes the following guidance, which was amended by ASU 2018-20, on accounting for certain variable payments that are not included in the lessor's initial determination of the consideration in the contract:

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 not recognize [the lease and nonlease components related to] those payments before 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). When the changes in facts and circumstances on which the variable payment is based occur, the lessor shall allocate those payments to the lease and nonlease components of the contract. The allocation shall be on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component(s). Variable payment amounts allocated to the lease component(s) shall be recognized as income in profit or loss in accordance with this Topic, while variable payment amounts allocated to nonlease component(s) shall be recognized in accordance with other Topics (for example, Topic 606 on revenue from contracts with customers). [Emphasis added]

Question

Under ASC 842-10-15-40, should the pattern of revenue recognition for the portion of the variable payments attributable to the nonlease component(s) differ from how those amounts would be recognized as revenue in accordance with ASC 606?

Answer

No. The amount of variable payments allocated to the nonlease components should be recognized in accordance with ASC 606, resulting in a pattern of revenue recognition that is consistent with the control transfer principle in ASC 606. Before the issuance of ASU 2018-20, ASC 842-10-15-40 implied, when read literally, that as soon as an uncertainty that created variability in the consideration is resolved, that amount should be recognized as revenue regardless of whether the item to which it is related has been delivered to the customer/lessee. Accordingly, the FASB amended the guidance by requiring a lessor to allocate (rather than recognize) certain variable payments to the lease and nonlease components when the changes in facts and circumstances on which the variable payment is based occur. After the allocation, the amount of variable payments allocated to the lease component would be “recognized as income in profit or loss in accordance with [ASC 842], while variable payment amounts allocated to nonlease component(s) [would] be recognized in accordance with other Topics (for example, Topic 606 . . . ).”

Example

Landlord enters into a five-year arrangement with Retailer to lease a retail space in a mall. Monthly payments are based on a variable structure, with a guaranteed minimum, as follows:

- Four percent of monthly retail sales from January through June of each year.
- Two percent of monthly retail sales from July through December of each year.
- Minimum amount due each month is $20,000.
Example (continued)

Each monthly payment is compensation for the right to use the retail space (including reimbursement of associated property taxes and insurance), CAM, and an annual report. Landlord will provide the report on December 31 of each year. The report will include various statistical metrics and analyses (e.g., customer foot traffic, customer buying habits, video tracking data).

Landlord identifies three components:

- A lease component for the right to use the retail space.
- A nonlease component for the CAM.
- A nonlease component for the annual report that is a performance obligation distinct from the CAM services.

Landlord determines that, in accordance with ASC 606, the annual report (a nonlease component) is a performance obligation satisfied at a point in time and that control is transferred to Retailer upon delivery of the report on December 31. Accordingly, any variable payments received during the year attributable to the annual report for the nonlease component should be deferred and recognized as revenue when the report is delivered and control is transferred at a point in time (i.e., at the end of each year). This conclusion is true regardless of whether the lessor has elected the practical expedient related to combining lease and nonlease components. This is because the nonlease component for the annual report would not meet the scope criteria for combination since its pattern of transfer (at a point in time) is not the same as the pattern of transfer of the lease component (over time provided that the lease component is an operating lease).

Connecting the Dots — Differences Between Lessee and Lessor Allocation

As discussed in the Connecting the Dots in Section 4.4.1.2, the method under which a lessee allocates the consideration in the contract on a relative stand-alone price basis is similar to the framework in ASC 606 for allocating the transaction price. Because lessors use ASC 606 to allocate the consideration in the contract, the method that lessees use is therefore similar to that for lessors.

However, there are two primary differences between the requirements for lessees and those for lessors:

1. Lessees always allocate the consideration in the contract proportionally to the lease and nonlease components on a relative stand-alone price basis. That is, there are no special considerations for allocating discounts or variable consideration. Lessors, on the other hand, would apply the specific requirements in ASC 606 to allocate discounts and variable consideration. For example, a lessor could allocate a discount entirely to the nonlease component, whereas the lessee would be required to spread that discount proportionately over all the components in the contract.

2. Lessors must determine the stand-alone selling price of each component in the contract to allocate the consideration in the contract. Accordingly, lessors must determine the price at which the entity (i.e., the lessor) would sell that promised good or service separately to a customer. On the other hand, the observable stand-alone price that the lessee must use for allocation purposes is the price at which either the lessor or similar suppliers sell similar lease or nonlease components on a stand-alone basis. That is, the lessee may take into account observable evidence of pricing by other suppliers (i.e., not just the lessor) in the market when determining the stand-alone price.
Lessors may incorporate observable data related to the pricing of goods or services by its competitors when using an adjusted market assessment approach to estimate the stand-alone selling price. However, the intent of that approach is to adjust such data to reflect the lessor’s costs and margins so that it may identify the price at which the entity would sell that good or service separately.

**Connecting the Dots — Allocation Between Revenue-Generating Activities Under ASC 842 Is Consistent With ASC 606**

In ASC 606, the FASB developed a comprehensive framework for allocating consideration between performance obligations. Because leasing represents a revenue-generating activity for lessors, the Board found it appropriate for lessors to deploy that same framework in contracts that contain a lease.

The Board explains its rationale for this decision in paragraph BC153 of ASU 2016-02:

> In the Board's view, leasing transactions are fundamentally a revenue-generating activity (even if the principal revenue stream is interest income) in which the item that a lessor transfers to the customer is the right to use the underlying asset. Accordingly, it is appropriate for a lessor to allocate consideration to the lease and nonlease components as a seller allocates the transaction price (and changes in the transaction price) to performance obligations in a revenue contract and does not allocate consideration to activities or costs that do not transfer a good or service to the lessee.

**Q&A 4-12 Concurrently Delivered Lease and Nonlease Components**

**Question**

If a lease component’s pattern of transfer to the lessee is the same as that for a nonlease component, is separation of (and allocation of consideration in the contract to) the lease and nonlease components required?

**Answer**

It depends. If an entity elects the practical expedient that allows lessors, when certain conditions are met, not to separate lease and nonlease components, separation of (and allocation of consideration in the contract to) the lease and nonlease components is not required. The remainder of this Q&A is written on the premise that a lessor does not elect the practical expedient (see Section 4.3.3.2). Paragraph BC153 of ASU 2016-02 states, in part:

> In reaching its decisions on lessor allocation, the Board noted that the basis for conclusions in Update 2014-09 states that an entity is not precluded from accounting for concurrently delivered goods or services that have the same pattern of transfer to the customer as if they were a single performance obligation, even if they are distinct from each other, because the outcome would be the same as accounting for the goods and services separately. Therefore, it similarly would be reasonable for lessors to account for multiple components of a contract as a single component if the outcome from doing so would be the same as accounting for the components separately (for example, a lessor may be able to conclude that accounting for an operating lease and a related service element as a single component results in the same accounting as treating those two elements as separate components). The previous sentence notwithstanding, a lessor may need to separately consider presentation and disclosure in accordance with other Topics. [Emphasis added]
The last sentence in paragraph BC153 of ASU 2016-02 (emphasized in bold above) is the most important point — although the accounting (and revenue recognition) for a lease component may be the same as that for a nonlease component, the presentation and disclosure requirements for lease components differ from those for nonlease components (i.e., the requirements in ASC 842 and those in ASC 606, respectively). Therefore, separation of (and allocation of consideration in the contract to) the components in a contract is still required for presentation and disclosure purposes, even when the pattern of transfer to the lessee for a lease component is the same as that for a nonlease component. (See Chapters 14 and 15 for detailed discussion of the presentation and disclosure requirements, respectively, in ASC 842.)

However, paragraph BC153 of ASU 2016-02 also notes that the transfer of a right to use an underlying asset (i.e., a lease component) and a service (i.e., a nonlease component) are both revenue-generating activities. Accordingly, even when ASC 842 (and interactions between ASC 842 and ASC 606) requires separation and allocation for presentation and disclosure purposes, it may be reasonable to account for (and recognize revenue from) the lease component and nonlease component together if they have the same pattern of transfer (e.g., when both an operating lease and a nonlease service component are transferred evenly over the contract term).

Paragraph BC116 of ASU 2014-09 (and paragraph BC153 of ASU 2016-02) mentions this concept with respect to accounting for distinct goods or services that have the same pattern of transfer as if they were a single performance obligation; paragraph BC116 of ASU 2014-09 states, in part:

> The Boards noted that Topic 606 would not need to specify the accounting for concurrently delivered distinct goods or services that have the same pattern of transfer. This is because, in those cases, an entity is not precluded from accounting for the goods or services as if they were a single performance obligation, if the outcome is the same as accounting for the goods and services as individual performance obligations. [Emphasis added]

### Connecting the Dots — Practical Expedient for Concurrently Delivered Lease and Nonlease Components

As discussed in Section 4.3.3.2, in July 2018, the FASB issued ASU 2018-11, which includes a practical expedient that allows lessors, when certain conditions are met, not to separate lease and nonlease components. One of those conditions is that the lease component’s pattern of transfer to the lessee is the same as that for the nonlease component (i.e., the lease and nonlease components are concurrently delivered). Lessors availing themselves of this practical expedient would not need to separate the lease and nonlease components, even for presentation and disclosure purposes (as discussed in Q&A 4-12). Rather, lessors would account for the lease component and its related nonlease component(s) as a single component.

If the practical expedient is elected, separation of (and allocation of consideration in the contract to) the components is not required when the patterns of transfer are the same. However, if the practical expedient is not elected, such separation and allocation are required in these circumstances.

See Sections 4.3.3.2 and 17.3.1.4.2 for detailed discussions of the practical expedient and its effects on the accounting by lessors.

The split model for measuring variable consideration (discussed in the Connecting the Dots in Section 4.4.2.1), as well as the requirements in ASC 606, increases the complexity of allocating variable consideration to the lease and nonlease components. The following decision tree illustrates how variable consideration is allocated in accordance with ASC 842-10-15-38 through 15-40.
Example 14, Cases A–C, in ASC 842-10-55-150 through 55-158 (reproduced in Section 4.4.3) illustrates the guidance in ASC 842-10-15-38 through 15-40 for lessors on allocating the consideration in the contract. The following examples also illustrate the guidance in ASC 842-10-15-38 through 15-40 (note that, in these examples, it is assumed that the lessor has not elected the practical expedient discussed in Section 4.3.3.2):

**Example 4-9**

This example represents a continuation of Example 4-7. Customer X, which manufactures and sells complex battery systems to electric car manufacturers, enters into a contract with Lessor Y to lease a piece of machinery for use in creating the specialized batteries. According to the terms of the contract, Y will provide (1) the machinery at a fixed rate of $220,000 per year for a period of five years and (2) marketing services over that same period to make electric car manufacturers more aware of X’s product. In consideration for the marketing services, X will pay an additional fixed fee of $30,000 per year.

Lessor Y determines that there are two components in the contract:

- A lease component for the right to use the piece of machinery.
- A nonlease component for the marketing services.
Chapter 4 — Components of a Contract

Example 4-9 (continued)

Case A — Variable Consideration Is Partially Related to the Lease Component

The facts below are consistent with Example 4-7, Case A.

Assume that the contract also stipulates that X will pay Y a commission of 2 percent of sales per year for each year for which sales have increased by 10 percent or more over the prior year. Therefore, Y also identifies variable consideration in the form of the 2 percent revenue-sharing commission.

Lessor Y determines that the consideration in the contract is $250,000 per year ($220,000 for use of machinery + $30,000 for marketing services), or $1,250,000 in total over the five-year contract term. No variable consideration is included in Y’s measurement of the consideration in the contract because the variable consideration (i.e., the 2 percent of sales per year for each year in which sales have increased by 10 percent or more over the prior year) is partially related to the lease component.

The facts below are unique to Example 4-9, Case A.

Lessor Y determines that the stand-alone selling prices of the lease and nonlease component are as follows:

- Lease component: $1,125,000 ($225,000 per year × 5 years).
- Nonlease component: $175,000 ($35,000 annual payment × 5 years).

Accordingly, the contract contains a discount of $50,000 ($1,300,000 total stand-alone selling price – $1,250,000 consideration in the contract). However, Y does not have observable evidence to support, in accordance with ASC 606-10-32-37, that the entire discount is related to only one of the components in the contract.

Lessor Y allocates the consideration in the contract to the lease and nonlease components as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Selling Prices</th>
<th>Percentage of Total Stand-Alone Selling Price</th>
<th>Relative Stand-Alone Selling Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right to use the machinery</td>
<td>$ 1,125,000</td>
<td>($1,125,000 ÷ $1,300,000) = 86.54%</td>
<td>$ 1,081,731</td>
</tr>
<tr>
<td>Marketing services</td>
<td>175,000</td>
<td>($175,000 ÷ $1,300,000) = 13.46%</td>
<td>168,269</td>
</tr>
<tr>
<td></td>
<td>$ 1,300,000</td>
<td></td>
<td>$ 1,250,000</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.

Case B, Scenario 1 — Variable Consideration Is Specifically Related, and Allocated Entirely, to the Nonlease Component

The facts below are consistent with Example 4-7, Case B.

Assume that the contract also stipulates that X will pay Y a fee of $25 for every customer (or potential customer) of X that clicks on Internet advertisements that Y places on behalf of X as part of providing the marketing services in the contract. Therefore, Y also identifies variable consideration in the form of the $25 fee per click.

Lessor Y determines that the consideration in the contract is $1,500,000 in total over the five-year contract term ($1,250,000 fixed consideration over the five-year contract term + $250,000 total estimate of variable consideration).
Example 4-9 (continued)

The facts below are unique to Example 4-9, Case B, Scenario 1.

Lessor Y determines that the stand-alone selling prices of the lease component and nonlease component are as follows:

- Lease component: $1,100,000.
- Nonlease component: $400,000.

Lessor Y concludes that (1) the variable consideration is specifically related to an outcome from transferring the marketing services and (2) allocating the variable consideration entirely to the marketing services is consistent with the allocation objective in ASC 606-10-32-28 (i.e., there is no discount in the arrangement — see Scenario 2 below, in which this outcome is inconsistent with the allocation objective as a result of a discount that is not clearly related to one or more components in the contract). In addition, to maintain consistency with the allocation objective, on the basis of the stand-alone selling prices noted above, the fixed consideration would need to be allocated to both the lease and nonlease components.

Lessor Y allocates the fixed consideration in the contract to the lease and nonlease components as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Selling Prices</th>
<th>Percentage of Total Stand-Alone Selling Price</th>
<th>Relative Stand-Alone Selling Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right to use the machinery (lease component)</td>
<td>$1,100,000</td>
<td>($1,100,000 ÷ $1,250,000) = 88.00%</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Marketing services (nonlease component)</td>
<td>$150,000*</td>
<td>($150,000 ÷ $1,250,000) = 12.00%</td>
<td>150,000</td>
</tr>
<tr>
<td></td>
<td>$1,250,000</td>
<td></td>
<td>$1,250,000</td>
</tr>
</tbody>
</table>

* The $400,000 total stand-alone selling price, less the estimate of variable consideration of $250,000, results in $150,000 of the stand-alone selling price that is attributable to fixed consideration. To allocate the fixed consideration on a relative stand-alone selling price basis in a manner that is consistent with the allocation objective in ASC 606-10-32-28, Y must use a stand-alone selling price for the nonlease component that includes only a representative portion of the fixed consideration. Because all of the variable consideration is allocated entirely to the nonlease component, not adjusting the stand-alone selling price of the nonlease component would result in an allocation of the fixed consideration that is skewed inappropriately toward the nonlease component.

Lessor Ys resulting allocation of the consideration in the contract is as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Fixed Consideration</th>
<th>Variable Consideration</th>
<th>Total Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right to use the machinery (lease component)</td>
<td>$1,100,000</td>
<td>$0</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Marketing services (nonlease component)</td>
<td>150,000</td>
<td>250,000</td>
<td>400,000</td>
</tr>
<tr>
<td></td>
<td>$1,250,000</td>
<td>$250,000</td>
<td>$1,500,000</td>
</tr>
</tbody>
</table>
Example 4-9 (continued)

Case B, Scenario 2 — Variable Consideration Is Specifically Related to the Nonlease Component and Is Allocated on the Basis of Stand-Alone Selling Prices

The facts below are consistent with Example 4-7, Case B.

Assume that the contract also stipulates that X will pay Y a fee of $25 for every customer (or potential customer) of X that clicks on Internet advertisements that Y places on behalf of X as part of providing the marketing services in the contract. Therefore, Y also identifies variable consideration in the form of the $25 fee per click.

Lessor Y determines that the consideration in the contract is $1,500,000 in total over the five-year contract term ($1,250,000 fixed consideration over the five-year contract term + $250,000 total estimate of variable consideration).

The facts below are unique to Example 4-9, Case B, Scenario 2.

Lessor Y determines that the stand-alone selling prices of the lease component and nonlease component are as follows:

- Lease component: $1,250,000.
- Nonlease component: $300,000.

Accordingly, the contract contains a discount of $50,000 ($1,550,000 total stand-alone selling price – $1,500,000 consideration in the contract). However, Y does not have observable evidence to support, in accordance with ASC 606-10-32-37, that the entire discount is related to only one of the components in the contract. Lessor Y concludes that allocating the variable consideration entirely to the nonlease component is inconsistent with the allocation objective in ASC 606-10-32-28, because doing so would inappropriately skew allocation of the discount toward the nonlease component.

Lessor Y allocates the consideration in the contract to the lease and nonlease components as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Selling Prices</th>
<th>Percentage of Total Stand-Alone Selling Price</th>
<th>Relative Stand-Alone Selling Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right to use the machinery (lease component)</td>
<td>$1,250,000</td>
<td>($1,250,000 ÷ $1,550,000) = 80.65%</td>
<td>$1,209,677</td>
</tr>
<tr>
<td>Marketing services (nonlease component)</td>
<td>300,000</td>
<td>($300,000 ÷ $1,550,000) = 19.35%</td>
<td>290,323</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,550,000</strong></td>
<td></td>
<td><strong>$1,500,000</strong></td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.
Example 4-10

Case A — Gross Lease of Real Estate

Lessee enters into a five-year lease (a gross lease) of a building from Lessor under which Lessee is required to make a fixed annual lease payment of $35,000 (payments total $175,000 over the five-year term). In accordance with the terms of the contract, the $35,000 annual payment comprises $20,000 for building rent, $7,000 for CAM, $5,000 for property taxes, and $3,000 for insurance that protects Lessor's interest in the building. From Lessor's perspective, the stand-alone selling price of the right to use the building (including an estimate of Lessor's costs for taxes and insurance) is $29,500 per year and the stand-alone selling price of the maintenance services is $7,650 per year.

In evaluating the separate components in the contract, Lessor would need to determine what goods and services are being provided, which may include both lease and nonlease components. In this contract, the primary good or service is the right to use the building, which is considered a lease component. In addition, the contract requires Lessor to provide maintenance services, which represent a nonlease component (i.e., a service to be accounted for in accordance with ASC 606).

As part of the $35,000 fixed annual lease payment, Lessee also pays Lessor consideration attributable to property taxes and insurance. However, in accordance with ASC 842-10-15-30, those payments would not be considered separate components (either lease components or nonlease components), since each fee is a reimbursement of Lessor's costs. Therefore, despite requiring the payment of four separately described fees in the contract, the arrangement includes only two components. The total fees of $35,000 must be allocated between the two identified goods and services representing the lease component and nonlease component.

As a result, Lessor allocates the consideration in the contract ($175,000) as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Selling Prices</th>
<th>Percentage of Total Stand-Alone Selling Price</th>
<th>Relative Stand-Alone Selling Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right to use the building (lease component)</td>
<td>$147,500</td>
<td>($147,500 ÷ $185,750) = 79.40%</td>
<td>$138,964</td>
</tr>
<tr>
<td>CAM (nonlease component)</td>
<td>38,250</td>
<td>($38,250 ÷ $185,750) = 20.60%</td>
<td>36,036</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$185,750</strong></td>
<td></td>
<td><strong>$175,000</strong></td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.

Note that the contract contains a discount of $10,750 ($185,750 total stand-alone selling price – $175,000 consideration in the contract). However, Lessor does not have observable evidence to support, in accordance with ASC 606-10-32-37, that the entire discount is related to only one of the components in the contract. Therefore, Lessor appropriately allocates the consideration in the contract proportionately to the lease and nonlease components on a relative stand-alone selling price basis.
Example 4-10 (continued)

Case B — Triple Net Lease of Real Estate

Assume the same facts as in Case A, except that Lessee is required to make fixed annual lease payments of only $20,000 for building rent. Lessor charges payments for property taxes, insurance, and CAM to Lessee on the basis of Lessee’s share of actual costs incurred. Thus, payments for property taxes, insurance, and CAM all represent variable consideration. Lessor estimates that Lessee’s share of CAM will be $7,000 annually and that Lessee’s share of property taxes and insurance will be a total of $8,000 annually.

In a manner consistent with that in Case A, Lessor concludes that there are two components in the contract:

- A lease component for the right to use the underlying asset, with a stand-alone selling price of $29,500 annually (which includes an estimate of Lessee’s share of the variable charges for taxes and insurance).
- A nonlease component for the CAM, with a stand-alone selling price of $7,650 annually.

In a manner consistent with that in Q&A 4-10, Lessor concludes that the variable consideration for the CAM is entirely related to the CAM nonlease component. Using the expected value method in ASC 606, Lessor estimates that the amount of consideration to which it will be entitled in exchange for transferring the CAM to Lessee is $7,000 annually. Lessor determines that it is probable that there will not be a significant reversal in the amount of cumulative revenue recognized with respect to its estimate.

However, Lessor does not include an estimate of the variable consideration for the property taxes and insurance in the consideration in the contract. The variable charges for property taxes and insurance that Lessee will pay are entirely or partially related to the lease component and are therefore excluded from the consideration in the contract. In accordance with ASC 842-10-15-40, Lessor, will (1) when changes in facts and circumstances upon which the variable payments are based occur, allocate those payments for property taxes and insurance in accordance with the same initial relative stand-alone selling price basis as for the consideration in the contract and (2) recognize the payments in accordance with the applicable guidance.

Therefore, Lessor concludes that the consideration in the contract is $135,000 ($20,000 fixed consideration for rent × 5 years + $7,000 estimated variable consideration for CAM × 5 years).

When allocating the consideration in the contract, Lessor considers the guidance in ASC 842-10-15-39 and determines that allocating the variable consideration entirely to the nonlease component would be consistent with the allocation objective in ASC 606-10-32-28. This is because allocating the variable consideration for CAM to the CAM nonlease component and the fixed consideration for the building rent to the lease component is in line with the stand-alone selling prices of each component (i.e., when Lessee’s estimated share of property taxes and insurance are also considered in the determination of the stand-alone selling price of the lease component).

Accordingly, Lessor applies the lessor accounting guidance (see Chapter 9) to the fixed consideration of $100,000 and the revenue recognition guidance in ASC 606 to the $35,000 of the estimated variable consideration included in the consideration in the contract. When changes in facts and circumstances upon which the variable payments for property taxes and insurance are based occur, Lessor will allocate those payments to the lease component (i.e., because allocating any of the payments to the nonlease component would not meet the allocation objective with respect to either the lease component or the nonlease component, when the stand-alone selling price of each is taken into account).

Q&A 4-13 Estimating the Stand-Alone Selling Price of the Lease Component by Reference to a Gross Real Estate Lease at Fair Value

Example 4-10, Case A, illustrates an allocation by which the real estate lessor is able to estimate the stand-alone selling price of the lease component in a gross lease. However, lessors of real estate under gross leases often do not lease real estate separately without CAM and other services (i.e., they do not also lease on a triple net basis); thus, it may be difficult to estimate the stand-alone selling price of the lease component. However, a lessor of real estate under gross leases may be able to estimate the stand-alone selling price of CAM by using the expected-cost-plus-a-margin approach in ASC 606-10-32-34(b).
**Question**

If a real estate lessor under a gross lease can show that the contract is priced at fair market value and can estimate the stand-alone selling price of CAM, can the real estate lessor estimate the stand-alone selling price of the lease component by reference to the fair market value price of the entire contract and the nonlease component?

**Answer**

It depends. The allocation method described above effectively results in the following, when there are only two components in the contract (i.e., a lease component and nonlease component for CAM): stand-alone selling price of lease component = fair market value price of entire contract – estimate of stand-alone selling price of CAM.20

This allocation method is similar mathematically to the residual approach in ASC 606-10-32-34(c), which states:

Residual approach — An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met:

1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).

2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

However, when a lessor of gross real estate can prove by reference to objective and observable market data that the entire contract is priced at fair market value, we think that the allocation method described above is an acceptable approach to estimating the stand-alone selling price of a lease component. ASC 606-10-32-34 states that the approaches listed in ASC 606-10-32-34(a)–(c) are “[s]uitable methods for estimating the standalone selling price of a good or service” but that methods of estimating a stand-alone selling price “are not limited to” those approaches.

In addition, we think that the following conditions should also be met before a lessor of gross real estate may use the allocation method described above:

1. The lessor can reasonably estimate the stand-alone selling price of the CAM by using a suitable method in ASC 606-10-32-34(a) or (b). For example, the lessor can show, by using objective and observable market data (e.g., quotes from asset managers), that its estimate for the stand-alone selling price of CAM is in line with market pricing for related services.

2. The objective and observable market data used to prove that the entire contract is priced at fair market value sufficiently indicate that there is no discount in the contract. (If there is a discount, it must be allocated in accordance with ASC 606-10-32-36 through 32-38 and such allocation may not be on a relative stand-alone selling price basis.)

3. The allocation method generally should not result in an estimate of zero for the stand-alone selling price of one of the components in the contract. (However, see Q&A 4-9 for further discussion.)

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20 For example, by using an expected-cost-plus-a-margin approach.
When the entire contract is priced at fair market value and the other three conditions above are met, we think that the allocation method described above is effectively an adjusted market assessment approach in accordance with ASC 606-10-32-34(a) and that use of such an approach would result in sufficient objective evidence that the contract does not contain a discount. On the other hand, if a lessor of real estate under a gross lease is unable to prove, using objective and observable market data, that the entire contract is priced at fair market value, the allocation method described above is effectively the residual approach. In such cases, we think that neither the contract nor the good or service (i.e., the lease component) would meet the criteria in ASC 606-10-32-34(c) for use of the residual approach.

Real estate lessors that are considering the allocation method described above should consult with their accounting advisers and monitor developments on the topic, since views on the applicability of this method may differ.

Q&A 4-13A  Allocating Consideration in Arrangements Involving the Use of an Asset for “Free”

Vendors in certain industries often provide customers with the right to use, for a specified period, a piece of equipment for no charge (“free equipment”) in exchange for exclusive rights to supply related products (i.e., consumables). The equipment typically can be used only to dispense consumables that are sold by the vendor. In many cases, the customer has the right, but not the obligation, to purchase consumables from the vendor at a specified price. These arrangements may be referred to as “free lease” arrangements because they often contain no explicit consideration related to the use of the equipment; rather, the consideration in the contract consists of a charge per unit of consumable purchased by the customer. Examples of such arrangements may include a contract that conveys the use of an x-ray scanner to a hospital (the hospital may purchase contrast dyes only from the vendor) and a contract that conveys the use of a soft drink fountain dispenser to a restaurant (the restaurant may purchase soda syrup only from the vendor).

Question 1

Should a vendor in a “free lease” arrangement allocate the consideration in the contract between the use of the equipment (i.e., a lease component) and the purchase of the consumables (i.e., a nonlease component)?

Answer

It depends. In general, we would expect the consideration in the contract (even if the consideration is all variable) to be allocated among the contract components. We would not normally expect a vendor to provide equipment to a customer without expecting compensation. This would suggest that some of the per-unit price of the consumables should be allocated to the use of the equipment.

However, in some limited circumstances, we would not object to allocating 100 percent of the per-unit price to the consumable sales if the following criteria are met:

- The contract only includes variable payments not based on an index or rate; that is, the contract does not contain any fixed or in-substance fixed payments.
- The consumables are priced at (or below) their stand-alone selling price.
- The equipment is insignificant in the context of the contract.
If the contract contains a fixed or in-substance fixed payment, as described in ASC 842-10-30-5 and ASC 842-10-15-35 (e.g., a minimum commitment to purchase consumables), such amounts must be allocated between the identified equipment in the arrangement and any nonlease components. In these situations, provided that the customer has the right to control the use of the identified equipment, we believe that such a contract contains a lease of the equipment. (A lease is defined as the “right to control the use of identified [PP&E] for a period of time in exchange for consideration” (emphasis added).)

The second criterion is designed to identify scenarios in which a vendor has not “marked up” the consumables to compensate itself for providing the customer with use of the equipment. To the extent that the per-unit price is at or below the vendor’s stand-alone selling price for the consumables (i.e., the per-unit price is the same as or lower than the per-unit price for a customer that purchases the equipment), this fact constitutes evidence that the vendor is not seeking or receiving incremental compensation for the equipment.

If the first two criteria are met, the vendor should evaluate the equipment’s value in relation to the overall combined value of the arrangement (including an estimate of the consumable value by using its best projection of consumables to be purchased over the contract term). The vendor should also consider other relevant factors (qualitative and quantitative) to determine whether the equipment is insignificant in the context of the contract.

The fact that an arrangement satisfies these three criteria may suggest that the vendor has provided the right to use its asset over the term of the contract for no compensation. While future consumable purchases are expected, there are no enforceable rights to require future purchases. Therefore, in a manner consistent with an optional purchase model for a revenue transaction (as described in TRG Paper 48), those future consumable purchases are not enforceable and do not create additional consideration in the arrangement, and the customer thus obtains use of the vendor’s asset without any obligation to make payments. This outcome is consistent with a revenue transaction in which a vendor provides its customer with an up-front deliverable (e.g., a razor) for no consideration and expects (but is not able to require) the customer to make subsequent purchases of consumables (razor blades). In this revenue transaction, the vendor would record no revenue for the up-front deliverable (razor) and would incur a day 1 loss upon the transfer of control of the deliverable (razor) to the customer.

**Example**

Vendor L provides Customer H with “free” diagnostic equipment for a stated noncancelable term of five years. The equipment has no use other than in combination with consumables sold by L to produce a testing result. The equipment is explicitly specified in the contract, and H controls the use of the equipment during the five-year contract term through its exclusive use and ability to direct the use of the equipment. Customer H is required to return the equipment to L at the end of the contract term. The contract contains no explicit consideration for the use of the equipment; the consideration consists of a cost per unit of consumable purchased by H.

Throughout the five-year contract term, H has the right, but not the obligation, to purchase consumables from L to use in operating the equipment. The contract does not contain any minimum purchase commitments related to the consumables. Customer H may only use the consumables with the equipment provided by L and may not use a third-party vendor’s consumables with the equipment.

Vendor L has determined that the stand-alone selling price for the use of the equipment over a five-year term is $200,000.
**Question 2**

In the example above, is L required to allocate the consideration in the arrangement between the sale of consumables and the use of the equipment and, if so, how should the payments received by L for consumables purchased by H be allocated between the equipment (i.e., the lease component) and consumables (i.e., the nonlease component)?

**Answer**

**Scenario 1**

At contract inception, L estimates that H will purchase 100,000 consumables during the five-year contract term. The stand-alone selling price of consumables is $6 per unit and the selling price within the contract is $7.50 per unit, yielding an estimated $750,000 of contract consideration.

On the basis of these additional facts, the contractual price of consumables (i.e., $7.50 per unit) is higher than the stand-alone selling price of the consumables (i.e., $6 per unit). The higher contractual price is most likely established to compensate L for the use of the equipment. Even though there are no fixed or in-substance fixed payments, since the price of the consumables is higher than the stand-alone selling price, L would conclude that this contract includes both a lease component and a nonlease component.

Vendor L would be required to allocate consideration between the use of the equipment (a lease) and the sale of consumables. Vendor L will allocate the consideration between the equipment and the estimated future consumable purchases on the basis of their respective stand-alone selling prices, as determined at lease inception. The consideration in the contract is allocated as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Contractual Consideration</th>
<th>Stand-Alone Selling Price</th>
<th>Allocation Percentage</th>
<th>Allocated Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Five-year lease of equipment (i.e., variable lease income)</td>
<td>$ —</td>
<td>$ 200,000</td>
<td>25%</td>
<td>$ 187,500 ($1.88 per consumable)</td>
</tr>
<tr>
<td>Consumables (i.e., revenue)</td>
<td>750,000</td>
<td>600,000</td>
<td>75%</td>
<td>562,500 ($5.63 per consumable)</td>
</tr>
<tr>
<td>Total</td>
<td>$ 750,000</td>
<td>$ 800,000</td>
<td>100%</td>
<td>$ 750,000</td>
</tr>
</tbody>
</table>

Since consideration must be allocated to the use of the equipment, this component of the arrangement will generally meet the definition of a lease (i.e., the right to control the use of identified PP&E for a period of time in exchange for consideration). For each consumable purchased by H, L will recognize $1.88 as variable lease income and $5.63 as revenue.

This scenario resulted in a conclusion that a lease exists because the contractual price of consumables is higher than the stand-alone selling price. However, even if this were not the case, because the equipment value is quantitatively assessed as 25 percent of the total contract value, a lease component would most likely still be identified given the significance of the equipment to the overall contract.
Depending on the life of the equipment compared with the contract term (i.e., if the contract term is greater than 75 percent of the useful life of the equipment), these arrangements may qualify as sales-type leases and could lead to commencement losses because of their dependence on variable consideration. (See Q&A 9-13 for more information about commencement losses related to sales-type leases.)

With respect to operating leases of equipment, we also note that vendors will generally not qualify to use the lessor practical expedient related to not separating the lease (i.e., equipment) and nonlease (i.e., consumables) components in the contract because the transfer of consumables occurs at a point in time whereas the transfer of the leased equipment is over time.

**Scenario 2**

At contract inception, L estimates that H will purchase 450,000 consumables during the five-year contract term. The stand-alone selling price of consumables is $7.50 per unit, as evidenced by separate observable sales of consumables within contracts in which L sells the equipment to customers. Use of the contractual price of $7.50 per unit yields an estimated $3,375,000 of contract consideration.

First, L observes that the contract does not include any fixed or in-substance fixed payments throughout the contract term. Then, L considers that its business model is to provide the equipment for free to drive consumable sales, which is corroborated by the fact that the contractual price of consumables is identical to the stand-alone selling price of the consumables (i.e., a customer that purchases the equipment would pay the same price as a customer that signs this contract); L’s primary objective is to sell consumables, not to sell the insignificant equipment.

The following table illustrates how L may assess the relative value within the contract and how it would allocate the consideration to the potential components:

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Selling Price</th>
<th>Allocation Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>$200,000</td>
<td>5.6%</td>
</tr>
<tr>
<td>Consumables</td>
<td>$3,375,000</td>
<td>94.4%</td>
</tr>
<tr>
<td>Total</td>
<td>$3,575,000</td>
<td>100%</td>
</tr>
</tbody>
</table>

On the basis of this calculation, L concludes that the equipment value is approximately 5.6 percent of the total contract value. Upon considering this quantitative factor as well as other qualitative factors, L determines that the equipment is insignificant to the overall contract.

Accordingly, in this scenario, it may be acceptable for L to conclude that this contract does not include a lease since L has determined that no consideration is provided for the use of the equipment. (A lease is defined as the “right to control the use of identified [PP&E] for a period of time in exchange for consideration” (emphasis added).) As a result, 100 percent of the consideration would be allocated to the sale of the consumables (i.e., revenue). Compared with the conclusion reached in Scenario 1, this conclusion does not result in a timing
difference for revenue recognition purposes but could result in a different presentation and
disclosure outcome: revenue from contracts with customers and variable lease income would
be presented in Scenario 1, whereas only revenue from contracts with customers would be
presented in Scenario 2.

In addition, L should assess whether H obtains control of the equipment (not just the right to
use it for five years). If control has been transferred, L would incur a day 1 loss\(^{21}\) upon delivery of
the equipment to H, in a manner similar to the above example involving razors and razor blades.
Conversely, if L determines that H did not obtain control of the equipment, L would continue
to recognize the equipment as PP&E subject to the guidance in ASC 360 on subsequent
measurement (e.g., depreciation and impairment). We generally believe that control of the
equipment is transferred to the customer when the term of the arrangement constitutes the
major part of the remaining useful life of the equipment. However, if the vendor has a right to
reclaim the equipment during the term of the arrangement without the customer’s permission
(e.g., in cases in which the customer is not purchasing as many consumables as expected), this
reclamation right may indicate that control of the equipment has not been transferred.

4.4.2.3 **Remeasure and Reallocate Consideration**

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-41 A lessor shall remeasure and reallocate the remaining consideration in the contract when there</td>
</tr>
<tr>
<td>is a contract modification that is not accounted for as a separate contract in accordance with paragraph</td>
</tr>
<tr>
<td>842-10-25-8.</td>
</tr>
</tbody>
</table>

A lessor is required to remeasure and reallocate (rather than only reallocate, as required by ASC
842-10-15-42 and discussed in Section 4.4.2.2) the consideration in the contract only when there is
(1) a contract modification that is not accounted for as a separate contract, (2) an exercise of an option
for the lessee to extend the lease or purchase the underlying asset that the lessee was not previously
certain to exercise, or (3) a lessor’s exercise of an option to terminate the lease that the lessor was not
previously reasonably certain to exercise. (See Section 9.3.4 for detailed discussion of the contract
modification guidance for lessors.) Upon the occurrence of a contract modification that is not accounted
for as a separate contract, the lessor would measure the remaining consideration in the contract in
accordance with Section 4.4.2.1 and allocate it in accordance with Section 4.4.2.2.

If the consideration in the contract is reallocated in accordance with ASC 842-10-15-41 as a result of a
contract modification that is not accounted for as a separate contract, and there is a subsequent change
in the consideration in the contract that must be allocated in accordance with ASC 842-10-15-42, the
allocation of the changed consideration should be on the same basis as the most recent allocation (i.e.,
on the same basis as the allocation performed as a result of the contract modification).

4.4.3 **Codification Examples**

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-32 See Examples 11 through 14 (paragraphs 842-10-55-131 through 55-158) for illustrations of the</td>
</tr>
<tr>
<td>requirements for allocating consideration to components of a contract.</td>
</tr>
</tbody>
</table>

\(^{21}\) Vendor L would derecognize the full carrying value of the equipment and would record a corresponding loss.
Examples 11–14 in ASC 842-10-55 illustrate implementation of the guidance in ASC 842-10-15-28 through 15-40. Although Examples 12 and 13 in ASC 842-10-55 are reproduced in Sections 4.3 and 4.2.3 (since they are particularly related to identifying the nonlease components in a contract and separating lease components in a contract, respectively), Examples 11 and 14 in ASC 842-10-55 are reproduced below in this section, since they address the determination and allocation of the consideration in the contract by both lessees and lessors. Rather than carving up each example and reproducing different pieces throughout this chapter, we have decided to keep them intact in their entirety since we find that approach to be more useful.

**ASC 842-10**

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

**Case A — Allocation of Consideration in the Contract**

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.

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:

- 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).
- 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.

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 in paragraph 842-10-15-37 or Lessor elects the practical expedient in paragraph 842-10-15-42A when the conditions in that paragraph are met—see Case B [paragraphs 842-10-55-138 through 55-140] for an example in which Lessee elects the practical expedient). In accordance with the identifying performance obligations guidance in paragraphs 606-10-25-19 through 25-22, Lessor further concludes that its maintenance obligations 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).

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.
ASC 842-10 (continued)

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.

<table>
<thead>
<tr>
<th></th>
<th>Lease</th>
<th>Maintenance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulldozer</td>
<td>$ 200,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Truck</td>
<td>120,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Crane</td>
<td>240,000</td>
<td>70,000</td>
</tr>
<tr>
<td></td>
<td>$ 560,000</td>
<td>$ 140,000</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th></th>
<th>Lease</th>
<th>Maintenance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulldozer</td>
<td>$ 171,429</td>
<td>$ 42,857</td>
</tr>
<tr>
<td>Truck</td>
<td>102,857</td>
<td>17,143</td>
</tr>
<tr>
<td>Crane</td>
<td>205,714</td>
<td>60,000</td>
</tr>
<tr>
<td></td>
<td>$ 480,000</td>
<td>$ 120,000</td>
</tr>
</tbody>
</table>

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

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.

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.
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.

<table>
<thead>
<tr>
<th></th>
<th>Standalone Price</th>
<th>Relative Standalone Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulldozer</td>
<td>$230,000</td>
<td>$215,625</td>
</tr>
<tr>
<td>Truck</td>
<td>130,000</td>
<td>121,875</td>
</tr>
<tr>
<td>Crane</td>
<td>280,000</td>
<td>262,500</td>
</tr>
<tr>
<td></td>
<td>$640,000</td>
<td>$600,000</td>
</tr>
</tbody>
</table>

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

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

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.

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.

<table>
<thead>
<tr>
<th></th>
<th>Standalone Price</th>
<th>Relative Standalone Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease</td>
<td>$285,000</td>
<td>$259,091</td>
</tr>
<tr>
<td>Maintenance</td>
<td>45,000</td>
<td>40,909</td>
</tr>
<tr>
<td></td>
<td>$330,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

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.
ASC 842-10 (continued)

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 will allocate, in accordance with paragraph 842-10-15-40, the variable payments between the lease and nonlease maintenance services (on the same basis as the initial allocation of the consideration in the contract), when and if the productivity targets are met. Lessor will recognize the portion allocated to the lease at that time and will recognize the portion allocated to the nonlease maintenance services in accordance with the guidance on satisfaction of performance obligations in Topic 606 on revenue from contracts with customers.

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

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.

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.

<table>
<thead>
<tr>
<th></th>
<th>Standalone Price</th>
<th>Relative Standalone Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease</td>
<td>$ 285,000</td>
<td>$ 277,227</td>
</tr>
<tr>
<td>Maintenance</td>
<td>$ 45,000</td>
<td>$ 43,773</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 330,000</strong></td>
<td><strong>$ 321,000</strong></td>
</tr>
</tbody>
</table>

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.
ASC 842-10 (continued)

Case C — Allocating Variable Payments Entirely to a Nonlease Component

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).

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.

4.5 Contract Combinations

ASC 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.

An entity is required to “combine two or more contracts ... entered into at or near the same time with the same counterparty” if any of the criteria in ASC 842-10-25-19(a)–(c) above are met. The contract combination guidance should be assessed at contract inception. An entity will need to use judgment in determining whether multiple contracts are “entered into at or near the same time.” As a general rule, the longer the period between entering contracts with the same counterparty, the more likely those contracts are not economically linked.
The contract combination guidance in ASC 842 is generally consistent with that in ASC 606. In paragraph BC165 of ASU 2016-02, the FASB acknowledged that this consistency was intentional:

The Board included guidance in Topic 842 for when an entity should combine two or more contracts and account for them as a single contract. Although it is usually appropriate to account for a contract individually, an entity should assess the combined effect of contracts that are interdependent. An entity may enter into multiple contracts in contemplation of another such that the contracts, in substance, form a single arrangement that achieves an overall commercial effect. The financial reporting effect of recognizing those contracts separately may be different from the financial reporting effect of recognizing those contracts on a combined basis. In those situations, accounting for the contracts independently might not result in a faithful representation of the combined transaction. This accounting has been acknowledged throughout GAAP, and guidance similar to that in Topic 842 was included in Topic 606. [Emphasis added]

Although the contract combination guidance is generally consistent with that in ASC 606, the requirements in ASC 842-10-25-19 apply to both lessees and lessors. Therefore, an entity should establish policies and procedures to ensure that controls are in place to identify and consider arrangements entered into "at or near the same time." Given that the guidance on this topic in ASC 842 is consistent with that in ASC 606, we would generally expect entities to adopt consistent policies related to what they consider "at or near the same time" when determining whether and, if so, when to combine contracts.

Generally, it will be appropriate for lessees and lessors to account for contracts individually. However, when certain contracts are interdependent, entities should assess their combined effect to determine whether the financial reporting outcome of accounting for those contracts on a combined basis is more representationally faithful than the outcome when those contracts are accounted for individually. This will generally be the case when the contracts are entered into to achieve a single, overall commercial objective. As a result, an entity must account for its arrangements on the basis of the substance (i.e., one commercial arrangement) rather than the form (e.g., three separate legal contracts).

The following examples and Q&A illustrate the application of the guidance in ASC 842-10-15-19:

### Example 4-11

**Combining Contracts**

Company EC, the lessor, and LH Cruises, the lessee, enter into an initial agreement on January 1, 20X8, in which the lessor will provide a named sailboat to the lessee for a three-year period commencing on April 1, 20X8. One week after the initial agreement was executed, on January 8, 20X8, a separate contract was executed for the use of a specified dock to store the sailboat, also for a three-year period and commencing on April 1, 20X8.

The lessee will pay $25,000 per year for the right to use the sailboat. The dock space was leased at a rate of $5,000 per year. Under the contract to lease the dock space, the lessee also agrees to pay $500 for every hour that the sailboat is not docked. The standard rate at which the lessor rents sailboats is $40,000 annually, while the market rate for dock space is $5,000 per year.

Both the lessee and the lessor conclude that the contracts should be combined and accounted for as a single transaction because they are interdependent. The sailboat and dock are used in conjunction to achieve the single commercial objective of providing a sailboat and a dock to store the sailboat.

The contracts are combined in accordance with ASC 842-10-25-19 on the basis of the following:

- The contracts are entered into at or near the same time (i.e., within one week of each other, between January 1, 20X8, and January 8, 20X8) with the same counterparty.
- The annual lease payment for the sailboat is lower than the market rate because the lessor expects to recover the difference through the fixed and variable pricing (based on performance) of the dock rental. The criterion in ASC 842-10-25-19(b) is met.
Example 4-12

Lease-In and Lease-Out Transaction

Company M, an automobile manufacturer, and Company D, an unrelated car dealer, both want to benefit from a car dealership in Fort Worth, Texas, that will exclusively sell M’s cars. Company D owns the land and building in Fort Worth, and M wants to ensure that D will only use that property for the intended purpose for at least 25 years. To ensure that the property is used as a car dealership selling vehicles produced by M, the parties structure the transaction as a "lease-in and lease-out" (LILO), in which M leases the property from D and simultaneously subleases the property back to D.

The following are relevant terms of the LILO arrangement:

- The terms of the head lease (i.e., D, as a lessor, leases to M, as a head lessee) and sublease (i.e., M, as a head lessee and sublessor, leases to D, as a sublessee) mirror each other. The head lease and sublease have identical fixed rental payments and 25-year fixed lease terms.
- The terms of the sublease limit D’s use of the property to activities defined in the contract as “dealership activities” (i.e., use of the property as a car dealership to sell vehicles produced by M).
- As the sublessee, D cannot assign or transfer its rights under the sublease, or further sublease the property, without M’s consent.
- If D, as the sublessee, defaults on the sublease agreement (e.g., D fails to pay rent, or D conducts activities other than dealership activities), M has the option to (1) sublease the property to another car dealer or (2) terminate the sublease and retain control of the property for the remainder of the term of the head lease.
- Under the head lease and during its term, D has the right to sell the property to a third party, with the following stipulations: (1) M has a first right of refusal and may purchase the property and (2) upon a sale, the property continues to be subject to the head lease and sublease (which will be assigned to the new owner of the property).

Both M and D conclude that the head lease and the sublease should be combined and accounted for as a single transaction because the contracts are interdependent. The contracts are combined in accordance with ASC 842-10-25-19 because the head lease and sublease were negotiated as a package with the same commercial objective. That is, the contracts were executed to ensure that D would use the property for 25 years as a car dealership to sell vehicles manufactured by M.

ASC 842-10-25-19 does not require that the contracts under consideration be coterminous. Therefore, the fact that the two contracts may not always be coterminous (e.g., if M were to terminate the sublease upon a default by D as the sublessee) is not relevant to the above conclusion to combine the head lease and sublease.

As a result, neither M nor D accounts for the head lease or the sublease as leases within the scope of ASC 842. Companies M and D must look to other applicable GAAP to account for the substance of the transaction (i.e., to ensure that D uses the property as a dealership to sell M’s cars).

Q&A 4-14  Combining Contracts With Unrelated Parties

Entity L enters into a contract to lease an asset to Retailer K, which K intends to simultaneously sublease to End User B for five years. Entity L separately contracts with B to provide maintenance services related to the asset for the five-year lease term. In legal form, there are three separate contracts: (1) the lease contract between L and K, (2) the lease contract between K and B, and (3) the service contract between L and B.

The three contracts are negotiated as a package with the same commercial objective of allowing B to use the asset and receive maintenance services. In addition, the consideration paid by B in its lease and service contracts depends on the price paid by K in its lease contract.
**Question**

Should L combine its contracts to lease the asset to K and provide maintenance services to B?

**Answer**

No. Under ASC 842-10-25-19, the contracts must be with the same counterparty (or related parties) to be combined. Therefore, the contracts in the above example cannot be combined even though (1) they are entered into simultaneously and are negotiated as a package with a single commercial objective and (2) the amount of consideration in one contract depends on the price of the other contract.

Sylvia Alicea, a professional accounting fellow in the SEC's Office of the Chief Accountant, addressed this topic in a speech at the 2016 AICPA Conference on Current SEC and PCAOB Developments. Ms. Alicea stated, in part:

Next, I'll share some observations related to the contract combination guidance. I observe that the guidance in Topic 606 explicitly limits which contracts should be combined. In the consultation that OCA evaluated, the registrant had two contracts that were entered into at the same time and met some of the criteria for contract combination because they were: (i) negotiated between all parties with a single commercial objective; and (ii) were priced interdependently such that consideration paid under one contract was dependent on the price in the other contract. However, the contracts did not meet the requirement in Topic 606 to be with the same customer or related parties of the customer. Therefore, OCA objected to the registrant's extension of the contract combination guidance beyond those parties. [Footnotes omitted]

Although Ms. Alicea's remarks were associated with ASC 606, we believe that the same conclusion would be reached under ASC 842 because of the similarities between the two standards' contract combination guidance.
Chapter 5 — Commencement Date, Lease Term, and Purchase Options

5.1 Commencement Date of a Lease
   5.1.1 Lease Commencement Date for Master Lease Agreements

5.2 Lease Term
   5.2.1 Noncancelable Period
   5.2.2 Periods Covered by Options (Reasonably Certain)
   5.2.3 Periods Within the Control of the Lessor
   5.2.4 Application of the Lease Term Guidance

5.3 Purchase Options

5.4 Reassessment of Lease Term and Purchase Options
   5.4.1 Lessees
   5.4.2 Lessors
5.1 Commencement Date of a Lease

ASC 842-10 — 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.

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ASC 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).

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 of the lease is important under ASC 842 because that date is when (1) lease classification is determined (see Sections 8.3 and 9.2 for more information about lessee and lessor classification, respectively) and (2) the lease is initially measured (see Sections 8.4.2 and 9.3.2 for discussion of lessee and lessor initial measurement, respectively). As noted above, the commencement date is the “date on which a lessor makes an underlying asset [i.e., the PP&E subject to the lease] available for use by a lessee.” The commencement date may differ from the date stated in the contract and is not affected by when the lessee (1) must make lease payments (e.g., if the lessor grants the lessee a rent holiday) or (2) expects to use or actually uses the underlying asset. A lease agreement may grant the lessee access to and control over the leased asset before the beginning of the fixed noncancelable term stated in the lease agreement. This is common, for example, when the lessee needs time to construct leasehold improvements or otherwise prepare the leased space for its intended use. It is also common for the lessee not to be required to begin making rental payments until the beginning of the fixed noncancelable lease term.

Q&A 5-1 Lease Term for Accounting Purposes Can Differ From the Term Stated in the Lease

**Question**

Can a lease commence, for accounting purposes, before the beginning of the fixed noncancelable term stated in a lease agreement?

**Answer**

Yes. ASC 842-10-20 defines the lease commencement date as the “date on which a lessor makes an underlying asset available for use by a lessee.” Further, ASC 842-10-55-19 states that “[i]n some lease arrangements, the lessor may make the underlying asset available for use by the lessee . . . before it begins operations or makes lease payments under the terms of the lease.” In such cases, the lease commences when the lessee has access to and control over the leased asset, even if that occurs before the beginning of the fixed noncancelable lease term stated in the lease agreement.
Example

A lease agreement for office space is signed on January 1, 20X9, and the fixed noncancelable term begins on June 1, 20X9, at which time the lessee will begin making rental payments. Under the terms of the lease agreement, the lessee is granted access to the office space to make improvements to the space beginning on January 1, 20X9. In this situation, the lease term commences on January 1, 20X9.

5.1.1 Lease Commencement Date for Master Lease Agreements

ASC 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.

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.

In a manner consistent with how an entity determines the commencement date for a single lease, an entity must determine the commencement date for each underlying asset that is leased under a master lease agreement on the basis of the date on which the underlying asset is made available for use by a lessee. Therefore, under a master lease agreement, there may be different commencement dates related to when the different underlying assets are made available for the lessee's use.

5.2 Lease Term

ASC 842-10 — 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.
Chapter 5 — Commencement Date, Lease Term, and Purchase Options

ASC 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.

55-25 The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor.

The lease term is an important input to lease classification and to the initial and subsequent measurement of a lease. The lease term is determined in accordance with ASC 842-10-30-1 (as illustrated below). The sections below further discuss the composition of the lease term and related issues.

5.2.1 Noncancelable Period and Enforceable Period

ASC 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.

A contract is an agreement between two or more parties that creates enforceable rights and obligations. Any noncancelable period within a lease contract would generally be considered enforceable and should be included in the lease term. In addition, cancelable periods should also be evaluated for enforceability in accordance with ASC 842-10-55-23. For a lease to no longer be enforceable under ASC 842-10-55-23, both parties must “have the right to terminate the lease . . . with no more than an insignificant penalty.” Accordingly, a lease is considered enforceable over a cancelable period if either (1) only one party has a termination right or (2) both parties have a termination right but either party would incur a more than insignificant penalty by terminating the lease. After determining the enforceable period, the parties should consider the guidance in ASC 842-10-30-1 (as discussed in Sections 5.2.2 and 5.2.3 below) to determine the lease term within the enforceable period (i.e., the lease term will either be shorter than or equal to the enforceable period).
Connecting the Dots — Enforceability Is a Broad Concept

As noted above, “noncancelable” and “enforceable” have different meanings under ASC 842, and entities are required to evaluate whether a contract is enforceable over optional periods on the basis of the economic consequences to the parties rather than solely on the basis of contractual or legal enforceability. Periods in which one or both parties have the contractual right, but not the obligation, to extend the agreement are enforceable but not noncancelable periods. Periods in which either but not both parties have the right to terminate the agreement are also enforceable but not noncancelable periods. Periods in which both parties have the right to terminate the agreement are not enforceable unless either party would incur a more than insignificant penalty by exercising its right. For example, a lease would be considered enforceable over the period in which the lessee would incur a more than insignificant penalty by terminating the lease, even when the lease is subject to a contractual cancellation right held by the lessor.

Further, in determining the lease term, both the lessee and the lessor should evaluate options to extend or terminate the lease during the enforceable period. Enforceable periods covered by options that provide the lessor with the right to extend or unilaterally terminate the lease are included in the lease term (i.e., it is assumed that the lessor will extend or not terminate the lease). For enforceable periods in which the lessee has the right to extend or terminate the lease, the probability of exercise needs to be assessed. The lease term would include enforceable periods in which it is reasonably certain that the lessee will extend or not terminate the lease (see Section 5.2.2). Importantly, “reasonably certain” (which is used in the determination of the lease term) differs from “more than insignificant” (which is used in the determination of the enforceable period). For example, when both parties have the right to terminate the lease yet the lessee would incur a more than insignificant penalty to do so, the optional period is enforceable, but this does not mean that the lessee is reasonably certain not to exercise its termination option. However, any economic penalty (or incentive) that would cause a lessee to be reasonably certain not to terminate a lease would also indicate that the lessee would incur a more than insignificant penalty by terminating the lease; the related period would thus be included in both the enforceable period and the lease term.
5.2.2 Periods Covered by Options (Reasonably Certain)

ASC 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.

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.

Entities must assess whether it is reasonably certain that a lease will continue into periods covered by renewal or termination options. When assessing the likelihood of whether a lessee will be economically compelled to (i.e., when assessing whether it is reasonably certain that a lessee will) exercise or not exercise an option to renew or terminate a lease, respectively, the lessee and lessor should consider various economic factors (e.g., contract-based, asset-based, entity-based, and market-based factors). In addition, lessees must perform this assessment and determine the lease term in order to apply the short-term lease recognition exemption (discussed in detail in Section 8.2.1).

Connecting the Dots — “Reasonably Certain” and “Reasonably Assured”

Under IAS 17, an entity uses the “reasonably certain” threshold to evaluate the lease term; this threshold is generally interpreted as high. When developing ASC 842, the Board decided to use the term “reasonably certain” to be consistent with IFRS 16 (which supersedes IAS 17). However, paragraph BC195 of ASU 2016-02 indicates that the “reasonably certain” threshold is substantially the same as the “reasonably assured” threshold under ASC 840. Therefore, we do not expect that ASC 842 will change the threshold used to determine the lease term; that is, “reasonably certain” will also be considered a high threshold of probability under ASC 842, as the FASB indicates in paragraph BC71(b) of ASU 2016-02.
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.

As described in ASC 842-10-20 above, a penalty is any requirement associated with a lease agreement or outside of the lease agreement that could have an adverse financial impact on a lessee (e.g., require disbursement of cash, performance of service, surrendering of an asset). While a penalty may impose a requirement on a lessee to make an additional payment or payments to a lessor, it could also be linked to payments to an independent party or result in a loss of future economic benefits to the lessee as a whole. For example, if a lease termination will result in a loss of a significant amount of income for a lessee, that termination could be viewed as a penalty.

The existence of a penalty, if large enough, could affect the evaluation of lease term, lease payments, and renewal and purchase options. For example, if a lessee is required to pay the lessor a significant penalty for not renewing a lease, it would be appropriate to conclude at lease commencement that the lease term would include the renewal period because the potential to pay the penalty economically compels the lessee to renew the lease. Similarly, an entity may conclude that it is reasonably certain to exercise a purchase option to the extent that the lease agreement includes a significant penalty payable by the lessee to the lessor for failure to exercise such an option (as discussed in Section 5.3). A penalty is included in lease payments (see Chapter 6) when it is not significant enough to make the exercise of a renewal or purchase option reasonably certain at lease commencement.
5.2.2.1 Contract-Based Factors

Contract-based factors affecting the determination of the likelihood that a lessee will exercise or not exercise an option are linked to the terms of the lease agreement. Examples of contract-based factors include:

- The existence of a bargain renewal option.
- The existence of contingent or variable payments.
- The nature and terms of renewal or termination options.
- The costs the lessee would incur to restore the asset before returning it to the lessor.

Q&A 5-2 Renewal Option Preceding a Purchase Option at Below Market Rates

ASC 840 requires entities to include in the lease term “[a]ll periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable.” In contrast, ASC 842 requires an entity to include in the lease term “[p]eriods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option.” ASC 842-10-55-26 expands on the term “reasonably certain,” stating, in part:

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: . . .

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).

ASC 842 does not explicitly include a requirement to identify a bargain purchase option and to include any ordinary renewal options preceding the exercise date of the bargain purchase option. However, ASC 842-10-55-26(a)(3) requires an entity to consider renewal options preceding a “purchase option that is exercisable at the end of an extension period at . . . below market rates.” Accordingly, while an entity may need to use greater judgment in applying the above guidance from ASC 842, we believe that the accounting outcome achieved under ASC 842 should generally be consistent with that achieved under the more explicit guidance in ASC 840.

We believe that, in evaluating bargain purchase options that are exercisable after a renewal period, an entity should consider all relevant facts and circumstances, including, but not limited to, the utility of the PP&E to the lessee during the renewal period. In addition, we believe that when an ordinary (i.e., nonbargain) renewal option exists, the lease can be considered to have a noncancelable term followed immediately by a purchase option. The exercise price of that purchase option would represent the present value at the end of the noncancelable term of the renewal-period lease payments and the price of the purchase option.
Example

Consider the following example:

- Entity X, the lessee, enters into a lease for equipment with an initial term of five years. The lease includes two lessee-specific options: (1) a five-year renewal option at market rates and (2) an option to purchase the equipment for $100 at the end of the renewal period (i.e., at the end of 10 years). At lease commencement, the equipment is expected to have a fair value significantly greater than $100 when the purchase option is exercisable.
- Entity X plans to use the equipment for a specific project that is expected to be completed at the end of the initial five-year lease term. The project is unique and X does not have an alternative use for the equipment outside of the identified project. Therefore, there is no clear utility of the equipment to X over the five-year renewal term.
- Entity X concludes that the present value, at the end of the initial term, of the lease payments for the renewal period, plus the purchase option exercise price of $100, does not represent a bargain purchase option when compared with the expected fair value of the equipment at the end of the initial term.

Question

Is X required to include the renewal period in the lease term?

Answer

No. On the basis of the factors (not all-inclusive) outlined in the background above, the purchase option at a below market rate does not represent an economic incentive that would cause the lessee to determine that it is reasonably certain to exercise the renewal option.

A purchase option at a below market rate will often provide an economic incentive for the lessee to exercise the intervening renewal option. However, in this case, the utility of the equipment during the renewal period is uncertain and therefore significantly reduces the lessee’s incentive to exercise the renewal option. In addition, the present value, at the end of year 5, of the renewal-period lease payments, plus the purchase option price of $100, does not represent a bargain purchase option when compared with the expected fair value of the equipment. Therefore, it is not reasonably certain that X will exercise the renewal option even though the renewal period is followed by a bargain purchase option.

Connecting the Dots — Residual Value Guarantee Affecting Lease Term and Lease Payments

Some lease agreements may allow a lessee to early terminate a lease only if the lessee guarantees the residual value of the underlying asset as of the termination date. In these cases, the lessee should evaluate the residual value guarantee when determining whether it is reasonably certain that the option to terminate early will not be exercised. That is, the lessee should evaluate the impact of the residual value guarantee when considering whether it will be economically compelled to terminate the lease before the end of the lease term or whether the residual value guarantee itself would result in the lessee’s continuation of the lease for the full term. This evaluation and the resulting conclusions may affect both the determination of the lease term and the lease payments. See Section 6.7 for additional discussion of residual value guarantees.
5.2.2.2 **Asset-Based Factors**

Asset-based factors depend on specific characteristics of the underlying asset. Examples of asset-based factors include:

- The existence of significant lessee-installed leasehold improvements that would still have economic value when the option becomes exercisable.
- The physical location of the asset.
- The costs that would be incurred to replace or find an alternative asset.

**Q&A 5-3  Lease Term Considerations — Economic Penalty Caused by Leasehold Improvements**

**Question**

If a lease contains renewal options, should the lessee’s investment in leasehold improvements be considered in the determination of whether renewal periods need to be included in the lease term?

**Answer**

Yes. The value of leasehold improvements at the end of the noncancelable lease period could be considered an economic penalty and could provide reasonable certainty that the lessee will renew the lease rather than surrender the value of the leasehold improvements.

When evaluating whether the abandonment or relocation of leasehold improvements constitutes a significant penalty, an entity should consider, among other things, the lessee’s ability or willingness to (1) bear the cost of relocating or replacing the leased property at market rental rates or (2) tolerate other parties using the leased property. Ordinarily, lessees would be expected to be unwilling to abandon leasehold improvements or other assets that are expected to have a significant remaining fair value that would not otherwise be available to the lessee at the end of the lease’s fixed noncancelable term. Similarly, lessees typically would not be expected to be willing to incur significant costs, directly or indirectly, to relocate leasehold improvements.

Therefore, when it is expected that there will be a loss of significant fair value or an incurrence of significant costs, (1) there is usually an economic penalty and (2) the penalty causes the lessee to conclude that exercise of the renewal options is reasonably certain. As a result, the lessee includes the renewal periods in the lease term.

Further, situations in which the lessee is prepared to incur a significant economic penalty rather than extend the lease term beyond its fixed noncancelable term (i.e., lease renewal is not reasonably certain) are expected to be rare. In cases in which the lessee is prepared to abandon the leasehold improvements and incur the economic penalty, the leasehold improvements should be depreciated to a residual value of zero over the fixed noncancelable term of the lease.
5.2.2.3 **Entity-Based Factors**

The impact of entity-based factors depends on the entity's historical practice, management's intent, and common industry practice. Examples of entity-based factors include:

- The financial impact on the entity of extending or terminating the lease.
- The importance of the leased asset to the entity's operations.

5.2.2.4 **Market-Based Factors**

Market-based factors include the market rental or purchase rates for comparable assets and any potential implications of local regulations and statutory requirements.

5.2.3 **Periods Within the Control of the Lessor**

ASC 842-10-30-1(c) states that “[p]eriods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor” should be included in the lease term. Effectively, under ASC 842, it is assumed that when a lessor has the sole option to continue the lease into optional periods, it will choose to do so.

See Section 5.2.4.1 below for discussion of how to differentiate between a cancelable lease and a lease with a lessor-controlled option to terminate.

5.2.4 **Application of the Lease Term Guidance**

The sections below further discuss application of, and issues related to, the lease term guidance.

5.2.4.1 **Cancelable Leases**

A lease contract *would not* be considered enforceable (i.e., it would be considered cancelable) if the lessee and lessor each have the separate right to terminate the lease without incurring a more than insignificant penalty (see Section 5.2.1 for more information). If the lessee or the lessor individually has the separate right to terminate the lease, those termination options would be assessed as follows:

- If a lease contract includes a termination option that gives only the lessee the right to terminate the lease, an entity would evaluate whether it is reasonably certain that the lessee will not exercise that termination option (as discussed in Section 5.2.2).
- If a lease contract includes a termination option that gives only the lessor the right to terminate the lease, an entity would not consider that termination option when evaluating the lease term (i.e., it should be assumed that the lessor will not elect to terminate early, as discussed in Section 5.2.3 above).
5.2.4.2 Evergreen Leases

In addition to contracts that specify a period that includes renewal options occurring on an “as exercised” basis, ASC 842 also applies to contracts that automatically renew. For example, leases characterized as “evergreen,” “month to month,” “perpetual,” or “rolling” would meet the definition of a contract and would be subject to ASC 842 if such a contract includes enforceable rights and obligations.

In determining the lease term for such arrangements, an entity would consider the same factors as it would for all other leases. That is, an entity would need to consider contract-based, asset-based, market-based, and entity-based factors to determine the term over which the lessee is reasonably certain to extend the lease.

5.2.4.3 Short-Term Leases

<table>
<thead>
<tr>
<th>ASC 842-10 — Glossary</th>
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<tbody>
<tr>
<td><strong>Short-Term Lease</strong></td>
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<tr>
<td>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.</td>
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A lessee can elect (by asset class) not to record on the balance sheet a lease whose term is 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise (i.e., treat the lease like an operating lease under ASC 840). When determining whether the lease qualifies for this election, the lessee would include renewal options only if they are considered part of the lease term (i.e., those options the lessee is reasonably certain to exercise). If the lease term increases to more than 12 months, or if it is reasonably certain that the lessee will exercise an option to purchase the underlying asset, the lessee would no longer be able to apply the short-term lease exception and would account for the lease as it would other leases. See Section 8.2.1 for a lessee’s accounting for a lease that qualifies for the short-term exemption.

5.2.4.4 Impact of a Sublease on Lease Term

A lessee that enters into an agreement to sublease the underlying asset needs to assess whether the sublease term will affect the term of the head lease. For example, if the sublease includes renewal options that would, if exercised, extend past the initial term of the head lease, the head lessee would need to evaluate whether it would incur any penalty for not exercising its renewal options in the head lease. The head lessee would consider this factor in addition to other relevant contract-based, asset-based, entity-based, and market-based factors when evaluating whether it is reasonably certain that it will (1) exercise an option to renew, (2) not exercise an option to terminate, or (3) exercise an option to purchase the underlying asset. The existence of a renewal provision in the sublease does not automatically indicate that it is reasonably certain that the head lessee will exercise the renewal options on its head lease. See Q&A 12-1 for further discussion.

5.2.4.5 Lease Term When a Lease Consists of Nonconsecutive Periods of Use

An entity may enter into an arrangement for the right to use an asset during nonconsecutive periods. Such an arrangement may contain a lease as defined in ASC 842-10. Questions have arisen about whether the lease term in such an arrangement should consist of only the nonconsecutive periods of use or the entire period of the arrangement. The lease term is important to the determination of the lease classification and how, and the period over which, to recognize rental expense.
Q&A 5-4 Determining Lease Term When a Lease Consists of Nonconsecutive Periods of Use

**Question**
How should a lessee determine the lease term when a lease consists of nonconsecutive periods of use (i.e., should the lease term comprise only the nonconsecutive periods of use or the entire period of the arrangement)?

**Answer**
The ASC master glossary defines a lease 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.” Control of the use of the underlying property depends on whether, over the period of use, the lessee has the right to (1) substantially all of the economic benefits from use of the identified asset and (2) direct the use of the identified asset. (The period of use related to identifying a lease is further discussed in Section 3.5.)

Further, ASC 842-10-20 defines the period of use as “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).” Therefore, in evaluating the lease term, a lessee must determine the period over which it has the right to control the use of the underlying asset, which may comprise only the sum of nonconsecutive periods.

**Example 1**
Retailer A enters into a lease arrangement for the use of mall space for only three consecutive months of the year (the holiday period) for 10 years. Because A only has the right to control the use of the asset for 30 months (i.e., the total of the nonconsecutive periods), A determines that the lease term consists of only the nonconsecutive periods. Therefore, A should use a lease term of 30 months for classification purposes and should recognize rental expense only during these periods, provided that the lease is an operating lease.

**Example 2**
Company B owns a commercial parking garage in a large retail shopping district and charges customers a higher rate to use the garage between the hours of 10 a.m. and 10 p.m. (peak hours). Company B enters into an arrangement with Retailer X that will give X the exclusive right to use the parking garage during peak hours for the next three years. Companies other than X have the right to use the parking garage during off-peak hours.

In this example, the lease term is 18 months (i.e., 12 hours a day for 36 months). Company B and Retailer X should therefore use this lease term when determining the lease classification.

**Connecting the Dots — Interaction Between Nonconsecutive Periods and the Short-Term Lease Recognition Exemption**
As discussed in Q&A 5-4 above, the lease term comprises the period of use and the period of use comprises the sum of nonconsecutive periods. Therefore, if the aggregate of the nonconsecutive periods (that comprise the period of use) is 12 months or less, the lease term would also be 12 months or less. Accordingly, the short-term lease recognition exemption (see Section 8.2.1) may be elected.
The following examples illustrate this notion:

**Example 5-1**

**Seasonal Retail Lease**
RetailCo enters into a three-year agreement with Landlord under which RetailCo will lease a store in a mall during the months of October, November, and December in each year. Landlord agrees to provide the same store for each of the three years. The aggregate of the nonconsecutive periods (i.e., the period of use) during which the store will be leased by RetailCo is nine months (i.e., three months for each year of the agreement). Accordingly, the lease term is also nine months. RetailCo may elect the short-term lease recognition exemption in this scenario.

**Example 5-2**

**Stadium Lease**
TeamCo enters into a 30-year agreement with City for a lease of a stadium. The terms of the agreement stipulate that TeamCo will have the right to use the stadium for 10 home games a year. The home games are played on various days (i.e., would be nonconsecutive). Because the period of use is 300 days (i.e., 10 days per year for 30 years), the lease term is also 300 days. TeamCo may elect the short-term lease recognition exemption in this scenario.

### 5.2.4.6 Fiscal Funding Clauses

**ASC 842-10 — Glossary**

**Fiscal Funding Clause**
A provision by which 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.

**ASC 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 in a lease gives a governmental agency (as lessee) the option to cancel the lease if it does not receive funding through the appropriation process to meet its payment obligation under the terms of the lease. Under ASC 842, the lessee and lessor must evaluate the likelihood that the fiscal funding clause will be exercised.

If exercise of the fiscal funding clause is deemed remote, the lease would be considered noncancelable. In contrast, if the exercise of the fiscal funding clause is considered more than remote, the lease term would include only periods for which it is considered reasonably certain that the government agency will obtain the funding.
### 5.2.4.7 Examples Illustrating the Lease Term Guidance

The scenarios below in Example 5-3 illustrate the application of the guidance on lease term discussed in Section 5.2.

<table>
<thead>
<tr>
<th>Example 5-3</th>
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<tbody>
<tr>
<td><strong>Determining Lease Term</strong></td>
</tr>
<tr>
<td><strong>Scenario 1 — Exercise of the Renewal Option Is Not Reasonably Certain</strong></td>
</tr>
</tbody>
</table>
| On January 15, 20Y5, Company A enters into a lease for a machine that includes a noncancelable period of five years, with a three-year renewal option that will require payments based on market rents. The machine has not been customized and the arrangement does not include a termination penalty for not renewing the lease.  
At lease commencement, A determines that the lease term is limited to the noncancelable period of five years. This determination is made on the basis that A is not economically compelled to exercise the three-year renewal option because (1) the lease payments during the renewal period are at market, (2) there is no termination penalty if it does not renew the lease, and (3) the machine has not been customized. |
| **Scenario 2 — Exercise of the Renewal Option Is Reasonably Certain** |
| On May 15, 20Y5, Company B enters into an equipment lease that includes a noncancelable period of five years, with a three-year renewal option that includes payments based on market rents. Company B modifies and configures the underlying asset at a significant cost. In addition, the equipment is a vital asset in B's manufacturing process (i.e., B's production output would be significantly affected if this asset were not in place).  
At lease commencement, the lease term would be eight years. After considering the asset-based factors, B concludes that it would suffer a significant penalty if it were to exit the lease at the end of the noncancelable period because it would abandon the costs associated with modifying and configuring the equipment. Further, since this asset is vital to B's manufacturing process, nonrenewal of the lease may adversely affect the company's operations. On the basis of these factors, B concludes that it is reasonably certain that it will exercise the renewal option. As a result, the lease term is eight years. |
| **Scenario 3 — Lessee and Lessor Both Have Right to Terminate** |
| On April 9, 20Y6, Lessee A enters into a four-year equipment lease with Lessor B with no renewal or purchase options. Under the terms of the lease, A and B have the unilateral right to terminate the lease at the end of the lease's second year without cause or penalty.  
In this scenario (in the absence of other contract-, market-, or entity-based factors), the noncancelable period, as well as the lease term, would be two years. According to the terms of the arrangement, B has the right to terminate the lease at the end of year two, thereby limiting A's ability to extend the lease past this period. In addition, because A can terminate the lease at the end of year two, it does not have an obligation to make lease payments past that period. |
| **Scenario 4 — Lessor Has the Right to Terminate** |
| On June 1, 20Y6, Lessee A enters into a four-year equipment lease with Lessor B in which B has the right to terminate the lease at the end of year two without cause or penalty.  
In this scenario, the noncancelable period and the lease term are four years. The lease term would always include optional periods that are controlled by the lessor. |
| **Scenario 5 — Lessee Has the Right to Terminate** |
| On June 1, 20Y6, Lessee A enters into a four-year equipment lease with Lessor B in which A has the right to terminate the lease at the end of year 2.  
In this scenario, both parties must assess whether it is reasonably certain that A will not terminate the lease after year 2 (in considering the factors described in ASC 842-10-55-26). The lease term would be two years unless the parties conclude that it is reasonably certain that A will not terminate the lease. |
Chapter 5 — Commencement Date, Lease Term, and Purchase Options

**Illustration of Lessee Accounting for Purchase Options**

55-210 Examples 23 through 24 illustrate the evaluation of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset.

The Codification examples referenced in ASC 842-10-30-4 and ASC 842-10-55-210 are reproduced as follows:

- Example 23 in ASC 842-10-55-211 through 55-217 is reproduced in Section 8.9.2.1.
- Example 24 in ASC 842-10-55-218 through 55-224 is reproduced in Section 8.9.2.2.

### 5.3 Purchase Options

**ASC 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.

When evaluating the lease term, an entity would consider a purchase option in the same manner as it would an option to extend or not to terminate a lease. If it is reasonably certain that a lessee will exercise the option to purchase the underlying asset at the end of the lease term, the lessee will (1) classify the lease as a finance lease (see Section 8.3.3.4) and (2) amortize the ROU asset over the underlying asset’s remaining useful life and not over the lease term (see Section 8.4.3.1). Section 6.4 discusses the effect on lease payments of determining that the exercise of a purchase option is reasonably certain.

### 5.4 Reassessment of Lease Term and Purchase Options

#### 5.4.1 Lessees

**ASC 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:

- 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.
- 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 even though the entity had previously determined that the lessee was not reasonably certain to do so.
- The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.
See paragraphs 842-10-55-28 through 55-29 for implementation guidance on reassessing the lease term and lessee options to purchase the underlying asset.

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.

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, a lessee must be on the lookout for the occurrence of certain discrete events or changes in circumstances that are within the control of the lessee, as described in ASC 842-10-35-1 and ASC 842-10-55-28. Upon the occurrence of such an event or change in circumstances that is within the control of the lessee, a lessee must reassess the lease term or its conclusion about whether exercise of a purchase option is reasonably certain. A lessee would not reassess the lease term or its conclusion about whether exercise of a purchase option is reasonably certain on the basis of the occurrence of events that are outside its control (e.g., on the basis of only market-driven factors, like changes in fair market rental rates).

When there is a change in lease term or in the conclusion about whether it is reasonably certain that an option to purchase the underlying asset will be exercised, a lessee must (1) reassess lease classification, (2) remeasure the lease liability by using revised inputs as of the reassessment date, and (3) adjust the associated ROU asset. For more information, see Sections 8.3.1 and 8.5.1.

Example 5-4

Lease Term Reassessment Would Not Be Required (Lessee)

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

On January 15, 20Y5, the city in which the warehouse is located significantly improves its highway system, thereby making the warehouse location more desirable for A’s distribution needs. This by itself would not result in the need for A to reassess whether it will exercise any remaining renewal options, since the significant event or change in circumstances is outside of A’s control.
Q&A 5-5  Impact of ROU Asset Impairment Indicator on Lease Term

As discussed in Section 8.4.4, lessees are required to test ROU assets for impairment in accordance with ASC 360 when events or changes in circumstances indicate that the carrying amount of an asset group containing an ROU asset may not be recoverable (i.e., an impairment indicator). In some cases, a lessee may have concluded at lease commencement that it was reasonably certain to exercise a renewal option (or not exercise a termination option); however, upon the occurrence of an impairment indicator, the lessee may no longer be reasonably certain that it will exercise the renewal option. Therefore, if the lessee were to reassess the lease term upon the occurrence of the impairment indicator, it would no longer include the renewal period in the lease term; as a result, the ROU asset subject to the ASC 360 impairment test would decrease and the total potential impairment would be reduced.

**Question**

Should an ROU asset impairment indicator trigger a reassessment of the lease term?

**Answer**

No, an impairment indicator alone should not trigger a reassessment of the lease term. ASC 842-10-35-1 states that a lessee should only reassess the lease term when one of the following conditions is met:

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.

Under ASC 842-10-35-1(a), for a significant event or change in circumstances to trigger a lease term reassessment, the event or change in circumstances must be within the lessee’s control. ASC 842-10-55-28 and 55-29 provide implementation guidance on the types of events that would or would not meet this requirement:

**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.

**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. [Emphasis added]

Therefore, a lessee should not reassess the lease term solely because of external events or changes in circumstances that are outside the lessee’s control.
On the other hand, ASC 360-10-35-21 gives the following examples of impairment indicators:

a. A significant decrease in the market price of a long-lived asset (asset group)

b. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition

c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator

d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)

f. A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term *more likely than not* refers to a level of likelihood that is more than 50 percent.

Accordingly, a significant event or change in circumstances driven solely by market-based factors (e.g., a significant decrease in market price) may constitute an impairment indicator under ASC 360 but would not qualify, in isolation, as a lease term reassessment event.

Furthermore, in many situations involving asset group impairments, management may have made an internal decision not to exercise the renewal option and may have communicated this decision publicly or to the board of directors. However, we do not believe that such an internal decision alone constitutes a lease term reassessment event, because no significant event or change in circumstances within the lessee's control has yet taken place.

Therefore, upon the occurrence of an impairment indicator, entities should *separately* consider whether one of the conditions in ASC 842-10-35-1 related to reassessing the lease term has also been met. If none of those conditions are met, a lessee would not be permitted to change the lease term, even though the lessee may no longer be reasonably certain to exercise a renewal option previously included in the lease term.

**Example**

**Scenario 1**

On July 1, 20X2, Retailer L enters into a 10-year operating lease of a building with a 10-year renewal option. At lease commencement, L is reasonably certain that it will exercise the renewal option because of its installation of significant leasehold improvements; therefore, L determines that the initial lease term is 20 years. However, as a result of a significant decrease in market demand for L's products, L concludes that an impairment indicator exists on June 30, 20X7, at which point L is no longer reasonably certain that it will exercise the renewal option; accordingly, L's management communicates to L's board of directors that it no longer intends to exercise the option.

The change in L's conclusion regarding the exercise of the renewal option is solely a result of the decrease in market demand. No significant event or change in circumstances has occurred that is within L's control and directly affects whether L will exercise the renewal option. Therefore, L would not reassess the 15-year remaining lease term on June 30, 20X7, and would test the asset group containing the full ROU asset for impairment in accordance with ASC 360.
Scenario 2
Assume that in addition to experiencing a significant decrease in market demand for its products (as addressed in Scenario 1 above), L disposes of its significant leasehold improvements on June 30, 20X7. In this scenario, L concludes that the disposal constitutes a significant change in circumstances that is within its control and directly affects whether it will exercise the renewal option. Therefore, L would reassess the lease term on June 30, 20X7, and since it is no longer reasonably certain that it will exercise the renewal option, L would reduce the remaining lease term from 15 years to 5 years and would remeasure the lease, resulting in a decrease in the lease liability and the corresponding ROU asset. Then, L would test the asset group containing this lower ROU asset for impairment in accordance with ASC 360.

5.4.1.1 Reassessing the Lease Term and Purchase Options Upon Construction of Leasehold Improvements

In addition to evaluating the impact of leasehold improvements at lease commencement, an entity should consider the effect of leasehold improvements that are made after lease commencement. As discussed in Section 5.4.1, a lessee is required to reassess the lease term or a lessee option to purchase the underlying asset when a significant event or a significant change in circumstances that is within the control of the lessee directly affects whether the lessee is reasonably certain to exercise its related option.

In accordance with ASC 842-10-55-28, a lessee should assess the nature and effect of significant leasehold improvements constructed after the lease commencement date to determine whether the lessee is required, as a result of such improvements, to reassess the lease term and the probability of exercising a purchase option, if applicable.

Example 5-5
Lease Term Reassessment Would Be Required (Lessee)
On June 15, 20Y1, Company A leases a building to be used as a storage and distribution warehouse for a 10-year term, with two 5-year renewal options. Company A initially determines that, on the lease commencement date, it is not reasonably certain that it will exercise either of the renewal options and therefore concludes that the lease term is 10 years.

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

5.4.2 Lessors

ASC 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 the lease or purchase the underlying asset that the lessor previously determined the lessee was not reasonably certain to exercise or exercises an option to terminate the lease that the lessor previously determined the lessee was reasonably certain not to exercise, the lessor shall account for the exercise of that option in the same manner as a lease modification.
A lessor does not reassess the lease term or a lessee purchase option unless the lease is modified and the modification is not accounted for as a separate contract. A lessee's exercise of an option to extend or terminate the lease or purchase the underlying asset would be accounted for by the lessor in a manner similar to a lease modification unless the initial lease term determination includes the effects of those options. If a lessor includes in its lease term an optional renewal period because it is reasonably certain that the lessee would exercise that option, the lessor would not account for the lessee's exercise of the renewal option as a lease modification.
Chapter 6 — Lease Payments

6.1 General
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   6.2.1 In-Substance Fixed Payments
   6.2.2 Lease Incentives
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6.1 General

To determine the appropriate lease classification and measure a lessee’s ROU asset and lease liability and a lessor’s net investment in the lease at lease commencement, lessees and lessors, respectively, must determine the lease payments related to the use of the underlying asset during the lease term. Lease payments are determined after the lease term has been established (see Chapter 5). This determination will include an assessment of any payments during renewal periods for which exercise is deemed reasonably certain. The following graphic depicts the types of payments that are and are not included in the calculation of the lease payments at lease commencement:

Types of payments that are included in the calculation of the lease payments at lease commencement

- Fixed payments (see Section 6.2)
- Variable lease payments that depend on an index or a rate (see Section 6.3)
- Exercise price of a purchase option reasonably certain to be exercised (see Section 6.4)
- Penalties for terminating a lease (see Section 6.5)
- Fees paid by the lessee to owners of special-purpose entities (see Section 6.6)
- Amounts that it is probable that the lessee will owe under a residual value guarantee (see Section 6.7)

Types of payments that are not included in the calculation of the lease payments at lease commencement

- Variable lease payments that do not depend on an index or rate (see Section 6.9.1)
- Lessee’s guarantee of the lessor’s debt (see Section 6.9.2)
- Amounts allocated to nonlease components (see Section 6.9.3)
Connecting the Dots — Lease Payments May Be an Allocated Amount

As discussed in Chapter 4, once an entity determines that a contract contains a lease, the entity must identify and separate the lease and nonlease components in the contract. While this process for lessees differs slightly from that for lessors, in both cases the total consideration in the contract must be measured and allocated to the lease and nonlease components by maximizing the use of observable inputs. ASC 842-10-30-5 indicates that lease payments are amounts related to the use of the underlying asset (i.e., the lease component(s) in the contract). Therefore, when nonlease components are present, the lease payments are the consideration in the contract that is allocated to the lease component(s) rather than the total consideration in the contract.

Example 6-1

Company L (the lessee) enters into an arrangement to lease a building for 10 years. As part of the arrangement, the lessor is required to provide CAM services for the 10-year lease term. In exchange for the right to use the building and obtain the CAM services, L will make fixed monthly payments of $5,000. Company L concludes that the right to use the building and the CAM are separate lease and nonlease components in the contract, respectively, for which the consideration in the contract should be allocated on a stand-alone price basis. The stand-alone price of the monthly building lease and CAM is $4,750 and $500, respectively.

The following table illustrates the allocation of the monthly contractual consideration of $5,000 between the lease and nonlease components in the contract.

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Price</th>
<th>Allocation Percentage</th>
<th>Allocated Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease — building</td>
<td>$4,750</td>
<td>90.5%</td>
<td>$4,525</td>
</tr>
<tr>
<td>Nonlease — CAM</td>
<td>500</td>
<td>9.5%</td>
<td>475</td>
</tr>
<tr>
<td></td>
<td>$5,250</td>
<td>100.0%</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

Company L’s monthly lease payments are equal to $4,525, which is the amount allocated to the lease component of the contract. The $475 monthly amount allocated to the nonlease component (i.e., the CAM service) is not included in L’s lease payments.

For additional information on separating lease and nonlease components and allocating the consideration in the contract to those components, see Chapter 4.

Q&A 6-1 Including Noncash Consideration in Lease Payments

Some leases require the lessee to make some or all of the lease payments with noncash consideration. For example, a lessee could be required to provide value in the form of hard assets, stock of the lessee or others, or guarantees of certain of the lessor’s obligations. The final value of the consideration at the time of payment may differ from the estimate of that value at lease commencement.

Question

Should an entity (a lessee or a lessor) include noncash consideration in its determination of lease payments?
Answer

Generally, yes. Noncash consideration should typically be included in an entity's determination of lease payments and should be measured at fair value at lease commencement. That is, we believe that the fair value of the noncash consideration would generally be akin to an index or rate, which is included in lease payments at commencement. Any fluctuations in the fair value of noncash consideration to be provided between the initial measurement of the ROU asset and liability, or the net investment in the lease, and the final measurement determined in accordance with other U.S. GAAP should be recognized as variable lease income or expense. For noncash consideration in the form of a guarantee (other than a residual value guarantee and a guarantee of the lessor's debt, the latter of which is discussed below), the amounts accrued and ultimately paid under the guarantee would not be considered variable lease payments. Rather, the providing of the guarantee is the lease payment because the lessee has delivered its stand-ready obligation under the guarantee.

Note, however, that a guarantee of the lessor's debt is outside the scope of lease payments.

Example 1

Company A provides Company B with materials and labor needed to build a tavern, and A has agreed to lease the tavern from B at the end of the construction period. Company A does not control the asset under construction. The fair value of the materials and labor provided to B should be recognized by A as a prepaid lease payment and should be included in the measurement of the ROU asset at lease commencement.

Example 2

Company X (the lessee) enters into an arrangement to lease an aerosol can factory from Company Y (the lessor) for three years. As consideration for the right to use the aerosol can factory, X agrees to transfer to Y 50, 60, and 70 shares of stock in Company Z, in arrears each year, respectively. As of lease commencement, the fair value per share of Z's stock is $20. Company X uses its incremental borrowing rate of 9 percent when discounting the lease payments since the rate implicit in the lease is not known.

In accordance with the lease classification tests (for lessees and lessors) under ASC 842-10-25-2(d), the lease payments should include the three payments made in shares of Z's stock. Assume that the lease is an operating lease. The lessee's lease obligation should be measured at $3,009. Further assume that the fair value of the stock at the end of year 1 of the lease (transfer date of the 50 shares) is $25 per share. The lessee should recognize the incremental fair value not included in the lease liability as a variable lease cost (i.e., $250, which represents 50 shares multiplied by the increase in the value of the stock since lease commencement). However, the shares to be delivered in years 2 and 3 should not be adjusted to their fair value at the end of year 1 because the fair value of the stock is an index or rate that is not adjusted after lease commencement unless the lease is remeasured for other reasons.

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1 See ASC 842-10-30-5(b), reproduced in Section 6.3.
2 See ASC 842-10-30-6(b), reproduced in Section 6.9.2.
3 See ASC 842-40-55-3 through 55-6.
4 Calculated as the sum of the present value of the lease payments — $1,000 ($20 × 50 shares) paid at the end of year 1, $1,200 ($20 × 60 shares) paid at the end of year 2, and $1,400 ($20 × 70 shares) paid at the end of year 3 — discounted at 9 percent.
Q&A 6-2  Nonrefundable Deposits

Certain leasing arrangements may include a security deposit that must be paid to the owner of the leased asset at or before lease commencement. The security deposit is generally provided to support the lessee’s intent and commitment to lease the underlying asset (i.e., upon receipt of a security deposit, the lessor typically stops marketing the asset for lease). Security deposits can be either nonrefundable or refundable depending on the terms of the contract.

ASC 842-10 defines lease payments with respect to identifying the types of payments that an entity should consider when determining the classification, initial measurement, and subsequent measurement of a lease. Specifically, ASC 842-10-30-5 states, in part:

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).

Question

Is a nonrefundable deposit a lease payment?

Answer

Yes. A nonrefundable deposit is an amount the lessee pays the lessor to secure the terms of the contract for both parties. This payment represents a portion of the consideration to be transferred during the contract term and is not refunded by the lessor. Because the payment to the lessor is nonrefundable, it is considered a fixed payment under ASC 842-10-30-5.

Q&A 6-3  Refundable Deposits

Question

Is a refundable deposit a lease payment?

Answer

No. A refundable security deposit is an amount that the lessee is required to submit to the lessor to protect the lessor's interest in the contract and the property. The lessor holds this amount until the occurrence of an event that would allow it to use some or all of the deposit to meet the contract requirements (e.g., use the deposit to recover any shortfall in the lessee’s payment or to repair any damages to the leased property). In the absence of such a need, the lessor would generally be required under the contract to return the remaining, unused security deposit to the lessee at the end of the lease. Because the payment is refundable, it would not meet the definition of a lease payment.

Note that when the lessor recovers a portion of a refundable security deposit to recover a shortfall in a lease payment, the lessor would effectively be settling a portion of the lease liability associated with the missed payment. In contrast, any portion of the refundable security deposit retained by the lessor for other reasons (e.g., excess wear and tear on the underlying
asset) would generally be considered a variable lease payment. As with other variable payment requirements, lessees should consider the implementation guidance in ASC 842-20-55-1 and 55-2 when evaluating whether a lessee should recognize costs from variable payments before the achievement of a specified target (see Q&A 8-10).

In addition, to the extent that the arrangement provides for interest to be earned on the deposit, any interest earned on the refundable security deposit that the lessee forgoes (i.e., that the lessor is entitled to retain) should be considered a variable lease payment.

**Changing Lanes — Treatment of Executory Costs**

Under ASC 840, some lessees may have determined that the definition of minimum lease payments included “executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon” (although executory costs may have been excluded from classification, measurement, or disclosure — for example, in accordance with ASC 840-10-25-1(d)). See Q&As 16-1 and 16-2A for additional discussion.

Under ASC 842, an entity needs to distinguish between lease and nonlease components in accounting for payments made for insurance, maintenance, and taxes as part of a lease contract. Components for separate services, such as CAM, represent a nonlease component in the contract to which a portion of the consideration is allocated. (See Section 4.3.1 for detailed discussion of nonlease components.) However, in other cases, such as the reimbursements of lessor costs, there is no transfer of a good or service to the customer and thus such payments do not represent a lease or nonlease component in the contract (e.g., insurance and taxes). (See Section 4.3.2 for detailed discussion of “noncomponents.”) In such cases, no portion of the consideration is allocated to items that do not transfer a good or service to the customer (i.e., to the noncomponents). See Chapter 4 for further discussion on separating lease and nonlease components and allocating the consideration in the contract.

### Example 6-2

Company L (the lessee) enters into an arrangement to lease a building for 10 years. As part of the arrangement, the lessor is required to provide CAM services for the 10-year lease term. In exchange for the right to use the building and obtain the CAM services, L will make fixed monthly payments of $5,000. In addition, L agrees to pay the lessor a fixed monthly payment of $300, which is intended to reimburse the lessor for its property taxes and insurance for the building. The stand-alone price of the monthly building lease and CAM is $5,050 and $500, respectively.

Under ASC 840, the fixed monthly payment of $300 to reimburse the lessor for its property taxes and insurance would not be included in the measurement of minimum lease payments.

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5 ASC 842 defines variable lease payments as “[p]ayments 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.” Therefore, any portion of a refundable security deposit that is retained by a lessor because of changes in facts and circumstances after the lease commencement date represents a variable lease payment and should be recognized as an expense from the lessee’s perspective and as income in profit or loss from the lessor’s perspective in the period when incurred (lessee) or earned (lessor).
Example 6-2 (continued)

Under ASC 842, the property taxes and insurance on the building do not represent a lease or nonlease component in the contract. Therefore, the related fixed monthly payment of $5,300 should be allocated between the lease (i.e., building) and nonlease (i.e., CAM) components in the contract, as shown in the following table:

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Price</th>
<th>Allocation Percentage</th>
<th>Allocated Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease — building</td>
<td>$5,050</td>
<td>91%</td>
<td>$4,823</td>
</tr>
<tr>
<td>Nonlease — CAM</td>
<td>500</td>
<td>9%</td>
<td>477</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$5,550</strong></td>
<td><strong>100%</strong></td>
<td><strong>$5,300</strong></td>
</tr>
</tbody>
</table>

6.2 Fixed Payments

**ASC 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). . . .

Cash flows in a lease contract that are known are the simplest inputs to recognition and measurement. Fixed payments in the contract that are related to the right to use the underlying asset (including those that are “in-substance fixed”) are included in the lease payments, regardless of their timing. For example, fixed payments made by the lessee before lease commencement should be included in lease payments.

The sections below further discuss common ways in which payments may be fixed.

6.2.1 In-Substance Fixed Payments

**ASC 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.

Paragraph BC203 of ASU 2016-02 states that “[i]n substance fixed lease payments are payments that may, in form, appear to contain variability but are, in effect, fixed and unavoidable” and that the Board included these payments “in the measurement of lease assets and lease liabilities because those payments are unavoidable and, thus, are economically indistinguishable from fixed lease payments.”
ASC 842-10-30-5 and 30-6 indicate that lease payments include in-substance fixed lease payments but exclude variable lease payments that do not depend on an index or rate. Because the treatment of lease payments may differ depending on whether the payment is a variable or in-substance fixed payment, an entity will need to carefully evaluate such payments to determine whether a lease payment is truly variable or in-substance fixed. The following example illustrates the accounting for an in-substance fixed lease payment:

**Example 6-3**

Company P (the lessee) leases an automobile for a two-year lease term. In exchange for the right to use the automobile, P has the option to pay either (1) a fixed monthly payment of $250 or (2) $0.25 per mile driven with a minimum monthly payment of $100. Company P makes its election at the beginning of each month.

In accordance with ASC 842-10-55-31(b), because P must choose between the two sets of payments, both containing a fixed amount, its monthly payment is an in-substance fixed payment. The amount that should be included in lease payments is equal to the lesser of the two fixed amounts. Because the payment under the second option is, in part, variable and is not tied to an index or a rate, the in-substance fixed portion equals the minimum monthly amount of $100. Given that the unavoidable monthly amount of $100 in the second option is lower than the fixed monthly payment of $250 in the first option, the lease payments are $100 per month.

**Connecting the Dots — Virtually Certain Variable Lease Payments Do Not Represent In-Substance Fixed Lease Payments**

In some cases, a contract includes a variable lease payment that depends on the performance or usage of the underlying asset and a payment is virtually certain (e.g., a variable payment for highly predictable output from a solar farm or a variable payment for retail space that is based on a fixed percentage of a minimal retail sales volume). Although the probability of these payments may be virtually certain, we do not believe that the payments are in-substance fixed because they are contingent on the performance or usage of the underlying asset and thus are avoidable if the triggering event does not occur. However, we believe that, in accordance with ASC 842-10-55-31(a), an exception applies to situations in which contingent rental provisions are nonsubstantive and appear to be designed so that rental escalation is excluded from the lease payments.

Examples 6-4 and 6-5 illustrate both of these scenarios.

**Example 6-4**

**Virtually Certain Lease Payments That Depend on the Performance or Usage of the Underlying Asset**

Company H (the lessee) enters into an arrangement to lease a space in a building for two years to use as a retail store. In exchange for the right to use the building space, H pays the lessor a fixed monthly fee of $1,500 and 5 percent of any sales exceeding $10,000 each month. Company H is virtually certain that its retail sales will be at least $12,000 each month.

Although H is virtually certain that it will exceed the $10,000 sales threshold each month, such amounts do not represent in-substance fixed payments and thus should not be included in H’s or the lessor’s lease payments. Company H’s lease payments and the lessor’s lease payments consist only of the $1,500 fixed monthly rental fee.
Example 6-5

Contingent Rental Provisions Designed to Enable Exclusion of Rental Escalation From Lease Payments

Company M (the lessee) leases a piece of equipment for three years. Company M’s lease payments for the first year are $750 per month. After the first year, the lease payments are subject to the lesser of a 2 percent increase or 1 percent for every 0.1 percent increase in CPI from the previous year. On the basis of historical evidence, there is a remote likelihood that the CPI will increase by less than 0.3 percent each year. Because the likelihood of an increase less than 0.3 percent each year is remote, this represents a form of nongenuine variability (i.e., any variability below 0.3 percent is not a genuine form of variability) in accordance with ASC 842-10-55-31(a).

The SEC has previously indicated that under ASC 840 there does not appear to be any economic reason for the leverage factor described above and it appears that the CPI adjustment provision was put in place to avoid inclusion of the higher fixed rentals in the minimum lease payments. Our general view is that ASC 842 would not change this conclusion.

Because there is a remote likelihood that the CPI will increase by less than 0.3 percent each year, we believe that M should adjust its lease payments by 2 percent. Therefore, M calculates its lease payments as follows:

- Year 1: $9,000 ($750/month multiplied by 12 months)
- Year 2: $9,180 ($9,000 prior-year payment adjusted by 2 percent)
- Year 3: $9,364 ($9,180 prior-year payment adjusted by 2 percent)

Connecting the Dots — Consistency With Other Topics in U.S. GAAP

The guidance on in-substance fixed lease payments is generally consistent with existing interpretive guidance on in-substance fixed payments in other areas of U.S. GAAP. Paragraph BC204 of ASU 2016-02 notes that although the FASB decided not to provide specific examples of what constitutes an in-substance fixed lease payment, “the examples that exist in practice and that are included in various pieces of interpretive guidance provide useful information on how the Board [FASB] intends this concept to apply in Topic 842.” One example that the FASB specifically points out in paragraph BC204 of ASU 2016-02 is the determination of whether a notional amount exists in the accounting for derivatives under ASC 815. On the basis of such comparisons, we do not expect the accounting for in-substance fixed lease payments under ASC 842 to differ from that under other literature.

6.2.2 Lease Incentives

ASC 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 for use of the assumed underlying asset.
As indicated above, lease incentives include both (1) payments made by the lessor “to or on behalf of the lessee” and (2) any “losses incurred by the lessor as a result of assuming a lessee’s preexisting lease with a third party.” Lease incentives reduce the lease payments that are used to determine the appropriate lease classification and to measure the ROU asset (and the lease liability if not yet received) or the net investment in the lease at lease commencement.

Example 6-6

Company D (the lessee) is currently leasing a building from an unrelated third party and is obligated to continue leasing the building for six additional months in exchange for a fixed monthly fee of $1,000 (i.e., D is obligated to pay an additional $6,000 under its current lease).

Although D’s current lease is still effective, D enters into a separate agreement with Company T (the lessor) to lease a different building for a five-year term in exchange for fixed monthly payments of $1,500. To incentivize D to enter into the new lease, T agrees to pay D a lump-sum amount of $5,000, which is intended to defray a portion of D’s remaining costs under its existing lease.

The lease payments under the new lease are equal to $85,000, which are calculated as follows:

- Fixed lease payments: $90,000 ($1,500 monthly payment multiplied by the 60-month lease term)
- Less: Lease incentives: $5,000 payment made by T to D.

Connecting the Dots — No Changes in the Definition of Lease Incentives

The description of lease incentives in ASC 842-10-55-30 is consistent with the definition of lease incentives under ASC 840-20-25-7. For information on accounting for lease incentives that reduce lease payments by lessees and lessors, see Chapters 8 and 9, respectively.

Q&A 6-4 Treatment of Payments to a Lessee When a Lease is Terminated and the Lessee Enters Into a New Lease for Similar Assets

In certain situations, a lessor may pay a lessee consideration to terminate a lease before its originally negotiated end date.

Question 1

If a lessor terminates an existing lease, as a result of which the lessee must enter into a new lease agreement for the same type of equipment with the same lessor, must the lessee account for the consideration received with regard to the first lease (as compensation for terminating the lease) as a lease incentive for its new lease?

Answer

Generally, yes. In accordance with ASC 842-10-55-30(a), payments made to or on behalf of a lessee to enter into a lease are lease incentives. In this situation, the payment made by the lessor is related to terminating the first lease, but the payment also incentivizes the lessee to enter into the new lease. Therefore, we believe that the substance of the payment is typically an incentive for the new lease, which the lessee should defer as part of the ROU asset related to the new lease.
Chapter 6 — Lease Payments

Question 2

If a lessor terminates an existing lease, as a result of which the lessee enters into a new lease agreement for the same type of equipment with a new lessor, must the lessee account for the consideration received from its original lessor (as compensation for terminating the lease) as a lease incentive for its new lease?

Answer

It depends. If, as part of the termination of the existing lease, the lessee is contractually required to enter into the new lease, we believe that the payment typically represents an incentive that the lessee should defer as part of the ROU asset related to the new lease. However, if the lessee is not contractually required to enter into the new lease with a new lessor, we believe that the payment typically does not represent an incentive for the new lease and that the lessee should instead take into account the payment received in determining the gain or loss upon termination of the original lease, as discussed in Section 8.7.2.

Example

Lessee enters into a nonassignable agreement to lease a 3-D printer from Lessor A. During the current year, A decides to sell its entire portfolio of printers to Lessor B. To facilitate the sale, A agrees to pay Lessee $1,000 as consideration for the termination of the existing lease. In addition, A requires that Lessee enter into a new lease with B for a 3-D printer. Even if the specific model of 3-D printer is not specified, Lessee should account for the $1,000 payment from A as an incentive to enter into the new lease with B and should defer that incentive as part of the ROU asset related to the new lease. On the other hand, if Lessee had no contractual obligation to enter a new lease with B, Lessee would instead account for the $1,000 payment as part of its gain or loss upon termination of its original lease with A. This would be the case even if Lessee decides, or (because of its reliance on the leased asset) is economically compelled, to lease a replacement 3-D printer from another lessor.

Q&A 6-5  Payments From a Lessor to a Lessee During the Lease Agreement

Lease incentives are not always paid by the lessor to the lessee before lease commencement. In some cases, a lessor may make a payment to the lessee during the lease term.

Question

Do payments made by the lessor to the lessee during the lease term (i.e., after the lease commencement date) represent lease incentives that should reduce the lease payments?

Answer

Yes. Payments made by a lessor to a lessee, regardless of the timing of the payment, should be accounted for as lease incentives that reduce the lessee’s and lessor’s lease payments. Although payments from the lessor may be specifically identified for items such as “business interruption” or “lost revenues,” it is difficult to separate a transaction into components when a continuing lease arrangement exists. Applying, by analogy, the accounting guidance on business interruption insurance or litigation settlement to payments from a lessor to a lessee is generally inappropriate even when the payments may be related to certain costs or accounting periods.
Example 1

Entity A, a retailer, leases retail space in a building owned by Entity B, a real estate investment trust (REIT). The lease is an operating lease with a term of 20 years. Entity A leases a portion of the building, and the remaining portions of the building are vacant. In the lease contract, B agrees to make a payment to A at the end of each of the first five years of the lease in accordance with a fixed schedule.

The payment from B to A represents a lease incentive so that A would agree to lease a portion of the building while B attempts to fill the remaining portions with other tenants. Therefore, both A and B should include the annual payments as a reduction to the lease payments at commencement.

Example 2

Entity A, a retailer, leases retail space in a building owned by Entity B, a REIT. The lease is an operating lease with a term of 20 years. Entity A leases a portion of the building, and the remaining portions of the building are vacant. In year 5, A and B agree that A will vacate the premises for an indefinite period so that B can refurbish the building. In exchange for vacating the premises, B will make monthly payments to A during the renovation period to compensate A for business interruption, employee termination costs, and lost profits. Once the renovation is complete, A will return to the space and resume making lease payments under the preexisting lease agreements.

The payments from B to A represent a lease incentive. Therefore, both A and B should include the monthly payments as a reduction to the lease payments at the time the payment obligation arises (see Q&A 8-13 for a more detailed discussion of how a lessee should account for such incentives).

6.3 Variable Lease Payments That Depend on an Index or a Rate

ASC 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: . . .

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. . . .

ASC 842-10 — 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.

Paragraph BC211 of ASU 2016-02 states the following regarding the FASB’s decision to include variable lease payments that depend on an index or a rate in the lease payments:

For reasons similar to those for including in substance fixed payments in the measurement of lease assets and lease liabilities, the Board also decided to include variable lease payments that depend on an index or a rate in the measurement of lease assets and lease liabilities. Those payments meet the definition of assets (for the lessor) and liabilities (for the lessee) because they are unavoidable (that is, a lessee has a present obligation to make, and the lessor has a present right to receive, those lease payments). Any uncertainty, therefore, relates to the measurement of the asset or liability that arises from those payments and not to the existence of the asset or liability.

See Section 6.2.1 for information about in-substance fixed payments.
An entity should include variable lease payments that depend on an index or a rate in its lease payments on the basis of the spot index or rate at lease commencement.

In their initial proposals, the boards suggested that a lessee should remeasure variable lease payments that depend on an index or a rate whenever there is a change in contractual cash flows (e.g., a change in the CPI). However, as explained in paragraph BC236 of ASU 2016-02, some respondents “indicated concerns about the cost of performing reassessments and questioned whether the benefits for users of financial statements would justify the costs for preparers.” During redeliberations, the FASB agreed that the benefits of requiring lessees to remeasure variable lease payments upon changes in contractual cash flows would not outweigh the cost of performing the remeasurement. Consequently, as stated in paragraph BC237 of ASU 2016-02, the FASB decided that a lessee only “should” remeasure variable lease payments that depend on an index or a rate when the lessee remeasures the lease liability for another reason.6 See Section 6.10 for additional guidance on the remeasurement of variable lease payments that depend on an index or a rate.

The FASB included Example 25, Case A, in ASC 842-10-55-226 through 55-231 to illustrate the requirements for measuring variable payments that depend on an index or a rate:

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-8</strong> See Example 25 (paragraphs 842-10-55-225 through 55-234) for an illustration of the requirements on lessee accounting for variable lease payments . . . .</td>
</tr>
<tr>
<td><strong>55-225</strong> Example 25 illustrates how a lessee accounts for variable lease payments that depend on an index or a rate . . . .</td>
</tr>
</tbody>
</table>

**Example 25 — Variable Lease Payments That Depend on an Index or a Rate . . . .**

**Case A — Variable Lease Payments That Depend on an Index or a Rate**

- **55-226** Lessee enters into a 10-year lease of a building with annual lease payments of $100,000, payable at the beginning of each year. The contract specifies that lease payments for each year will increase on the basis of the increase in the Consumer Price Index for the preceding 12 months. The Consumer Price Index at the commencement date is 125. This Example ignores any initial direct costs. The lease is classified as an operating lease.

- **55-227** The rate implicit in the lease is not readily determinable. Lessee’s incremental borrowing rate is 8 percent, which reflects the rate at which Lessee could borrow an amount equal to the lease payment in the same currency, over a similar term, and with similar collateral as in the lease.

- **55-228** At the commencement date, Lessee makes the lease payment for the first year and measures the lease liability at $624,689 (the present value of 9 payments of $100,000 discounted at the rate of 8 percent). The right-of-use asset is equal to the lease liability plus the prepaid rent ($724,689).

- **55-229** Lessee prepares financial statements on an annual basis. Lessee determines the cost of the lease to be $1 million (the total lease payments for the lease term). The annual lease expense to be recognized is $100,000 ($1 million ÷ 10 years).

- **55-230** At the end of the first year of the lease, the Consumer Price Index is 128. Lessee calculates the payment for the second year, adjusted to the Consumer Price Index, to be $102,400 ($100,000 × 128 ÷ 125).

---

6 The IASB decided not to limit the remeasurement of variable lease payments that depend on an index or a rate to situations in which the lessee remeasures the lease liability for another reason. Rather, IFRS 16 requires lessees to remeasure variable lease payments that depend on an index or a rate whenever there is a change in contractual cash flows (e.g., changes in the CPI). See Appendix B for a summary of differences between ASC 842 and IFRS 16.
Because Lessee has not remeasured the lease liability for another reason, Lessee does not make an adjustment to the lease liability to reflect the Consumer Price Index at the end of the reporting period; that is, the lease liability continues to reflect annual lease payments of $100,000 (8 remaining annual payments of $100,000, discounted at the rate of 8 percent is $574,664). However, the Year 2 payment amount of $102,400 (the $100,000 annual fixed payment + $2,400 variable lease payment) will be recognized in profit or loss for Year 2 of the lease and classified as cash flow from operations in Lessee’s statement of cash flows. In its quantitative disclosures, Lessee will include $100,000 of the $102,400 in its disclosure of operating lease cost and $2,400 in its disclosure of variable lease cost.

The following Q&As further discuss the application of the guidance on variable payments that are based on an index or rate:

**Q&A 6-6 Variable Payments Based on an Index or Rate**

Frequently, leases contain terms that revise or reset the amounts payable to the lessor over the lease term. Those adjustments to the amounts payable to the lessor are described in ASC 842 as variable lease payments. Generally, ASC 842 differentiates between two categories of variability in lease payments:

- Variability based on an index or rate (e.g., escalators based on the CPI, or rents that are referenced to or are increased on the basis of LIBOR).
- Other variability, including variability that is typically described as based on performance or usage of the asset (e.g., rents based on the percentage of retail store sales or on mileage driven in a leased car).

ASC 842 requires only that limited types of variable payments be included in the lease payments that will affect the lease classification and measurement. Specifically, ASC 842-10-30-5 states that “[a]t the commencement date, the lease payments shall consist [in part] of the following payments relating to the use of the underlying asset during the lease term”:

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.

In addition, ASC 842-10-30-6 explicitly states that “[l]ease payments do not include [v]ariable lease payments other than those in paragraph 842-10-30-5(b).”

**Question**

How should a lessee initially measure its lease liability and ROU asset at lease commencement when there are variable payments based on an index or rate?

---

7 While this Q&A specifically focuses on the consideration of variable payments based on an index or a rate when a lessee initially measures its lease liability and ROU asset, the concept would similarly apply when a lessor initially measures its net investment in a sales-type or direct financing lease.
**Answer**

The initial measurement of the lease liability and ROU asset should be determined on the basis of the lease payments, which, as stated in ASC 842-10-30-5(b), include “[v]ariable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate).” An entity initially measures variable payments based on an index or rate by using the index or rate at lease commencement (i.e., the spot or gross index or rate applied to the base rental amount). The use of the spot rate at lease commencement is largely based on the FASB’s view that (1) the cost associated with forecasting future rates would outweigh the benefits provided and (2) the use of forecasted rates or indexes would be inconsistent among preparers and often imprecise.

In contrast, payments based on a change in an index or a rate should not be considered in the determination of lease payments. Given the cost-benefit considerations related to the use of forecasting techniques, ASC 842 does not allow an entity to forecast changes in an index or rate to determine lease payments. Rather, adjustments to lease payments that are based on a change in an index or rate are treated as variable lease payments and recognized in the period in which the obligation for those payments was incurred (as illustrated in Example 25, Case A, in ASC 842-10-55-226 through 55-231, reproduced above).

For example, assume that lease payments are made in arrears and are based on a fixed amount (e.g., a $100,000 base amount) adjusted each year by LIBOR at the end of the year. If LIBOR at lease commencement was 2.7 percent, the total lease payments used to measure the lease liability would be $102,700 per year of the lease, which includes $2,700 in variable lease payments based on an index or rate at lease commencement. In contrast, if the payments were based on a fixed amount ($100,000) that will subsequently be adjusted in a manner corresponding to the change in LIBOR each year throughout the lease term, the initial measurement of the lease liability and ROU asset would not take into account the future expected adjustments in LIBOR. Therefore, the initial measurement of the lease liability and ROU asset would be based only on the fixed payments through the lease term (see the example below).

---

**Example**

A retailer enters into a lease of a retail space for five years with the following terms:

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease term</td>
<td>5 years (no renewal options)</td>
</tr>
<tr>
<td>Lessee’s incremental borrowing rate*</td>
<td>7%</td>
</tr>
<tr>
<td>Lease classification</td>
<td>Operating lease</td>
</tr>
<tr>
<td>Annual lease payments</td>
<td>$100,000 (base amount) adjusted for the change in the CPI year over year</td>
</tr>
</tbody>
</table>

The first lease payment was made on January 1. Each subsequent payment is made on December 31. There were no initial direct costs or lease incentives. The lessee recognizes total lease expense and measures the lease liability and ROU asset in the manner shown in the table below (also see Chapter 8 for a detailed discussion of the lessee accounting requirements).
Example (continued)

<table>
<thead>
<tr>
<th>Date</th>
<th>Year</th>
<th>CPI</th>
<th>Payment</th>
<th>Liability***</th>
<th>Interest</th>
<th>Fixed Lease Expense</th>
<th>Variable Lease Expense</th>
<th>Amortization Expense</th>
<th>Total Expense Recognized***</th>
<th>ROU Asset†</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20X1</td>
<td>0</td>
<td>172</td>
<td>$100,000</td>
<td>$338,721</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$438,721</td>
<td></td>
</tr>
<tr>
<td>12/31/20X1</td>
<td>1</td>
<td>174</td>
<td>101,163</td>
<td>262,432</td>
<td>$23,710</td>
<td>$100,000</td>
<td></td>
<td>1,744</td>
<td>87,344</td>
<td>101,163</td>
</tr>
<tr>
<td>12/31/20X2</td>
<td>2</td>
<td>175</td>
<td>101,744</td>
<td>180,802</td>
<td>18,370</td>
<td>100,000</td>
<td>1,163</td>
<td>81,630</td>
<td>100,000</td>
<td>280,802</td>
</tr>
<tr>
<td>12/31/20X3</td>
<td>3</td>
<td>177</td>
<td>102,907</td>
<td>93,458</td>
<td>12,656</td>
<td>100,000</td>
<td>1,744</td>
<td>87,344</td>
<td>101,744</td>
<td>193,458</td>
</tr>
<tr>
<td>12/31/20X4</td>
<td>4</td>
<td>178</td>
<td>103,488</td>
<td>–</td>
<td>6,543</td>
<td>100,000</td>
<td>2,907</td>
<td>93,457</td>
<td>102,907</td>
<td>100,000</td>
</tr>
<tr>
<td>12/31/20X5</td>
<td>5</td>
<td>180</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>$509,302</td>
<td>$500,000</td>
<td>$9,302</td>
<td>$438,721</td>
<td>$100,000</td>
<td>$103,488</td>
<td></td>
</tr>
</tbody>
</table>

* The incremental borrowing rate is used because the rate the lessor charges the lessee is not known.

** The lessee measures the liability at the present value of the four remaining future lease payments (by using the base amount of rent at lease commencement) since the initial payment was made on January 1 (at lease commencement). The effect of the CPI was not included in the initial measurement of the liability because the variable payments are based on changes in the CPI rather than a specified index or rate. The lease liability and the ROU asset are not remeasured as a result of changes to the CPI.

*** The total lease expense recognized includes both the fixed lease expense and the variable lease expense for the change in the CPI for the year.

† The ROU asset is measured at the present value of the lease payments at the commencement of the lease (the present value of four payments of $100,000 [lease payments in arrears] plus $100,000 of prepaid rent). In subsequent years, the ROU asset is amortized in a manner consistent with the model described in Chapter 8 for operating leases. Note that amortization expense is calculated as the fixed lease expense less interest.

Q&A 6-7 Implications of Index- or Rate-Based Payment Adjustments

The subsequent remeasurement of a lease depends on whether the variability is associated with an index or rate or arises for other reasons. Specifically, ASC 842-10-35-4 and 35-5 require, in part, the following:

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. However, a change in a reference index or a rate upon which some or all of the variable lease payments in the contract are based does not constitute the resolution of a contingency subject to (b) (see paragraph 842-10-35-5 for guidance on the remeasurement of variable lease payments that depend on an index or a rate).

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.

**35-5** When one or more of the events described in paragraph 842-10-35-4(a) or (c) occur or when a contingency unrelated to a change in a reference index or rate under paragraph 842-10-35-4(b) is resolved, variable lease payments that depend on an index or a rate shall be remeasured using the index or rate as of the date the remeasurement is required. [Emphasis added]

**Question**
Do index- or rate-based payment adjustments in a lease require the lessee to remeasure the lease?

**Answer**
No. Changes in an index or rate alone would not give rise to a remeasurement of the lease. On the basis of discussions with the FASB staff and of ASU 2018-10 on Codification improvements to ASC 842, we understand that the guidance on remeasuring a lease liability after the resolution of a contingency is not meant to apply to index-based escalators even when those escalators serve to establish a new floor for the next lease payment. Therefore, even when the index or rate establishes a new floor (such as when the CPI increases and establishes a new rate that will be used as a benchmark for determining future lease payment increases), that adjustment would not result in a remeasurement of the lease liability as variable lease expense and of the ROU asset. As a result, the additional payments for increases in the CPI will be recognized in the period in which they are incurred.

However, as highlighted in ASC 842-10-35-5, if a lessee remeasures the lease payments for any of the other reasons detailed in ASC 842-10-35-4, the lessee is required to remeasure variable lease payments that depend on an index or rate by using the index or rate in effect on the remeasurement date.

**Bridging the GAAP**
While ASC 842 and IFRS 16 are generally converged with respect to the recognition and measurement of variable lease payments, there is a notable difference. Under IFRS 16, for lease payments based on an index or rate, the lease liability and ROU asset are remeasured when there is a change in cash flows as a result of a change in the index or rate. Therefore, entities that are subject to dual reporting under both U.S. GAAP and IFRS Standards (e.g., a parent entity that applies U.S. GAAP and has international subsidiaries applying IFRS Standards for statutory reporting) will be required to account for their leases under two different remeasurement models.

CPI and market interest rates are explicitly noted as examples of indexes and rates that should be considered in accordance with ASC 842-10-30-5(b). However, IFRS 16, which is converged with ASC 842 with respect to the initial measurement of variable lease payments that depend on an index or rate, also includes “payments that vary to reflect changes in market rental rates” as an additional example of variable payments that depend on an index or rate.

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8 In July 2018, the FASB issued ASU 2018-10, which makes Codification improvements to ASC 842 and amends ASC 842-10-35-4(b) and ASC 842-10-35-5 to clarify that changes in an index or rate alone would not give rise to a requirement to remeasure the lease. See Section 17.3.1.3 for further discussion of the ASU.
The following Q&A discusses our interpretation under ASC 842 of the applicability of ASC 842-10-30-5(b) to variable payments based on fair market rental rates:

### Q&A 6-8 Rents Based on Market Rates

Some lease agreements (typically real estate leases) include variability in the form of a rent reset provision that requires the future lease payments after a specified point in time to be reset to the fair market rental rates at that time. For example, a 10-year lease of property in Chicago that requires annual rental payments of $100,000 for years 1–5 may also include a provision to reset the rental payments in years 6–10 of the lease to the updated fair market rent as benchmarked to published rates for Chicago.

**Question**

Should the fair market rent reset feature described above be accounted for in accordance with the guidance on variable payments that are based on an index or rate?

**Answer**

Yes. Paragraph BC211 of ASU 2016-02 states the FASB’s rationale for including certain variable lease payments that depend on an index or rate in the measurement of the lease liability and ROU asset:

> For reasons similar to those for including in substance fixed payments in the measurement of lease assets and lease liabilities, the Board also decided to include variable lease payments that depend on an index or a rate in the measurement of lease assets and lease liabilities. Those payments meet the definition of assets (for the lessor) and liabilities (for the lessee) because they are unavoidable (that is, a lessee has a present obligation to make, and the lessor has a present right to receive, those lease payments). Any uncertainty, therefore, relates to the measurement of the asset or liability that arises from those payments and not to the existence of the asset or liability.

While ASC 842 does not define “index” or “rate,” we believe that an index or rate is based on underlying economic performance (e.g., the CPI measures the variation in prices paid by a consumer household for certain retail goods and services). Similarly, fair market rent is indicative of the economic performance of a specific geographic region and is analogous to a formally published index or rate. Further, the FASB and IASB converged certain aspects of their guidance on leases, including the treatment of payments subject to market rate resets as lease payments that vary on the basis of an index or rate. Paragraph 28 of IFRS 16 explicitly states that a variable payment that is based on an index or rate would include, among other things, “payments that vary to reflect changes in fair market rental rates.”

Since variable payments based on fair market rental rates were determined to be analogous to variable payments based on an index or rate, we believe that the specific guidance on variable payments based on an index or rate (see Q&As 6-6 and 6-7) should be applied to variable payments based on fair market rental rates. Accordingly, a lessee should measure the lease liability and ROU asset and a lessor should measure the net investment in the lease on the basis of the fair market rental rate in effect at lease commencement. The lessee’s lease liability and ROU asset and the lessor’s net investment in the lease would not be remeasured as a result of any subsequent change in the fair market rental rate (although remeasurement could be required for another reason); such a change would be recorded as variable lease expense or income, respectively, in the appropriate period depending on the change in the fair market rental rate.
6.4 Exercise Price of a Purchase Option Reasonably Certain to Be Exercised

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-5</strong> 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: . . .</td>
</tr>
<tr>
<td>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). . .</td>
</tr>
</tbody>
</table>

When calculating the lease payments, the lessee and the lessor should consider whether the lessee has the option to purchase the leased asset and, if so, the likelihood that the lessee will exercise the purchase option. (See Section 5.3 for a discussion of the effect of this assessment on the lease term.) If it is reasonably certain that the lessee will exercise its option to purchase the leased asset, the lease payments should include the exercise price of the purchase option. This assessment is consistent with the evaluation of the lease classification criterion in ASC 842-10-25-2(b) and is based on the economic factors in ASC 842-10-55-26 for determining whether a lessee is reasonably certain to exercise an option. Such factors include:

- Contract-based factors (e.g., the terms and conditions of a purchase option in the contract)
- Asset-based factors (e.g., impact of significant leasehold improvements)
- Market-based factors (e.g., costs associated with exercising the purchase option versus separately buying a similar asset or entering into a new lease for a similar asset)
- Entity-based factors (e.g., the lessee’s intent and past experience with exercising purchase options).

A lessee should remeasure its lease payments when there is a change in the assessment of whether the lessee is reasonably certain to exercise its purchase option in accordance with ASC 842-10-35-1. However, the lessor would not remeasure its lease payments in such circumstances. See Section 6.10 for more information about the requirements for lessees and lessors to remeasure lease payments.

**Example 6-7**

**Effect of Purchase Options on Lease Payments**

Company S (lessee) enters into an arrangement to lease a building for 10 years in exchange for fixed annual payments of $100,000. At the end of the 10-year lease term, S has the option to purchase the building for $326,000.

**Case A — Company S Is Reasonably Certain to Exercise Its Purchase Option**

On the basis of the factors outlined in ASC 842-10-55-26, S has concluded that it is reasonably certain to exercise its purchase option. Therefore, the lease payments are equal to $1,326,000 ($100,000 per year multiplied by 10 years plus the $326,000 purchase price of the building).

**Case B — Company S Is Not Reasonably Certain to Exercise Its Purchase Option**

If S determines that it is not reasonably certain to exercise its purchase option, it would not include the $326,000 purchase price in its lease payments. Rather, the lease payments would only consist of $1,000,000 ($100,000 per year multiplied by 10 years).

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ASC 842-10-25-2(b) requires that a lease be classified as a finance lease (lessee) or sales-type lease (lessor) if the lease grants the lessee an option to purchase the underlying asset and it is reasonably certain that the lessee will exercise that option.
6.5 Penalties for Terminating a Lease

As discussed in Chapter 5, the lease term includes any periods covered by an option to terminate the lease if it is reasonably certain that the lessee will not exercise that option. In a manner consistent with the determination of the lease term, the lease payments would not include a termination penalty if it is reasonably certain that the lessee will not exercise that termination option. However, if it is not reasonably certain that the lessee will not terminate the lease, the term would not include the period past the termination date and the lease payments would include any related termination penalty.

The same treatment would apply to renewal options. That is, to the extent that exercising a renewal option would require the lessee to pay a renewal fee, the lease payments would include the renewal fee if it is reasonably certain that the lessee will exercise the renewal option. Conversely, the lease payments would not include the renewal fee if it is not reasonably certain that the lessee will exercise the renewal option.

The FASB included Example 26 in ASC 842-10-55-235 through 55-238 to illustrate the impact of termination penalties on lease payments:

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**Example 26 — Termination Penalties**

55-236 Lessee enters into a 10-year lease of an asset, which it can terminate at the end of each year beginning at the end of Year 6. Lease payments are $50,000 per year during the 10-year term, payable at the beginning of each year. If Lessee terminates the lease at the end of Year 6, Lessee must pay a penalty to Lessor of $20,000. The termination penalty decreases by $5,000 in each successive year.

55-237 At the commencement date, Lessee concludes that it is not reasonably certain it will continue to use the underlying asset after Year 6, having considered both the significance of the termination penalty (in absolute terms and in relation to the remaining lease payments after the date the termination option becomes exercisable) and the other factors in paragraph 842-10-55-26.

55-238 Accordingly, Lessee determines that the lease term is six years. At the commencement date, Lessee measures the lease liability on the basis of lease payments of $50,000 for 6 years plus the penalty of $20,000 payable at the end of Year 6.
6.6  Fees Paid by the Lessee to Owners of Special-Purpose Entities

**ASC 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: . . .

   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). . . .

In the case of SPEs, lease payments should include any amounts paid by the lessee to the owners of the SPE for structuring the transaction. Although these fees are included in the lease payments, the fees should be excluded from the calculation of the fair value of the underlying asset in the determination of the appropriate lease classification under ASC 842-10-25-2(d).

**Example 6-8**

Lessor LLC (a VIE) holds a single real estate asset that it leases to Lessee. The lease contains a residual value guarantee (see Section 6.7 below). Lessee accounts for the lease as an operating lease. Further, Lessee has a variable interest in Lessor LLC through the residual value guarantee.

Although Lessee has a variable interest, Lessor LLC is consolidated by REIT, which is the primary beneficiary of Lessor LLC. REIT is in the business of owning real estate and leasing it to tenants as a source of financing. Lessor LLC was created by REIT to own the specific underlying real estate. REIT charges Lessee certain fees as compensation for the initial setup costs of Lessor LLC.

The lease payments should include the fees charged to Lessee by REIT for structuring the transaction.

6.7  Amounts That It Is Probable That the Lessee Will Owe Under a Residual Value Guarantee

**ASC 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: . . .

   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).

**ASC 842-10 — Glossary**

**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.
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.

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.

If a lease contract contains a provision under which the lessee guarantees to the lessor the residual value of the leased asset at the end of the lease term, the lessee should include in its lease payments the amount that it is probable that the lessee will owe at the end of the lease term. Paragraph BC214 of ASU 2016-02 explains the FASB’s rationale for requiring lessees to include in their lease payments amounts that it is probable that the lessee will owe under residual value guarantees:

In the Board’s view, payments probable of being owed under residual value guarantees meet the definition of a liability and are part of the cost of the right-of-use asset and, thus, should be recognized and measured as part of the lease liability and the right-of-use asset. That is because those payments cannot be avoided by the lessee — the lessee has an unconditional obligation to pay the lessor if the market price of the underlying asset moves in a particular way. Accordingly, any uncertainty does not relate to whether the lessee has an obligation. Instead, it relates to the amount that the lessee may have to pay, which can vary on the basis of movements in the market price for the underlying asset. In that respect, residual value guarantees are similar to variable lease payments that depend on an index or a rate for the lessee.

A lessee should remeasure its lease payments when there is a change in the amount that it is probable that the lessee will owe under a residual value guarantee. However, a lessor would not remeasure its lease payments in such circumstances. See Section 6.10 for more information on the requirements for lessees and lessors to remeasure lease payments.

Connecting the Dots — Requirements Related to Residual Value Guarantees for Lessees Differ From Those for Lessors

The requirement to include a portion of any residual value guarantee in the lease payments applies only to lessees. Although the guidance states that a lessor should not include any residual value guarantee amounts in its lease payments, a lessor would initially measure residual value guarantee amounts because, in accordance with ASC 842-30-30-1(a), a lessor would include in its lease receivable the full amount at which the residual asset is guaranteed by the lessee (or a third party). (See Chapter 9 for further information on how to calculate a lessor’s lease receivable.) In addition, a lessor would consider the full amount at which the residual asset is guaranteed when classifying a lease in accordance with ASC 842-10-25-2(d) and ASC 842-10-25-3(b). The following example illustrates how the accounting for a residual value guarantee for lessees differs from that for lessors:

Example 6-9

Lessees and Lessor Accounting for Residual Value Guarantees

A lessor leases equipment to a lessee for five years at $10,000 per year. The lessee guarantees that the equipment will have a residual value of at least $9,000 at the end of the lease. The expected residual value at the end of the lease term is $20,000.
Example 6-9 (continued)

**Lessee Accounting**

In its lease payment calculation, the lessee would only include the amount that it is probable that the lessee will owe under the residual value guarantee at the end of the lease term. Accordingly, the lessee would not include any amount in the initial measurement of the lease liability and ROU asset, because the expected residual value ($20,000) is greater than the guaranteed amount ($9,000). If the expected residual value was $8,000 instead of $20,000, the lessee would include the $1,000 difference between the expected residual value and the guaranteed residual value in its lease payments.

**Lessor Accounting**

The lessor would not include any amount of the residual value guarantee in its lease payment calculation. However, if the lease were classified as a sales-type lease or a direct financing lease in measuring its lease receivable, the lessor would include the entire portion of the residual asset guaranteed by the lessee (or any other party). Accordingly, in addition to the present value of the five annual lease payments of $10,000, the lessor would include the present value of the $9,000 guaranteed amount in its calculation of the lease receivable. The lessor’s net investment in the lease would consist of the total receivable (including the residual value guarantee) and the present value of the unguaranteed residual asset of $11,000.

**Changing Lanes — Full Amount of Residual Value Guarantee Versus Amount That It Is Probable That the Lessee Will Owe in Lease Payments**

Under ASC 840, a lessee includes in its minimum lease payments the entire amount of the residual value guarantee; however, under ASC 842, a lessee only includes in its lease payments those amounts that it is probable that the lessee will owe under the residual value guarantee at the end of the lease term. As a result, a lower ROU asset and lease liability will generally be recognized on the lessee’s balance sheet for new leases under ASC 842 compared with situations in which that lease was classified as a capital lease under ASC 840.

However, with respect to performing the lease classification test in ASC 842-10-25-2(d), we do not expect a difference between ASC 840 and ASC 842 because ASC 842-10-25-2(d) requires a lessee to include the full amount of any residual value guarantee, regardless of whether it is probable that the amount will be owed. (See Section 8.3.3.6 for a detailed discussion of a lessee’s application of the classification criterion in ASC 842-10-25-2(d).) This is consistent with the requirement under ASC 840 for the lessee to include the full amount of any residual value guarantee in its minimum lease payments when performing the lease classification test.

Entities should also consider whether the lessee has guaranteed the residual value for a group of leased assets when performing the lease classification test in ASC 842-10-25-2(d). Lessees often enter into lease agreements to lease multiple similar assets from a lessor. In these circumstances, lessees will often guarantee the residual value for the group of assets being leased rather than that for each individual underlying asset. Lessees should take into account the impact of the portfolio residual value guarantee (PRVG) when classifying the individual leases within a portfolio. Depending on the facts and circumstances, lessees should use either an “all-in approach” or a “pro-rata approach” to allocate the PRVG when classifying a lease. See Q&A 8-7A for further discussion of the impact of PRVGs on lessees and an example illustrating application of the all-in approach and pro rata approach. In addition, we believe that, in certain circumstances, lessors may take into account the impact of PRVGs when classifying the individual leases within a portfolio. See Q&A 9-8B for further discussion of the impact of PRVGs on lessors.
Q&A 6-9  Sales Proceeds in Excess of Residual Value Guarantee

Lease contracts may include a provision under which the lessee is entitled to receive any proceeds in excess of the residual amount guaranteed by the lessee upon the sale of the underlying asset at the end of the lease term.

Question

How should the lessee account for sales proceeds in excess of the residual value guarantee that it expects to receive at the end of the lease term?

Answer

Sales proceeds in excess of the residual value guaranteed by the lessee represent a contingent gain for the lessee. Therefore, the lessee should apply the guidance in ASC 450-30 on gain contingencies. ASC 450-30-25-1 precludes an entity from recognizing a gain contingency in its financial statements until the underlying contingency is resolved. Accordingly, a lessee should not recognize the excess sales proceeds as a reduction in lease payments, or as a gain in its income statement, until the underlying asset is sold and the contingency is resolved.

Connecting the Dots — Synthetic Lease Arrangements

As discussed above, under ASC 842, a lessee would include in its lease payments only those amounts related to a residual value guarantee that it is probable that the lessee will owe at the end of the lease term. Lease arrangements (such as a synthetic lease arrangement) in which a significant portion of the lease payments is structured as a residual value guarantee could therefore result in ROU assets and lease liabilities that are significantly lower than those in arrangements in which more of the lessee's obligation takes the form of fixed rental payments. For example, since many real estate assets are expected to hold their value over the lease term, amounts that it is probable the lessee will owe under residual value guarantees may be nominal. Accordingly, while these arrangements will be brought onto the balance sheet, synthetic leases and other lease arrangements in which a significant portion of the economics of the lease are structured as a residual value guarantee may continue to yield favorable accounting results (e.g., reduced leverage) under the new leasing guidance.

6.7.1 Residual Value Guarantee Obtained From Unrelated Third Party

<table>
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<tr>
<th>ASC 842-10</th>
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<tbody>
<tr>
<td>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.</td>
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To reduce its exposure associated with a residual value guarantee, a lessee may obtain a guarantee from an unrelated third party, such as an insurance company, for part or all of the value of the lessee's residual value guarantee owed to the lessor.
Lessee Purchase of Residual Value Insurance

*Question*

How should a lessee account for a residual value guarantee obtained from an unrelated third party, such as an insurance company?

*Answer*

The residual value guarantee obtained from an unrelated third party reduces the lessee’s lease payments only if the lessor explicitly releases the lessee from its obligation under the residual value guarantee provision in the lease contract between the lessee and lessor. The lessor must release the lessee not only from its primary obligation but also from any secondary obligation (i.e., the lessee’s obligation to pay the lessor if the insurance company defaults on its obligation).

**Example**

Lessee K leases equipment from Lessor W for five years in exchange for a fixed payment of $10,000 per year. Lessee K guarantees that the equipment will have a residual value of at least $5,000 at the end of the lease. To reduce its exposure associated with the $5,000 residual value guarantee, K obtains a matching guarantee from an insurance company. Therefore, in the event that the residual value of the equipment is less than $5,000 at the end of the lease term, the insurance company has agreed to pay the lessor the difference. The expected residual value at the end of the lease term is $1,000.

**Case A — Lessor Does Not Release the Lessee From Its Obligation**

In this case, W does not explicitly release K from its obligation to pay the residual value guarantee if the insurance company defaults on its obligation. Therefore, even though K may not be primarily obligated to pay the residual value guarantee, it still has a secondary obligation to W. Lessee K should not reduce its lease payments for the guarantee provided by the insurance company because W has not explicitly released K from its obligations related to the residual value guarantee. Therefore, K should include $4,000 in its lease payments, which represents the amount that it is probable W will be owed at the end of the lease term ($5,000 guaranteed amount less $1,000 expected residual value).

**Case B — Lessor Fully Releases the Lessee From Its Obligation**

In this case, because W has fully released K from any primary or secondary obligation related to the residual value guarantee, K should not include any amounts related to the residual value guarantee in its lease payments.

Effects of Costs to Secure a Residual Value Guarantee

*Question*

Should the costs incurred by the lessee to secure a third-party guarantee of residual value be included in the lessee’s lease payments?

*Answer*

It depends. A lessee may be obligated by the lessor or the lease agreement to obtain residual value insurance for the benefit of the lessor. In such cases, the lessee should include the costs incurred to secure the third-party guarantee of residual value in its lease payments (e.g., the amount of the insurance premium needed to obtain the residual value insurance). These types of costs are similar to payments made to an insurance company in which the payor does not benefit (i.e., the lessee pays the insurance company but the lessor is the beneficiary of the policy).
6.8 Costs Imposed to Dismantle and Remove an Underlying Asset at End of Lease Term

ASC 842-10

55-37 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.

A lessee may need to incur certain costs at the end of the lease term so that the lessee may return the asset to the lessor in accordance with the lease agreement. Those costs are generally considered to be either of the following:

- Lease payments, because the costs, which benefit the lessor and not the lessee, are imposed by the lease agreement and incurred to restore functionality of the leased asset or to dismantle or remove the actual underlying asset for return to the lessor (further discussed in Q&A 6-12 below).
- Asset retirement obligations in accordance with ASC 410-20, because the costs are incurred to remove lessee installations (e.g., leasehold improvements) so that the lessee may restore the underlying asset to its original condition (see Section 6.9.4).

Q&A 6-12 Treatment of Removal Costs of Leased Equipment

**Question**
A lessee often agrees to pay for the costs of removing and returning leased equipment to the lessor at the end of the lease. Should these costs be included in the lease payments?

**Answer**
Yes. In such situations, if the lessee is obligated to remove and return the equipment at the end of the lease, the lessee would be required to include its best estimate of those costs in the lease payments. For example, for an asset being leased, such as manufacturing equipment that must be returned to the lessor at the end of the lease, the amount that the lessee expects to incur to ship or otherwise return the manufacturing equipment to the lessor would be included in the lease payments.

6.9 Amounts Not Considered a Lease Payment

6.9.1 Variable Lease Payments That Do Not Depend on an Index or Rate

ASC 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) . . . .

Lease payments should exclude variable lease payments that do not depend on an index or a rate. Common examples of such variable lease payments include payments that depend on the lessee's performance or use of the underlying asset (i.e., whether a payment will be required is contingent on a future event). Paragraph BC210 of ASU 2016-02 explains that the Board decided to exclude such amounts from the lease payments because “variable [lease] payments contingent on future events (for example, performance or use) do not represent a present obligation of the lessee or a right of the lessor and, therefore, do not meet the definition of an asset or a liability.”
A lessee should remeasure its lease payments when the contingency underlying such variable payments is resolved and, as a result, some (or all) of the remaining payments become fixed for some (or all) of the remaining lease term (e.g., when the underlying asset is used and the payment becomes required and fixed). However, a lessor would not remeasure its lease payments in such circumstances. See Section 6.10 for more information about the requirements for when lessees and lessors remeasure lease payments.

**Connecting the Dots — Lessee Financial Statement Impact of Excluding Variable Lease Payments That Do Not Depend on an Index or a Rate**

The Board’s decision to exclude variable lease payments that do not depend on an index or a rate from lease payments will result in different accounting outcomes for lessees that have economically similar transactions with different payment structures (i.e., fixed lease payments versus variable lease payments that depend on performance or usage of the underlying asset).

**Balance Sheet Impact**

As discussed in Chapter 8, the initial measurement of a lessee’s ROU asset and lease liability includes the present value of the lease payments. There is a direct correlation between the amount of the lease payments and the amount that is recorded as the ROU asset and lease liability on the lessee’s balance sheet. Because a lessee includes fixed amounts in its lease payments but not variable payments that depend on something other than an index or a rate, lease contracts that are structured with fixed lease payments will result in a higher ROU asset and lease liability than those structured with contingent rentals.

**Income Statement Impact**

Under ASC 842, a lessee’s expense recognition pattern depends on whether the lease is classified as a finance lease or an operating lease. Lease classification is governed, in part, by the value of the lease payments compared with the fair value of the underlying asset (i.e., the higher the lease payments, the more likely that a lease will be classified by the lessee as a finance lease rather than as an operating lease). Therefore, lease contracts that are structured with fixed lease payments may result in a different expense recognition pattern than lease contracts structured with contingent rentals.

**ASC 842-10**

<table>
<thead>
<tr>
<th>Example 25 — ... Variable Lease Payments Linked to Performance ...</th>
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<tr>
<td><strong>Case B — Variable Lease Payments Linked to Performance</strong></td>
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<tr>
<td><strong>55-232</strong> Lessee enters into a 10-year lease of a building with annual lease payments of $100,000, payable at the beginning of each year. The contract specifies that Lessee also is required to make variable lease payments each year of the lease, which are determined as 2 percent of Lessee’s sales generated from the building.</td>
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<tr>
<td><strong>55-233</strong> At the commencement date, Lessee measures the lease liability and right-of-use asset at the same amounts as in Case A (paragraphs 842-10-55-226 through 55-231) because the 2 percent royalty that will be paid each year to Lessor under the lease is a variable lease payment, which means that payment is not included in the measurement of the lease liability (or the right-of-use asset) at any point during the lease.</td>
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<tr>
<td><strong>55-234</strong> During the first year of the lease, Lessee generates sales of $1.2 million from the building and, therefore, recognizes total lease cost of $124,000 ($100,000 + [2% × $1.2 million]). In its quantitative disclosures, Lessee will include $100,000 of the $124,000 in its disclosure of operating lease cost and $24,000 in its disclosure of variable lease cost.</td>
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Q&A 6-12A  Accounting for a Lease Liability and a Corresponding ROU Asset in a Contract Manufacturing Arrangement

Example

A customer (lessee) enters into a contract manufacturing arrangement with a supplier (lessor). The customer has appropriately determined that the contract manufacturing arrangement meets the definition of a lease under ASC 842 (see Section 3.2). In this example, assume the following:

- The customer has contracted with a supplier for exclusive use of a manufacturing line over a four-year period.
- The contract establishes a price per unit of product purchased and, periodically throughout the arrangement, the customer issues noncancelable purchase orders to the supplier when the customer wishes to procure manufactured products from the supplier.
- The purchase order establishes a time frame (e.g., one month, two months) over which the related products will be produced as well as an unconditional obligation for the customer to purchase the products from the supplier.
- The customer is not required to order a minimum volume of products over the four-year period. However, on the basis of its anticipated orders, the customer expects to use substantially all of the capacity of the supplier’s manufacturing line during the four-year term.
- The supplier ships manufactured products free on board to the customer’s facility, and the customer is contractually obligated to pay the supplier upon the delivery of products to the customer’s facility.
- The customer has identified a separate lease component (i.e., the right to use the supplier’s manufacturing line) and nonlease components associated with the arrangement.

Question 1

In the above example illustrating a contract manufacturing arrangement, should the customer, when submitting a purchase order, establish a lease liability and ROU asset related to the lease component associated with the committed purchases (i.e., the committed use of the manufacturing line during the time frame established by the purchase order)?

Answer

Yes. When the noncancelable purchase order is issued, the customer should establish a lease liability and ROU asset related to the lease component associated with the committed purchases. Although, at commencement, all payments in the arrangement are variable (given the lack of a minimum purchase quantity in the arrangement), at the time when the purchase order is issued, the payments related to the lease component associated with the committed purchases meet the definition of lease payments since the contingency upon which the variable lease payments are based is resolved. At that point, the customer has an unconditional obligation to purchase products from the supplier and therefore also has payments that meet the definition of lease payments in accordance with ASC 842-10-35-4(b), which states, in part:

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.

Depending on materiality, the accounting described in Question 1 (recognition of a lease liability and ROU asset for each discrete purchase order) may not be required in all circumstances. For example, there may be short-duration or low-dollar purchase orders for which the application of ASC 842 would not have a material impact on the financial statements.
The lessee would then recognize a lease liability and a corresponding ROU asset. We believe that each individual purchase order effectively creates fixed payments in the arrangement, in which the amount of the purchase order associated with the lease component is the minimum fixed amount that is owed to the supplier upon delivery of the manufactured products. Each subsequent purchase order would trigger another resolution of a contingency in accordance with ASC 842-10-35-4(b) and, as a result, the payments associated with the lease component of the purchase order become lease payments. The lessee thus recognizes a separate lease liability and a corresponding ROU asset (see Question 2 below for a discussion of the amortization period for the ROU asset) for the amount allocated to the lease component for each individual purchase order.

**Question 2**

Over what period should the ROU asset be amortized in light of the answer to Question 1: (1) the entire remaining lease term (contract term of four years in the example above) or (2) the time frame established by the specific purchase order?

**Answer**

It depends. Because there is no clear guidance on this topic in ASC 842, there may be various acceptable approaches to amortizing the ROU asset. Two such alternative approaches are:

- **Approach 1** — Because the purchase order has a specific production and payment schedule, the lease costs\(^{11}\) should be recognized over the purchase order term. This approach is consistent with the guidance in ASC 842-20-25-6(a), which states, in part:

  \[\text{[A]fter the commencement date, a lessee shall recognize . . . in profit or loss, [a] single lease cost, calculated so that the remaining cost of the lease . . . is allocated over the remaining lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset. [Emphasis added]}\]

  We believe that recognition of the costs over the purchase order term is a systematic and rational approach given that the consumption of the benefit associated with the ROU asset (manufacturing line) is directly aligned with the purchase order term. Under this approach, the ROU asset will be fully amortized over the period of the purchase order. This accounting will continue for the remainder of the lease term as each discrete ROU asset is amortized over the production period to which it is related. This approach may be less complex to apply than Approach 2 below and may better reflect the economics of a leasing structure that is based on purchase orders submitted.

- **Approach 2** — Recognize the lease costs over the full remaining lease term. This approach is also consistent with the guidance in ASC 842-20-25-6(a), which states, in part:

  \[\text{[A]fter the commencement date, a lessee shall recognize . . . in profit or loss, [a] single lease cost, calculated so that the remaining cost of the lease . . . is allocated over the remaining lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset. [Emphasis added]}\]

\(^{11}\) The reference to “lease costs” can include amounts that are recognized in other line items in the income statement besides line items in which lease expenses are recorded. For example, it may be common in a contract manufacturing arrangement for an entity to record costs associated with the use of a manufacturing line as capitalizable inventory costs. Those costs would ultimately be reflected within cost of goods sold in the income statement rather than in lease expense.
Likewise, an entity should recognize lease costs on the basis of whether it has the right to use an asset, not the pattern of use, in accordance with ASC 842-20-55-3, which states:

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.

This approach would result in the layering on of each additional ROU asset once a purchase order is issued. For example, on the basis of the facts in the example above, the total lease cost for the initial purchase order (provided that it is issued on the first day of the arrangement) would be recognized over the entire four-year lease term. The total lease cost incurred in connection with the second purchase order would be recognized over the remaining lease term at that time. The subsequent impact on the ROU asset each year would reflect all purchase orders previously submitted. This accounting would continue for the remainder of the lease arrangement. This approach will generally result in a more back-loaded lease cost recognition pattern than Approach 1.

Note that depending on the time frame established by the purchase order and the frequency of purchase order submission by the customer, there may be scenarios in which the accounting in this Q&A is not material to the financial statements. For example, under Approach 1 above, if purchase orders are submitted every month and establish a one-month production time frame, the customer's lease costs would be appropriately apportioned to the production month and the impact on the balance sheet on a particular reporting cut-off date may be immaterial. On the other hand, if the customer in the example above submitted a two-year purchase order, the accounting described above would most likely be necessary so that lease costs can be appropriately apportioned and the lessee's lease obligation can be properly reflected as of the intervening balance sheet dates.

### 6.9.2 Lessee’s Guarantee of the Lessor’s Debt

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
</table>
| **30-6** Lease payments do not include any of the following: . . .  
  b. Any guarantee by the lessee of the lessor’s debt . . . . |

A guarantee by the lessee of the lessor's debt should be excluded from lease payments.

#### Q&A 6-13 Lessee’s Guarantee of Lessor’s Debt

**Question**

Should a lessee's guarantee of a lessor's debt be treated as a residual value guarantee that would be included in the lessee's lease payments?
Answer

Generally, no. ASC 842-10-30-6(b) states that a lessee’s guarantee of the lessor’s debt should be excluded from the calculation of lease payments. Therefore, the lessee should consider the guarantee under ASC 460. If the guarantee is recognized on the balance sheet and initially measured in accordance with ASC 460, it may be reasonable to recognize the offset (i.e., the debit) as part of the ROU asset.

However, a lessee’s guarantee of a lessor’s loan in effect at the end of the lease term may, in substance, be a residual value guarantee that should be considered part of the lease payments in accordance with ASC 842-10-30-5(f). For example, when the lessor owns no significant assets other than the leased asset, a lessee’s guarantee of the debt is economically equivalent to the lessee’s providing a residual value guarantee, since the value of the property is the sole means of repaying the debt. Accordingly, a lessee’s guarantee of debt issued by an entity that has no significant assets other than the leased asset should be included in the lessee’s computation of lease payments when the fair value test in ASC 842-10-25-2(d) is applied, as long as the guarantee remains in effect at the end of the lease term.

For similar reasons, a lessee’s guarantee of a lessor’s loan that is nonrecourse to the lessor should also be treated as a residual value guarantee if the guarantee will remain in effect at the end of the lease term, since the value of the property is the sole means of repaying the loan.

Treating these loan guarantees as residual value guarantees may cause the lease to be classified as a finance lease. See Section 6.7 for further discussion of how residual value guarantees affect lease payments.

Connecting the Dots — Consistency With ASC 840 With Respect to a Lessee’s Guarantee of the Lessor’s Debt

The requirement in ASC 842-10-30-6(b) to exclude guarantees by the lessee of the lessor’s debt is consistent with the previous requirement in ASC 840-10-25-5(b). We therefore do not expect the application of this guidance under ASC 842 to differ from that under ASC 840.

6.9.3 Amounts Allocated to Nonlease Components

<table>
<thead>
<tr>
<th><strong>ASC 842-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-6</strong> Lease payments do not include any of the following: . . .</td>
</tr>
<tr>
<td>c. Amounts allocated to nonlease components in accordance with paragraphs 842-10-15-33 through 15-42.</td>
</tr>
</tbody>
</table>

As discussed in Section 6.1, lease payments are based on the consideration in the contract that is allocated to the lease component(s) in the contract. Any amounts allocated to the nonlease components in the contract should not be included in the calculation of lease payments. See Chapter 4 for a discussion of separating and allocating consideration to the lease and nonlease components in a contract.
6.9.4 Obligations to Return an Underlying Asset to Its Original Condition

ASC 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).

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.

To the extent that a lessee has agreed to remove modifications it has made to a leased asset so that it can return the asset to the lessor in its original condition (e.g., remove leasehold improvements), estimated future payments for such work would not be considered a future lease payment. Such an obligation would be accounted for under ASC 410-20. However, as discussed in Section 6.8, a lessee may also be required to restore functionality, at the end of the lease term, to a leased asset that benefits the lessor but not the lessee. The obligation related to such restorations would be considered a future lease payment.

Q&A 6-14 Treatment of Costs to Return an Underlying Asset to Its Original Condition

Entity B (the lessee) leases an aircraft under a 10-year lease. The terms of the lease require B to perform an overhaul of the aircraft (a C-check) every three years to comply with regulations. The cost of each C-check is $10,000. In addition, at the end of the lease term, B must perform a C-check when returning the plane to the lessor regardless of whether it recently performed one. This final C-check does not benefit the lessee since it is returning the aircraft; however, it does benefit the lessor, which will not need to perform another C-check on the aircraft for three years.

**Question**
Should the lessee in this scenario include in the lease payments the costs that it is estimated to incur in performing the final overhaul?

**Answer**
Yes. The determination of whether the overhaul costs should be included in the lease payments depends on whether the lessee has a present obligation to perform the overhauls, and therefore to incur the expenditure, at lease commencement for the benefit of the lessor.

In this scenario, the cost of the final C-check (i.e., the C-check that the lessee must perform immediately before returning the plane to the lessor) should be included in the lease payments because it represents a present obligation of the lessee and does not benefit the lessee. Because there is no present obligation for the lessee to perform any other C-checks throughout the lease term for the benefit of the lessor, the cost of those C-checks should not be included in the lease payments at lease commencement.
Q&A 6-15  Whether Leasehold Improvement Removal Costs Should Be Included in Lease Payments

At the end of the lease term, a lessee may incur costs to remove leasehold improvements from the leased asset.

**Question**
Should a payment made to remove leasehold improvements be included in a lessee's lease payments?

**Answer**
No. Under ASC 842-10-55-37, the removal of lessee-installed leasehold improvements is an example of a cost of returning an underlying asset that has been modified by a lessee to its original condition and such a cost should not be included in lease payments. Instead, a lessee should account for the removal of leasehold improvements under the guidance in ASC 410-20 on asset retirement and environmental obligations.

### 6.9.5 Indemnification Clauses for Certain Tax Benefits

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>55-40 Paragraph 842-30-55-16 discusses a lessor’s accounting for guarantee payments received.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

Some lease contracts include provisions under which the lessee commits to compensate the lessor for certain tax benefits that the lessor may lose if there is a change in the tax law. Although these indemnification payments vary because of changes in facts or circumstances occurring after the commencement date (i.e., a change in the tax law) and thus appear to meet the definition of a variable payment, the boards decided that these payments should not be accounted for as variable lease payments because of the strong correlation between the indemnification payment and the related tax law. Rather, such payments should be accounted for in accordance with ASC 460 in such a way that the tax law association is recognized.

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12 Lessor accounting for guarantee payments received is further discussed in Chapter 9.
### 6.10 Subsequent Measurement of Lease Payments

<table>
<thead>
<tr>
<th><strong>ASC 842-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-4</strong> A lessee shall remeasure the lease payments if any of the following occur:</td>
</tr>
<tr>
<td>a. The lease is modified, and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.</td>
</tr>
<tr>
<td>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. However, a change in a reference index or a rate upon which some or all of the variable lease payments in the contract are based does not constitute the resolution of a contingency subject to (b) (see paragraph 842-10-35-5 for guidance on the remeasurement of variable lease payments that depend on an index or a rate).</td>
</tr>
<tr>
<td>c. There is a change in any of the following:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

**35-5** When one or more of the events described in paragraph 842-10-35-4(a) or (c) occur or when a contingency unrelated to a change in a reference index or rate under paragraph 842-10-35-4(b) is resolved, variable lease payments that depend on an index or a rate shall be remeasured using the index or rate as of the date the remeasurement is required.

**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.
The following table summarizes the guidance in ASC 842-10-35-4 through 35-6 for both lessees and lessors:

<table>
<thead>
<tr>
<th>Lessee Remeasures Lease Payments Under ASC 842?</th>
<th>Lessor Remeasures Lease Payments Under ASC 842?</th>
</tr>
</thead>
<tbody>
<tr>
<td>The lease is modified and that modification is not accounted for as a separate contract (Chapters 8 and 9)</td>
<td>X</td>
</tr>
<tr>
<td>Contingency underlying variable lease payments that do not depend on an index or a rate is resolved and, as a result, some (or all) of the remaining payments become fixed for some (or all) of the remaining lease term (Section 6.9.1)</td>
<td>X</td>
</tr>
<tr>
<td>Change in the lease term (Section 5.4)</td>
<td>X</td>
</tr>
<tr>
<td>Change in whether the lessee is reasonably certain to exercise a purchase option (Section 6.4)</td>
<td>X</td>
</tr>
<tr>
<td>Change in the amount probable of being owed by the lessee under a residual value guarantee (Section 6.7)</td>
<td>X</td>
</tr>
</tbody>
</table>

**Bridging the GAAP**

Under ASC 842, when a lessee remeasures its lease payments for any of the reasons illustrated in the table above, the lessee should remeasure variable lease payments that depend on an index or a rate by using the index or rate as of the remeasurement date. As noted in Section 6.3, this requirement differs from the requirement under IFRS 16 to remeasure variable lease payments that depend on an index or a rate whenever there is a change in contractual cash flows (e.g., changes in the CPI).

**Q&A 6-15A  Accounting for a Lease Liability and Corresponding ROU Asset in an Arrangement Involving a “Minimum Annual Guarantee” Payment Structure in Which a New Lease Payment Floor Is Established Each Year**

Leasing arrangements may have a “minimum annual guarantee” (MAG) payment structure in which a lessee guarantees a minimum annual payment and only the minimum amount for the first year is known upon lease commencement. After year 1, the MAG will reset on the basis of the revenue, usage, consumption, or another similar factor for year 1. The reset mechanism can result in an increase or decrease compared with the amount of the year 1 MAG, indicating that, at lease commencement, there is no established floor for any year after year 1.
Example

Company B enters into a three-year real estate lease. The arrangement includes a rent payment structure in which the annual rent is an amount equal to 5 percent of annual revenue, with a MAG in year 1 of $210,000 (i.e., a fixed payment). For each subsequent year, the MAG is an amount equal to 5 percent of the prior year’s revenue, which establishes a payment floor for that year (e.g., the rent in year 2 will be the greater of 5 percent of year 2 revenue or 5 percent of year 1 revenue). Importantly, as of lease commencement, there are no fixed or in-substance fixed payments other than the MAG in year 1 of $210,000, since the sales each year, which are unknown, could result in a MAG that is higher or lower (or potentially zero) for subsequent years. The lease is classified as an operating lease. The table below illustrates the MAG for each year, which is based on the assumed annual revenue over the lease term.

<table>
<thead>
<tr>
<th>MAG Under Lease Agreement</th>
<th>Annual Revenue</th>
<th>Calculated MAG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$210,000</td>
<td>$210,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>5% of year 1 sales</td>
<td>$230,000 $(4,600,000 × 0.05)</td>
</tr>
<tr>
<td>Year 3</td>
<td>5% of year 2 sales</td>
<td>$237,500 $(4,750,000 × 0.05)</td>
</tr>
</tbody>
</table>

When analyzing these arrangements, it is critical for an entity to determine the substance of the pricing mechanism. We believe that these mechanisms are designed to establish minimum payments for future use rather than to impose incremental payments for past use. The questions below reflect our views on the accounting related to these arrangements; these views are based on our view of the substance of the MAG payment structure.

Question 1
How should Company B measure and account for the lease liability?

Answer
The MAG in year 1 of the real estate lease represents an in-substance fixed payment for year 1 only, because a floor is being set by the MAG (see Section 6.2.1 for additional discussion of in-substance fixed payments). Company B should calculate the lease liability at lease commencement on the basis of the present value of the MAG for the first year. We believe that the in-substance fixed payment is limited to the MAG in year 1 because the MAG amounts after year 1 (the MAG amounts applicable to years 2 and 3) could increase or decrease. Since the subsequent-year MAG amounts can decrease, as of the commencement date of the lease, a payment floor does not exist beyond year 1.

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13 This Q&A is written with an operating lease in mind, but similar considerations would apply to a finance lease. However, one notable difference between the two classifications pertains to the expense recognition pattern of the lease cost and the corresponding amortization of the ROU asset. Operating lease cost is recognized on a straight-line basis, while the expense recognition pattern for finance lease cost is front-loaded. The corresponding ROU asset amortization also depends on the classification. See Question 2 for more information about the expense recognition pattern for the lease cost and ROU asset amortization.
At the end of each year,\textsuperscript{14} B should calculate a new MAG for the following year (e.g., a MAG calculated on the basis of year 1 revenue establishes a rent floor for year 2), which constitutes a remeasurement event in accordance with ASC 842-20-35-5(c), since the resolved uncertainty associated with year 1 revenue represents the resolution of a contingency affecting B’s future lease payments. When a contingency is resolved, a lessee must remeasure the lease liability to reflect changes to the lease payments, as described in ASC 842-10-35-4(b), which states, in part:

> 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.

See Section 8.5.3.2 for more information about accounting for a change in lease payments resulting from the resolution of a contingency. Through the effective interest method, the year 1 lease liability will be reduced to zero by the time the MAG is reset at the end of year 1 (once the total sales for year 1 are known), at which point the new MAG will be used to determine the year 2 liability (the new MAG represents an in-substance fixed payment for year 2 since it establishes a payment floor for that year). Similarly, the year 2 liability will subsequently be amortized as B makes the year 2 payments. This accounting will continue over the remainder of the lease term. The expense recognition profile of the corresponding lease cost is discussed in Question 2 below.

**Question 2**

As discussed in Question 1, when the MAG is reset each year, Company B must consider the guidance in ASC 842-10-35-4(b) and remeasure the lease liability and ROU asset as of each reset date. How should Company B subsequently recognize the lease cost?

**Answer**

We believe that there may be more than one acceptable approach to recognizing the lease cost. We have outlined two acceptable alternative approaches below that we believe an entity can use to recognize the in-substance fixed payment (i.e., lease cost) on a straight-line basis over (1) the remaining lease term or (2) the year to which the MAG is related:\textsuperscript{15}

1. **Recognize the lease cost for each MAG over the remaining lease term** — The in-substance fixed payment in the form of a MAG represents payment for the right to use the underlying asset over the remaining lease term. This approach is supported by the guidance in ASC 842-20-25-6(a), which states, in part:

   > After the commencement date, a lessee shall recognize . . . in profit or loss, [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 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. [Emphasis added]

\textsuperscript{14} For simplicity, we have assumed that the metric that establishes the MAG for each year can increase or decrease over the course of the entire year and therefore does not establish an in-substance fixed payment for the following year until the measurement period ends. This could be the case with revenues, for example, which can decrease on the basis of customer returns. Depending on materiality to interim reporting, to the extent that the metric that establishes the MAG cannot decrease over time (i.e., in future interim periods), the accounting described in Question 1 may be accelerated and may involve multiple remeasurements.

\textsuperscript{15} The amortization of the ROU asset will be consistent with the method outlined in ASC 842-20-35-3(b) for an operating lease in which the amortization of the ROU asset generally increases in each period as the liability accretion decreases as a result of a declining lease liability balance. In contrast, the amortization of an ROU asset for a finance lease will generally be on a straight-line basis in accordance with ASC 842-20-35-7. Only the operating lease cost is illustrated in this example.
Under this approach, each additional ROU asset would be layered on once the MAG is reset in each annual period. That is, in the example above, the MAG lease cost of $210,000 in year 1 would be recognized over the entire three-year lease term (i.e., $70,000 of lease cost in all three periods). The lease cost of $230,000 related to the reset of the MAG at the end of year 1 (i.e., the year 2 MAG) would be recognized over the remaining two-year lease term (i.e., an additional $115,000 of lease cost in the two remaining periods). Accordingly, the balance of the ROU asset at the end of year 2 would include the remaining unamortized balance from both the year 1 MAG and the year 2 MAG. This accounting would continue for the remainder of the lease arrangement. This approach will result in higher expense recognition in the latter years of the contract (i.e., back-loaded lease cost), as illustrated in the table below.

<table>
<thead>
<tr>
<th>Year 1 MAG</th>
<th>Year 2 MAG</th>
<th>Year 3 MAG</th>
<th>Lease Cost Recognized in Each Year*</th>
</tr>
</thead>
<tbody>
<tr>
<td>70,000 (210,000 ÷ 3)</td>
<td>70,000 (230,000 ÷ 2)</td>
<td>70,000 (237,500 ÷ 1)</td>
<td>70,000</td>
</tr>
<tr>
<td>115,000</td>
<td>115,000</td>
<td>237,500</td>
<td>185,000 (70,000 + 115,000)</td>
</tr>
<tr>
<td>185,000</td>
<td>422,500</td>
<td>677,500</td>
<td>422,500</td>
</tr>
<tr>
<td>Total lease cost recognized</td>
<td>677,500</td>
<td>(70,000 + 185,000 + 422,500)</td>
<td></td>
</tr>
</tbody>
</table>

* Company B would also recognize variable lease cost each year for any payments in excess of the MAG, which is not included in this table.

2. **Recognize the lease cost for each MAG in the year to which the MAG is related** — Under this approach, the lease cost would be reflected for each MAG on the basis of the use of the underlying asset for one year only. Such cost recognition is aligned with the frequency at which lease payments are reset and in turn would be aligned with the physical-use pattern of the space. This approach is consistent with the guidance in ASC 842-20-25-6(a), which states, in part:

> After the commencement date, a lessee shall recognize . . . in profit or loss, [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 **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**. [Emphasis added]

The lease cost resulting from the year 1 MAG would be recognized on a straight-line basis over year 1, and the corresponding ROU asset would thus be fully amortized by the end of year 1. The reset of the MAG at the end of year 1 (i.e., the year 2 MAG) would trigger a resolution of a contingency in accordance with ASC 842-20-35-5(c) (see **Question 1** above), in which the payments associated with the MAG for year 2 become an in-substance fixed payment. Accordingly, the lessee would recognize a separate lease liability and a corresponding ROU asset for the year 2 MAG only, which would be completely amortized in year 2. This accounting would continue for the remainder of the lease term. The table below illustrates the total lease cost recognized in each year (and is based on the same facts as those in the example above). Overall, this approach may be easier to apply than the previous approach since an entity will not have to track separate layers of an ROU
asset as a MAG is reset over time. Rather, the entity will record a new ROU asset and lease liability each time a reset occurs, both of which will be exhausted during the year to which they are related. This approach may also better reflect the economics of a variable payment leasing structure with a floor mechanism that fluctuates over time.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Cost Recognized in Each Year (Consistent With the Calculated MAG)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>210,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>230,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>237,500</td>
</tr>
<tr>
<td>Total</td>
<td>677,500</td>
</tr>
</tbody>
</table>

* Company B would also recognize variable lease cost each year for any payments in excess of the MAG, which is not included in this table.

Note that we are aware of different views in practice regarding the substance of, and appropriate accounting for, leases that contain pricing reset mechanisms similar to the MAG structure discussed in this Q&A. According to one such view, the MAG reset is considered to be a variable lease expense associated with the period that establishes the new MAG. For example, the year 2 MAG of $230,000 in the example above would be treated as variable lease cost for year 1. This view therefore has a front-loading effect on recognition of lease costs. Given the diversity of views on the substance of these reset mechanisms and the related accounting requirements, we encourage entities affected by this issue to discuss their proposed accounting treatment with their auditors or accounting advisers.

### 6.11 Initial Direct Costs

**ASC 842-10 — Glossary**

**Initial Direct Costs**

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

**ASC 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.
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:

- General overheads, including, for example, depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time
- Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities
- 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.

Connecting the Dots — Definition of Initial Direct Costs Consistent With ASC 606

In a manner consistent with ASC 606, initial direct costs for both lessees and lessors include only those costs that are incremental to the arrangement and that would not have been incurred if the lease had not been obtained. Paragraph BC307 of ASU 2016-02 explains the FASB's decision for aligning the definition of initial direct costs under ASC 842 with that in ASC 606:

The Board [FASB] concluded that a lessor and a seller of the same good, including an entity that both sells and leases assets, should account for similar costs in the same way. In addition, the Board noted that the guidance on initial direct costs in previous GAAP was aligned with one of the two acceptable methods for accounting for costs to obtain a contract in previous revenue recognition guidance, and, therefore, the Board's decision on initial direct costs in Topic 842 maintains alignment between the leases and revenue recognition guidance for these types of costs.

Changing Lanes — Fewer Costs Qualify as Initial Direct Costs Under ASC 842

The definition of initial direct costs under ASC 842 is considerably more restrictive than the definition under ASC 840. For example, under ASC 842, commissions paid and payments made to existing tenants to obtain the lease are considered initial direct costs, whereas allocated internal costs and costs to negotiate and arrange the lease agreement that would have been incurred regardless of lease execution (e.g., professional fees such as those paid for legal and tax advice) no longer qualify as initial direct costs.

The FASB included Example 27 in ASC 842 to illustrate the types of costs that qualify as initial direct costs under ASC 842:

Example 27 illustrates initial direct costs.
Example 27 — Initial Direct Costs

55-240 Lessee and Lessor enter into an operating lease. The following costs are incurred in connection with the lease:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Travel costs related to lease proposal</td>
<td>$7,000</td>
</tr>
<tr>
<td>External legal fees</td>
<td>22,000</td>
</tr>
<tr>
<td>Allocation of employee costs for time negotiating lease terms and conditions</td>
<td>6,000</td>
</tr>
<tr>
<td>Commissions to brokers</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total costs incurred by Lessor</strong></td>
<td><strong>$45,000</strong></td>
</tr>
<tr>
<td>External legal fees</td>
<td>$15,000</td>
</tr>
<tr>
<td>Allocation of employee costs for time negotiating lease terms and conditions</td>
<td>$7,000</td>
</tr>
<tr>
<td>Payments made to existing tenant to obtain the lease</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Total costs incurred by Lessee</strong></td>
<td><strong>$42,000</strong></td>
</tr>
</tbody>
</table>

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.

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).

Q&A 6-16 Payment Made by a Lessor to a Lessee to Induce Early Termination of a Lease

A lessor may make a payment (or payments) to a lessee to induce the lessee to terminate the lease before the end of the lease term. Such a situation may arise, for instance, when the rental rate is unfavorable from the lessor’s perspective (i.e., below the prevailing market rate) or the lessor has an opportunity to lease the space to a more attractive tenant. Generally, at the time the payment is made, the lessor either will have secured a replacement lessee for the space (perhaps with eviction of the current tenant being the only unresolved matter) or, at a minimum, will have identified a replacement lessee and will be in the process of negotiating the lease.
**Question**

Does a payment made by a lessor to a lessee to induce the lessee to terminate the lease before the end of the lease term qualify as an initial direct cost of obtaining the new lease?

**Answer**

Generally, yes. Provided that, at the time of the payment, the lessor has identified a replacement lessee for the space and entering into the new lease with that identified replacement lessee is reasonably certain, the payment made to induce the current lessee to terminate the lease qualifies as an initial direct cost of obtaining the new lease. The lessor should defer the payment as an initial direct cost of obtaining the new lease and recognize it into income over the term of the new lease.

However, deferral of the payment would not be appropriate in situations in which, at the time the payment is made, either (1) a specific replacement lessee has not been identified or (2) a replacement lessee has been identified but entering into the new lease with that replacement lessee is not reasonably certain. In these situations, the payment would not constitute an initial direct cost and instead should be expensed as incurred.

**Q&A 6-17 “Key Money” Payment Made to an Existing Lessee to Assume a Lease**

In certain jurisdictions, lessees are able to renew leases at below-market rates because of the regulatory restrictions placed on lessors. Therefore, an entity is economically incentivized to assume a below-market lease from an existing lessee rather than negotiate a new lease at market rates. The entity will often pay the existing lessee to assume the lease; this payment is commonly referred to as a “key money” payment.

**Question**

How should a new lessee account for a key money payment made to an existing lessee to assume a lease?

**Answer**

We believe that key money payments typically should be accounted for as initial direct costs. ASC 842-10-20 defines initial direct costs as “[i]ncremental costs of a lease that would not have been incurred if the lease had not been obtained.” Further, ASC 842-10-30-9 gives examples of two types of initial direct costs:

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

Although key money payments are made to assume an existing lease with favorable market terms rather than simply to induce an existing tenant to terminate its lease, both represent costs incurred to obtain the right to use the underlying asset over the lease term and would not have been incurred if the lease had not been obtained. We therefore believe that key money payments typically meet the definition of initial direct costs.
Likewise, under the new leasing standard, lessees no longer record separate intangible assets for below-market lease payments upon acquiring an operating lease in a business combination; rather, such amounts are capitalized as part of the ROU asset in accordance with ASC 805-20-25-12. Therefore, we believe that entities should generally capitalize the entire key money payment as an initial direct cost — and thus as part of the ROU asset — and amortize this cost over the life of the ROU asset (i.e., over the lease term unless the lease transfers ownership or contains a purchase option that the lessee is reasonably certain to exercise).

Connecting the Dots — Initial Direct Costs May Be an Allocated Amount

As discussed in Section 6.1, when nonlease components are present in a contract, the consideration in the contract must be allocated to the lease and nonlease components. In a manner consistent with this requirement, ASC 842-10-15-38 requires that lessors allocate capitalized costs (including initial direct costs) to the separate components in the contract. As a general rule, we believe that lessors should allocate these costs on the same basis as the consideration in the contract (i.e., on the basis of stand-alone selling price). However, when the capitalized costs (e.g., commissions) are entirely related to the lease component(s) in the contract rather than to the overall contract (which contains both lease and nonlease components), we believe that it is acceptable to allocate these costs entirely to the lease component(s) in the contract.

On the other hand, ASC 842-10-15-33 requires that lessees allocate initial direct costs to the separate lease components in the contract on the same basis as lease payments (i.e., on the basis of stand-alone price).

Example 6-10

Company L (the lessee) enters into an arrangement to lease a building for 10 years. As part of the arrangement, the lessor is required to provide CAM services for the 10-year lease term. In exchange for the right to use the building and obtain the CAM services, L will make fixed monthly payments of $5,000. The stand-alone price of the monthly building lease and CAM is $4,750 and $500, respectively. As compensation for executing the contract, the lessor pays a one-time commission of $1,000 to its employee.

The following table illustrates the allocation of the $1,000 commission between the lease and nonlease components in the contract:

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Price</th>
<th>Allocation Percentage</th>
<th>Allocated Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease — building</td>
<td>$4,750</td>
<td>90.5%</td>
<td>$905</td>
</tr>
<tr>
<td>Nonlease — CAM</td>
<td>$500</td>
<td>9.5%</td>
<td>95</td>
</tr>
<tr>
<td></td>
<td><strong>$5,250</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>$1,000</strong></td>
</tr>
</tbody>
</table>

The $905 commission allocated to the lease component in the contract should be accounted for in accordance with the guidance on initial direct costs in ASC 842. The $95 commission allocated to the nonlease component in the contract should be accounted for in accordance with the guidance on incremental costs to obtain a contract in ASC 606 (see Section 12.2 of Deloitte’s Revenue Roadmap). The accounting treatment of the $905 commission under ASC 842 may not be aligned with that of the $95 commission under ASC 606.

See Chapters 8 and 9 for a discussion of the recognition and subsequent measurement of initial direct costs for lessees and lessors, respectively.
Chapter 7 — Discount Rates

7.1 General
   7.1.1 Rate Implicit in the Lease
   7.1.2 Incremental Borrowing Rate

7.2 Determination of the Discount Rate for Lessees
   7.2.1 Initial Determination of the Discount Rate
   7.2.2 Reassessment of the Discount Rate
   7.2.3 Use of a Risk-Free Rate by Lessees That Are Not Public Business Entities
   7.2.4 Incremental Borrowing Rate Used at a Subsidiary Level
   7.2.5 Determining a Discount Rate at a Portfolio Level

7.3 Determination of the Discount Rate for Lessors
   7.3.1 Initial Determination of the Discount Rate
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Chapter 7 — Discount Rates

7.1 General

ASC 842-10 — 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.

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.

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

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. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used.

An entity uses discount rates to calculate the present value of lease payments when (1) determining lease classification (see Section 8.3 for the lessee’s determination and Section 9.2 for the lessor’s determination), (2) measuring a lessee’s lease liability (see Section 8.4), and (3) measuring a lessor’s net investment in a lease for sales-type and direct financing leases (see Section 9.3). Under ASC 842, the discount rate used by a lessee and a lessor is determined on the basis of information as of the lease commencement date. A lessor will always use the rate implicit in the lease. A lessee will typically use its incremental borrowing rate for the reasons discussed in Section 7.2.

Connecting the Dots — Discount Rate for Lessors Rarely the Same as That for Lessees
As described above, the lessor is required to use the rate implicit in the lease when calculating the present value of lease payments. In contrast, a lessee will generally use its incremental borrowing rate, since many of the inputs used to calculate the rate implicit in the lease are not readily determinable from the lessee’s perspective (e.g., initial direct costs of the lessor and the lessor’s estimate of the residual value of the underlying asset). Therefore, the lessor discount rate and the lessee discount rate would rarely be the same.

Bridging the GAAP — Differences Between Discount-Rate Terminology Under U.S. GAAP and That Under IFRS Standards
While the principles in ASC 842 behind the definitions of the rate implicit in the lease and the incremental borrowing rate are generally consistent with those in IFRS 16, the wording in the definitions varies.

Specifically, ASC 842 defines the rate implicit in the lease as follows:

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. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used.

In contrast, IFRS 16 defines the interest rate implicit in the lease as:

The rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.

Further, ASC 842 defines the incremental borrowing rate as:

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.

On the other hand, IFRS 16 defines the lessee's incremental borrowing rate as:

The rate of interest that 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 right-of-use asset in a similar economic environment.

As a result of these wording differences, the accounting outcome for an entity that applies the above definitions under U.S. GAAP could slightly differ from that under IFRS Standards. For more information about the differences between ASC 842 and IFRS 16, see Appendix B.

7.1.1 Rate Implicit in the Lease

The “rate implicit in the lease” is the interest rate 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 minus any related investment tax credit retained . . . by the lessor and (2) any deferred initial direct costs of the lessor” (emphasis added).\(^1\)

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Changing Lanes — Impact of Initial Direct Costs on the Rate Implicit in the Lease

During redeliberations, the FASB and IASB evaluated whether it would be appropriate to include initial direct costs in the determination of the lease’s implicit rate (in a manner similar to IAS 17’s requirement) or whether they should be excluded (in a manner similar to ASC 840’s requirement). Ultimately, the boards concluded that it would be more appropriate for an entity to include initial direct costs when determining the rate implicit in the lease because a lessor would generally price the lease to obtain a specific return by considering all costs associated with entering into the lease, including initial direct costs. Therefore, the inclusion of initial direct costs in the calculation of the lease’s implicit rate under ASC 842 differs from the calculation of the lease’s implicit rate under ASC 840 and will result in a lower interest rate.

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\(^1\) ASC 842-10-25-4 states that “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.” Therefore, in a sales-type lease, initial direct costs will be recognized as an expense at lease commencement unless no selling profit or loss is recognized upon the derecognition of the leased asset.
7.1.2 Incremental Borrowing Rate

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.”

Connecting the Dots — Appropriate Forms of Collateral

On the basis of discussions with the FASB and SEC staffs, we think that in determining the incremental borrowing rate, a lessee should evaluate the collateral considered for the borrowing as follows:

- The lessee should start with a rate that is obtained for a general, unsecured, recourse borrowing and should adjust that rate for the effects of collateral. This should have the effect of reducing the rate.
- The lessee should assume full collateralization and should not assume under- or over-collateralization.
- The collateral considered does not have to be the leased asset. It can be the leased asset, but it may also be any form of collateral that a creditor would be expected to accept to secure a borrowing for a similar term (i.e., collateral that is at least as liquid as the leased asset).

Connecting the Dots — Incremental Borrowing Rate for Leases Denominated in a Foreign Currency

In determining an incremental borrowing rate for a lease denominated in a foreign currency, a lessee, rather than using its functional currency, should calculate its incremental borrowing rate by using assumptions that would be consistent with a rate that it would obtain to borrow — on a collateralized basis and in the same currency in which the lease is denominated — an amount equal to the lease payments in that currency over the lease term.

Changing Lanes — Changes in the Definition of Incremental Borrowing Rate

The incremental borrowing rate under ASC 842 differs from the incremental borrowing rate under ASC 840. For example, under ASC 842, the incremental borrowing rate is the rate that the lessee would pay to borrow an amount equal to the lease payments on a collateralized basis over a similar term. Under ASC 840, however, the incremental borrowing rate is the rate the lessee could obtain to borrow the funds necessary to purchase the underlying asset.

In addition, under ASC 842, the incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow on a collateralized basis (i.e., a secured borrowing). In contrast, under ASC 840, a lessee is not required to use a rate that takes collateral into account but should use a rate that is “determinable, reasonable, and consistent with the financing that would have been used in the particular circumstances,” regardless of whether the rate is secured.
7.2 **Determination of the Discount Rate for Lessees**

**ASC 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.

**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.

**30-4** See Example 2 (paragraphs 842-20-55-17 through 55-20) for an illustration of the requirements on the discount rate.

### 7.2.1 Initial Determination of the Discount Rate

At lease commencement, a lessee must develop a discount rate to calculate the present value of the lease payments so that it can determine lease classification and measure the lease liability. When determining the discount rate to be used at lease commencement, a lessee must use the rate implicit in the lease unless that rate cannot be readily determined. When the rate implicit in the lease cannot be readily determined (which we expect to generally be the case), the lessee should use its incremental borrowing rate.

**Changing Lanes — Required Use of Rate Implicit in the Lease (When Readily Determinable)**

Under ASC 842, when the rate implicit in the lease is readily determinable, the lessee must use this rate regardless of whether it is greater than the lessee’s incremental borrowing rate. This requirement differs from that under ASC 840, which indicates that a lessee can only use the rate implicit in a lease when that rate does not exceed the lessee’s incremental borrowing rate and is readily determinable.

The example and Q&As below further discuss the considerations related to the initial determination of the discount rate. In addition, Example 2 in ASC 842-20-55-17 through 55-20 (reproduced in Section 7.2.5) also illustrates this determination.

**Example 7-1**

**Determination of the Discount Rate for Lessees**

Company A enters into an arrangement to lease a crane from Supplier for five years, beginning on January 1, 20Y1. Assume the following facts:

- The estimated fair value of the crane is $195,000.
- Company A must pay Supplier $37,500 annually, with the payment due at the end of each year.
- The estimated residual value of the crane at the end of the lease term is $60,000.
- Company A does not know the total initial direct costs deferred by Supplier.
- Company A cannot readily determine Supplier’s estimate of the residual value of the crane at lease commencement.
- There are no separate nonlease components in the contract.
- Company A has an unsecured line of credit with a lending institution that bears an interest rate of 7.75 percent.
- Company A receives an interest rate quote of 6.50 percent from its lender for a five-year loan of $187,500 that is secured by commercial equipment.
Example 7-1 (continued)

**Evaluation of the Rate Implicit in the Lease**

A lessee must use the rate implicit in the lease as its discount rate unless that rate is not readily determinable. In this example, while certain components of the rate implicit in the lease are readily determinable (e.g., estimated fair value and the lease payments), A does not know the initial direct costs that Supplier deferred or Supplier’s estimate of the crane’s expected residual value. Therefore, A would be required to use its incremental borrowing rate.

**Evaluation of the Incremental Borrowing Rate**

As indicated in Section 7.1.2, the incremental borrowing rate is the rate that reflects the interest a lessee would have to pay to borrow funds on a collateralized basis over a similar term and in a similar economic environment. As a result, when determining its incremental borrowing rate, the lessee is not limited to a rate that is collateralized by the leased asset; rather, the lessee can use any interest rate as long as the rate reflects a term similar to the lease term and the borrowing is fully collateralized.

In this example, A cannot use the rate on its unsecured line of credit because the borrowing is not collateralized. Instead, A would use as its discount rate the interest rate quoted on its five-year loan secured by commercial equipment because that interest rate is fully collateralized and is based on a term similar to the lease term (i.e., five years).

### Q&A 7-1 Lessee’s Consideration of Whether the Rate Implicit in the Lease Is Readily Determinable

ASC 842-20-30-2 states, “A lessee should use the rate implicit in the lease whenever that rate is readily determinable” (emphasis added).

**Question**

When does the lessee consider the rate implicit in the lease to be “readily determinable”?

**Answer**

Generally, the rate implicit in the lease would be considered readily determinable when all of the material inputs used to calculate the rate are readily determinable (i.e., the lessee can readily determine the fair value of the underlying asset, the amount the lessor expects to derive from the underlying asset at the end of the lease term, and the lessor’s initial direct costs, provided that each of these has a material effect on the rate — see Section 7.1 for the definition of “rate implicit in the lease”). In contrast, the rate implicit in the lease would not be considered readily determinable when any of the material inputs are not readily determinable.

In scenarios in which material inputs are deemed readily determinable but immaterial inputs are not, it may be reasonable for a lessee to estimate those inputs when determining the rate implicit in the lease if such inputs are not expected to materially affect the resulting calculations (e.g., when the lessee does not know the lessor’s initial direct costs but the lack of precision in an estimate of a reasonable amount of initial direct costs would not have a meaningful impact on the calculated rate).
Connecting the Dots — “Readily Determinable” Is a High Hurdle

We believe that the phrase “readily determinable” is indicative of a high hurdle. That is, the information a lessee needs to determine the rate implicit in the lease would generally not be considered readily determinable from the lessee’s perspective because of its limited visibility into the actual inputs needed to calculate the precise rate (e.g., the lessee will generally not know the amount that the lessor expects to derive from the underlying asset at the end of the lease term). At the same time, lessees should not ignore available information about the inputs to the rate implicit in the lease.

Some may believe that a lessee can never readily determine the rate implicit in the lease unless all of the lessor’s inputs are fully transparent to the lessee. As discussed above, we believe that there may be limited exceptions to this view. Specifically, when a lessee is able to reasonably estimate the immaterial inputs used to calculate the rate implicit in the lease, we would not object to the use of an estimated implicit rate. However, a lessee is not required to attempt to estimate such inputs if they are not readily determinable in these circumstances and, therefore, may use its incremental borrowing rate when discounting its lease payments.

In January 2019, the FASB received an agenda request for inclusion of additional or amended guidance in ASC 842 regarding when a lessee should apply the rate implicit in a lease as its discount rate. Therefore, the guidance on this topic may change; companies should monitor developments in this area. See Section 17.3.3 for more information about ongoing FASB activity related to this topic.

Q&A 7-2 Factors to Consider in Determining the Lessee’s Incremental Borrowing Rate

Question 1

What factors should a lessee consider in determining its incremental borrowing rate?

Answer

A determination of the lessee’s incremental borrowing rate at the commencement date of a lease may be difficult. If a lessee did not incur borrowings at or near the commencement date of a lease that were for a term similar to the lease term, the lessee may need to determine its incremental borrowing rate through discussions with bankers, or other lenders, or by reference to obligations of a similar term issued by others with a credit rating similar to that of the lessee. The incremental borrowing rate should be an effective borrowing rate that takes into account any compensating balance or other requirements affecting the stated interest rate. When the lessee obtains a third-party guarantee of its lease payments, it should adjust its incremental borrowing rate to reflect the impact of that guarantee if obtaining a third-party guarantee for a similar borrowing that could have been used to purchase the leased asset would have affected the lessee’s borrowing rate for that debt.

Question 2

Can an entity’s collateralized rate be higher than its general unsecured borrowing rate?
**Answer**

No. The starting point for determining a collateralized incremental borrowing rate is an entity's general unsecured borrowing rate, given the term of the lease and the amount of the lease payments. That base rate is then adjusted to reflect the effect of collateral. Since adding collateral only improves the lender's level of security, this should lower the applicable borrowing rate.

**Question 3**

What collateral should an entity use when estimating an incremental borrowing rate?

**Answer**

It would generally be acceptable to use the leased asset itself as the assumed collateral. This view is consistent with most collateralized borrowings in which the lender can foreclose on the asset that was purchased with the proceeds of the loan. However, on the basis of discussions with the FASB and SEC staffs, we understand that other forms of collateral can also be used if they are likely to be accepted by a lender. For example, a lender that requires collateral would most likely accept U.S. Treasury securities instead of a fixed asset (e.g., building, equipment) because the Treasury securities are more liquid and therefore offer more security to the lender. In general, lender acceptance would most likely depend on the proposed collateral's level of liquidity in relation to the leased asset. Assets that are more liquid than the leased asset would most likely be accepted as collateral, while assets that are less liquid would not. In addition, the more liquid the collateral, the greater the effect we would expect on the incremental borrowing rate.

**Question 4**

Should an entity assume overcollateralization or undercollateralization if facts and circumstances suggest that a lender would require it for a similar borrowing?

**Answer**

On the basis of discussions with the FASB and SEC staffs, we understand that an entity should generally assume full collateralization (not undercollateralization or overcollateralization) and that it is not expected or required to establish levels of collateralization that would typically be required by lenders in similar circumstances (i.e., collateralization based on traditional loan-to-value requirements for loans related to different asset types).

**Connecting the Dots — A Lessee’s Consideration of Its Credit Rating When Determining Its Incremental Borrowing Rate**

As described above in Q&A 7-2, the determination of an incremental borrowing rate depends on a number of factors, including the amount of the borrowing, a lessee's credit rating, and the lease term. Therefore, irrespective of whether the lessee has an excellent credit rating, it would generally be inappropriate for the lessee to use the same incremental borrowing rate for all of its leases, since it will need to consider all relevant factors in determining this rate.
Q&A 7-3 Lessee’s Inability to Obtain Financing

As noted in Section 7.2.1, the incremental borrowing rate used by a lessee should reflect the interest rate that the lessee would have to pay to borrow funds from a third party on a collateralized basis. In certain instances, a lessee may not be able to obtain financing from a third party because of its overall financial condition and creditworthiness.

Question

How should a lessee determine its incremental borrowing rate if it is unable to obtain financing?

Answer

If a lessee is not able to obtain financing from a third party because of its overall financial condition and creditworthiness, the incremental borrowing rate may not be readily available. In such circumstances, the lessee should use, as its incremental borrowing rate, the interest rate available for the lowest-grade debt in the marketplace, adjusted for the effects of collateral.

Q&A 7-4 Consideration of Loan Origination Fees in the Determination of the Incremental Borrowing Rate

Question

Is it appropriate for a lessee to consider loan origination fees in determining its effective incremental borrowing rate?

Answer

Yes. The “rate” used as the incremental borrowing rate should be consistent with the lessee’s cost of borrowing for the specific purpose. That cost should be the effective cost of borrowing, including fees paid to originate the loan. Accordingly, the lessee should consider reasonable loan origination fees in computing its incremental borrowing rate.

7.2.2 Reassessment of the Discount Rate

A lessee must update the discount rate when the lease liability is remeasured (see Section 8.5 for a detailed discussion of lessee remeasurement), unless the remeasurement results from changes in one of the following:

- The lease term or the assessment of whether a purchase option will be exercised, and the discount rate already reflects the lessee’s option to extend or terminate the lease or purchase the asset.
- Amounts that it is probable the lessee will owe under a residual value guarantee.
- Lease payments resulting from the resolution of a contingency upon which some or all of the variable lease payments are based.

In addition, a lessee would be required to reassess the discount rate when the contract is modified and that modification does not result in a separate contract. See Section 8.6 for more information.
7.2.3 Use of a Risk-Free Rate by Lessees That Are Not PBEs

ASC 842-20-30-3 indicates that a lessee that is not a public business entity (PBE) is permitted, as an accounting policy election, to use a risk-free discount rate in lieu of its incremental borrowing rate when assessing lease classification and when measuring its lease liabilities.

Connecting the Dots — Use of a Risk-Free Rate May Have Unintended Consequences

While a lessee's use of a risk-free discount rate may reduce some of the complexities related to measuring its lease liabilities and ROU assets, there may be some unintended consequences. For example, using a risk-free discount rate would result in a lease liability and ROU asset that are larger than those that would have been calculated by using the lessee's incremental borrowing rate. In addition, using the risk-free rate could result in a present value calculation that may equal or exceed substantially all of the fair value of the underlying leased asset, causing the lease to be classified as a finance lease rather than an operating lease.

7.2.4 Incremental Borrowing Rate Used at a Subsidiary Level

In paragraph BC201 of ASU 2016-02, the FASB acknowledges that it may sometimes be appropriate for a subsidiary to use an incremental borrowing rate other than its own. That is, depending on the nature of the lease negotiations and the resulting terms and conditions of the agreement, it may be more appropriate to use a parent entity's or consolidated group's incremental borrowing rate if the borrowing power of these entities is factored into the lease negotiations.

Q&A 7-5 Determining a Subsidiary's Incremental Borrowing Rate When the Lease Terms Are Influenced by Parent or Group Credit

In some cases, a parent negotiates leases on behalf of its subsidiary so that the subsidiary can benefit from the parent's superior credit. In other cases, a consolidated group might have a centralized treasury function that negotiates on behalf of all of its subsidiaries for the same reason. The negotiations often include guarantees or other payment mechanisms that allow the lessor to look beyond just the subsidiary for payment. This raises the question of whether it would be appropriate for an entity to use a rate other than the subsidiary's incremental borrowing rate when accounting for a lease at the subsidiary level (if it is assumed that the implicit rate cannot be readily determined).

Question

Would it be appropriate for a subsidiary to use an incremental borrowing rate other than its own to measure its lease liability when the implicit rate cannot be readily determined?

Answer

It depends. The appropriate incremental borrowing rate for measuring the lease liability would generally be based on the terms and conditions negotiated between the lessee and the lessor. Often, the pricing of the lease will solely depend on the credit standing of the subsidiary itself (i.e., the lessee in the arrangement). In other cases, the pricing may be significantly influenced by the credit risk evaluated at another level in an organization (e.g., the parent or consolidated group) on the basis of guarantees or other payment mechanisms that allow the lessor to look beyond just the subsidiary for payment. If the pricing of the lease depends solely on the lessee's credit standing when the lease was negotiated, the lessee's incremental borrowing rate should
be used to measure the lease liability. However, if the pricing of the lease depends on the credit risk of an entity other than the lessee when the lease was negotiated (e.g., the lessee's parent or a consolidated group), it will generally be more appropriate to use the incremental borrowing rate of that other entity.

Decentralized treasury functions within an organization may be an indicator that it is appropriate for the reporting entity to use the incremental borrowing rate of the subsidiary (i.e., the lessee in the arrangement) when measuring the lease liability. However, this fact is not individually determinative and should be considered along with the determination of whether the subsidiary's (lessee's) credit standing was used in the negotiation of the lease agreement. This view is consistent with paragraph BC201 of ASU 2016-02, which states, in part:

The Board . . . considered that, in some cases, it might be reasonable for a subsidiary to use a parent entity or group's incremental borrowing rate as the discount rate. Depending on the terms and conditions of the lease and the corresponding negotiations, the parent entity's incremental borrowing rate may be the most appropriate rate to use as a practical means of reflecting the interest rate in the contract, assuming the implicit rate is not readily determinable. 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) and, 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.

The two examples below highlight scenarios commonly encountered in practice. In both examples, the credit of the parent or group is assumed to be superior to the credit of the subsidiary/lessee.

**Example 1**

On January 15, 20X1, Group A negotiates and executes a lease on behalf of Subsidiary B, one of the subsidiaries consolidated by A. The treasury function is maintained at A's level (i.e., B does not have a stand-alone treasury function), and pricing of the lease is based on A's creditworthiness. While both A and B are the named parties in the lease agreement, B is identified as the party that will occupy the leased property.

Since treasury operations (including the negotiation of lease agreements) are conducted centrally at A's level, it would generally be appropriate for B to use A's incremental borrowing rate (as opposed to B's rate) when measuring B's lease liability. This is because the negotiations with the lessor and the resulting pricing of the lease are based on the creditworthiness of A rather than that of B.

**Example 2**

On April 15, 20X1, Lessee A negotiates a building lease with Lessor B. Lessee A has its own treasury function that negotiates all significant agreements, including leases. However, A's parent, ParentCo, provides a guarantee of lease payments to B as part of the negotiated terms of the lease.

Although A has its own treasury function and negotiates the term of its lease, it would be reasonable to conclude that the pricing of the lease was significantly influenced by the creditworthiness of ParentCo (as evidenced by ParentCo's guarantee to the lessor). As a result, it would generally be appropriate for A as the reporting entity to measure the lease liability by using ParentCo's incremental borrowing rate.
7.2.5 Determining a Discount Rate at a Portfolio Level

**Example 2 — Portfolio Approach to Establishing the Discount Rate for the Lease**

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.

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.

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.

The FASB concluded that it may be appropriate in certain circumstances for an entity to apply the lease accounting guidance at a portfolio level. One such circumstance could be the lessee’s determination of the discount rate. When applying the guidance at a portfolio level, the lessee would need to appropriately stratify the lease population subject to this approach in such a manner that application of the lease guidance at the portfolio level results in an outcome that would not materially differ from the outcome that results from applying the guidance on a lease-by-lease basis. Examples of attributes that the lessee should consider in this exercise include lease term, form of underlying collateral, and amount of lease payments.

**Connecting the Dots — Determining a Discount Rate at a Portfolio Level**

During its redeliberations, the FASB considered how costly and complex it would be for preparers to apply the guidance in ASC 842. To alleviate this burden, the FASB decided to permit both lessees and lessors to apply the guidance in ASC 842 at a portfolio level. The Board noted that, when a portfolio approach is applied, it would be less costly not only to group similar leases together but also in other respects (e.g., when an entity uses judgments and estimates in recognizing a lease).

For example, paragraph BC121 of ASU 2016-02 indicates that it may be useful for an entity to use a portfolio approach when determining a discount rate:

The cost relief also could be particularly high for certain aspects of the leases guidance for which entities need to make judgments and estimates, such as determining the discount rate or determining and reassessing the lease term. For example, rather than establishing a specific discount rate for a
single leased asset, an entity might conclude that it can establish a single discount rate applied to all leases in a portfolio because using that discount rate would not result in a materially different answer than using a discount rate determined for each.

We believe that determining a discount rate at a portfolio level could help reduce the cost and complexity of applying this guidance.

### 7.3 Determination of the Discount Rate for Lessors

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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.

#### 7.3.1 Initial Determination of the Discount Rate

A lessor should use the rate implicit in the lease (i.e., the rate it charges the lessee) when evaluating lease classification and measuring its net investment in a lease, if applicable. (See Section 7.1.1 for the definition of the rate implicit in the lease.) Importantly, however, a lessor's consideration of initial direct costs in its calculation of the rate implicit in the lease will be different depending on whether the rate is being used to determine lease classification or when the lease is initially measured. As a result, a lessor may determine different rates implicit in a lease depending on whether the rate will be used to initially classify a lease or to initially recognize and measure the lease. See Q&A 9-7 for more information on how a lessor should consider initial direct costs when calculating the rate implicit in the lease.

As discussed in Section 9.3.7.1, it is possible for the lessor to have a sales-type or direct financing lease when the lease payments are entirely or significantly variable. In such situations, the calculation of the rate implicit in the lease may result in a negative discount rate. However, at its November 30, 2016, Board meeting, and as codified in ASU 2018-10, the FASB clarified that it would be inappropriate to use a negative discount rate. Therefore, lessors would use a 0 percent discount rate to measure the net investment in the lease. See Q&A 9-13 for a detailed discussion of lessor accounting in these situations (e.g., the possibility of a commencement-date loss when a sales-type or direct financing lease includes significant variable payments).²

#### 7.3.2 Reassessment of the Discount Rate

A lessor would only reassess the discount rate used for determining lease classification when a lease is modified and the modification is not accounted for as a separate contract or when an option is exercised that was originally determined to be not reasonably certain (including both lessee options to extend the lease term or purchase the underlying asset and lessor options to terminate the lease). This would occur, for example, when there is a change in the terms or conditions of the contract that affects the overall scope of or consideration received as part of the contract. The discount rate to be used depends on the classification of the lease before and after the lease modification. See Section 9.3.4 for additional discussion of lessor lease modifications.

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² In July 2018, the FASB issued ASU 2018-10, which makes Codification improvements to ASC 842 and amends the ASC master glossary's definition of the term 'rate implicit in the lease' to clarify that, under ASC 842, this rate cannot be less than zero. Therefore, the rate implicit in the lease would default to zero if it is calculated as less than zero. See Section 17.3.1.3 for further discussion of the ASU.
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   8.1.2 Navigating the Lessee Model
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8.6 Lease Modifications
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8.1 Overview

### ASC 842-20

**05-1** This Subtopic addresses accounting by lessees for leases that have been classified as finance leases or operating leases in accordance with the requirements in Subtopic 842-10. Lessees shall follow the requirements in this Subtopic as well as those in Subtopic 842-10.

**15-1** This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic.

8.1.1 Setting the Stage

As discussed in Chapter 1, the primary objective of the FASB's leasing project was to address the off-balance-sheet treatment of leases from the lessee's perspective. As a result, ASC 842 improves financial statement transparency related to the rights and obligations arising from leases by requiring the recognition, on the balance sheet, of the lessee's right to use the asset subject to the lease (the ROU asset) over the period of use and its corresponding commitment to the lessor (lease liabilities). ASC 842 also enhances transparency by introducing a number of new qualitative and quantitative disclosure requirements for lease agreements.

**Connecting the Dots — Impact of ASC 842 on Debt Covenants and Bank Capital Requirements**

Since ASC 842 requires a lessee to recognize a lease liability and corresponding ROU asset for all of its leases (including operating leases), financial statement preparers and users have raised questions about the impact of the new requirements related to operating lease liabilities and ROU assets on an entity's metrics (e.g., debt covenants and bank capital requirements).

**Impact on Debt Covenants**

During its redeliberations, the Board considered concerns about the potential impact of additional liabilities resulting from the application of ASC 842. Specifically, paragraph BC14 of ASU 2016-02 states:

The Board further considered the concern that the additional lease liabilities recognized as a result of adopting Topic 842 will cause some entities to violate debt covenants or may affect some entities' access to credit because of the potential effect on the entity's GAAP-reported assets and liabilities. Regarding access to credit, outreach has demonstrated that the vast majority of users, including private company users, presently adjust an entity's financial statements for operating lease obligations that are not recognized in the statement of financial position under previous GAAP and, in doing so, often estimate amounts significantly in excess of what will be recognized under Topic 842. The Board also considered potential issues related to debt covenants and noted that the following factors significantly mitigate those potential issues:

a. A significant portion of loan agreements contain “frozen GAAP” or “semifrozen GAAP” clauses such that a change in a lessee's financial ratios resulting solely from a GAAP accounting change either:
   1. Will not constitute a default.
   2. Will require both parties to negotiate in good faith when a technical default (breach of loan covenant) occurs as a result of new GAAP.

b. Banks with whom outreach has been conducted state that they are unlikely to dissolve a good customer relationship by “calling a loan” because of a technical default arising solely from a GAAP accounting change, even if the loan agreement did not have a frozen or semifrozen GAAP provision.
c. Topic 842 characterizes operating lease liabilities as operating liabilities, rather than debt. Consequently, those amounts may not affect certain financial ratios that often are used in debt covenants.

d. Topic 842 provides for an extended effective date that should permit many entities’ existing loan agreements to expire before reporting under Topic 842. For those loan agreements that will not expire, do not have frozen or semifrozen GAAP provisions, and have covenants that are affected by additional operating liabilities, the extended effective date provides significant time for entities to modify those agreements.

While the FASB has clearly articulated its view that lease liabilities resulting from operating leases under ASC 842 are intended to be characterized as operating liabilities outside of debt, the Board cannot dictate how banks and other lenders view such amounts.

It is unclear whether banks and other lenders will take a consistent approach in evaluating liabilities for debt covenant purposes. Therefore, we encourage preparers and other stakeholders to communicate with these organizations to better understand the effects of ASC 842 on existing and future lending agreements.

**Impact on Bank Capital Requirements**

Bank regulatory capital (expressed as a ratio of capital to risk-weighted assets or average assets) is the amount of capital that banking regulators (e.g., the FDIC, the Federal Reserve Board, and the OCC) require banks or bank holding companies to hold. Most intangible assets are deducted from regulatory capital, while tangible assets are not. Since ASC 842 does not provide definitive guidance on whether an ROU asset represents a tangible or an intangible asset, stakeholders have asked how bank regulators will treat ROU assets when establishing required capital.

On April 6, 2017, the Basel Committee on Banking Supervision (of which the United States is a member) issued FAQs on how an ROU asset would be treated for regulatory capital purposes. Specifically, the FAQs note that the ROU asset:

- “Should not be deducted from regulatory capital [since] the underlying asset being leased is a tangible asset.”
- “[S]hould be included in the risk-based capital and leverage [ratio] denominators.”
- “[S]hould be risk-weighted at 100%, [which is] consistent with the risk weight applied historically to owned tangible assets and to a lessee’s leased assets under leases accounted for as [capital] leases” under ASC 840.

### 8.1.2 Navigating the Lessee Model

This chapter of the Roadmap highlights the guidance and interpretations that a lessee must apply when accounting for its leases, including guidance on classifying leases and recognizing and measuring the lease liability as well as the corresponding ROU asset. In addition, this chapter discusses the income statement expense recognition profile and related presentation for both operating and finance leases. Other aspects of lessee accounting addressed in this chapter include:

- Remeasurement of the lease liability *(Section 8.5).*
- Accounting for lease modifications *(Section 8.6).*
- Lease derecognition *(Section 8.7).*
- Master lease agreements, leases denominated in foreign currencies, accounting for leasehold improvements and maintenance deposits *(Section 8.8).*
- Codification examples *(Section 8.9).*
The following chapters of this Roadmap also contain information relevant to the lessee model:

- **Chapter 2** — Discusses how to identify whether an arrangement involving an underlying asset is within the scope of the leasing standard.
- **Chapter 3** — Addresses factors related to evaluating whether a contract contains or is a lease.
- **Chapter 4** — Explains how to identify the separate lease components and nonlease components within a contract and how the consideration is allocated to components.
- **Chapter 5** — Discusses how the lessee should determine the lease term of its leases at lease commencement as well as when it should reassess the lease term.
- **Chapter 6** — Covers the identification of lease payments as well as the initial and subsequent measurement of consideration that must be allocated to the components identified.
- **Chapter 7** — Addresses how a lessee determines the appropriate discount rate as well as when it should reassess this rate.
- **Chapter 14** — Discusses the balance sheet, income statement, and cash flow statement presentation requirements from the lessee's perspective.
- **Chapter 15** — Outlines the interim and annual lessee disclosure requirements.

### 8.2 Policy Decisions That Affect Lessee Accounting

Before applying the accounting requirements in ASC 842, a lessee will need to make certain key accounting policy decisions. These decisions could have a significant impact on the amounts that are ultimately recognized, presented, and disclosed in the lessee’s financial statements. For discussion of a lessee’s decision on the election of a practical expedient to account for the nonlease components in a contract as part of the single lease component to which they are related, see Section 4.3.3.1.

This section discusses key policy decisions related to the following topics:

- The short-term lease recognition exemption (Section 8.2.1 below).
- Accounting for leases at a portfolio level (Section 8.2.2).

In addition, when making such key policy decisions, it would be reasonable for an entity to establish a balance sheet recognition capitalization threshold for its leases. See Section 2.2.5.2 for additional considerations.

#### 8.2.1 Short-Term Lease Recognition Exemption

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<th><strong>ASC 842-20</strong></th>
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<tr>
<td><strong>Short-Term Lease</strong></td>
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<td>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.</td>
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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.
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.

See Example 1 (paragraphs 842-20-55-13 through 55-16) for an illustration of the requirements on short-term leases.

### Illustration of a Short-Term Lease

Example 1 illustrates the assessment of whether a lease is a short-term lease.

**Example 1 — Short-Term Lease**

Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset.

Lessee enters into a 12-month lease of a vehicle, with an option to extend for another 12 months. Lessee has considered all relevant factors and determined that it is not reasonably certain to exercise the option to extend. Because at lease commencement Lessee is not reasonably certain to exercise the option to extend, the lease term is 12 months.

The lease meets the definition of a short-term lease because the lease term is 12 months or less. Consequently, consistent with Lessee's accounting policy election, Lessee does not recognize the right-of-use asset and the lease liability arising from this lease.

ASC 842-20 defines a short-term lease as a lease whose lease term, at commencement, is 12 months or less and that does not include a purchase option whose exercise is reasonably certain. ASC 842 permits a lessee, as an accounting policy election, not to recognize on its balance sheet assets and liabilities related to short-term leases. This accounting policy, if elected, would be applied by underlying asset class and would result in a lessee's recognition of its lease payments on a straight-line basis over the lease term in a manner similar to how operating leases are accounted for under ASC 840 (see Section 4.3.3.1 for considerations related to determining an underlying asset class). While this exemption will result in off-balance-sheet accounting for short-term leases, ASC 842 does include specific presentation and disclosure requirements for these leases. (See Sections 14.2 and 15.2.4.3, respectively, for additional information.)

As with other leases, renewal and purchase options for a lease that is subject to the short-term lease exemption need to be reassessed upon the occurrence of certain discrete reassessment events. (See Section 8.5.1 for additional information.) A lease will no longer meet the definition of a short-term lease and thus no longer qualify for the exemption if, as a result of a reassessment event, (1) the lease term changes and the change causes the remaining term to extend more than 12 months beyond the end of the previously determined lease term or (2) the lessee now concludes that the lessee's exercise of a purchase option is reasonably certain. When a lease no longer qualifies for the short-term lease exemption, a lessee will need to apply ASC 842's guidance on initial recognition and measurement; the commencement date of the lease for this purpose is the date of the change in circumstances.
**Example 8-1**

**Scenario A**
BuildCo enters into a lease for a crane. The lease is for a six-month noncancelable term, can be extended on a month-to-month basis after the six months, and does not include a purchase option. On the lease commencement date, BuildCo determines that (1) it will need the crane for a project that will take 18 months to complete and (2) the monthly rental payments during the extension period are significantly below market rates. On the basis of these factors, BuildCo concludes that it is reasonably certain that it will keep the lease for the 18-month period. BuildCo has an established accounting policy of using the short-term lease exemption for the class of underlying asset subject to this lease.

In this scenario, because BuildCo needs the underlying asset for its project and the pricing of the extension period is below the market rate, it is reasonably certain that BuildCo will extend the noncancelable period to 18 months. Therefore, the lease term is greater than 12 months (i.e., 18 months) and the lessee may not account for the lease as a short-term lease.

**Scenario B**
SalesCo enters into a vehicle lease that is subject to a 12-month noncancelable period, after which the lease will continue on a month-to-month basis. At any point after the noncancelable period, SalesCo can return the vehicle to the lessor and will be responsible for paying to the lessor any shortfall (or will receive any surplus) in the selling price of the vehicle compared with the remaining book value (terminal rental adjustment clause). SalesCo estimates that there will be a shortfall at the end of the first year that will be significant in such a way that SalesCo is likely to renew the lease and avoid the shortfall payment.

In this scenario, since SalesCo concludes that the estimated shortfall at the end of the first year is expected to be significant, it would not be reasonable to conclude that the term is 12 months since returning the vehicle after 12 months would generally result in an economic penalty to SalesCo. Therefore, it is reasonably certain that SalesCo will extend the lease beyond the 12-month period. Because the lease term in this scenario is greater than 12 months, the lessee may not account for the lease as a short-term lease.

**Scenario C**
Retailer enters into a lease of warehouse space. The lease is for a nine-month noncancelable term, can be extended for four months, and does not include a purchase option. On the lease commencement date, Retailer concludes that it is not reasonably certain that it will renew the lease beyond the nine-month noncancelable period because (1) the noncancelable period coincides with the period in which Retailer expects to need the additional storage and (2) the monthly lease payments during the optional extension period are expected to be at market rates.

In this scenario, because Retailer only needs the warehouse space to support its operations for a nine-month period and the pricing for the optional period is expected to be consistent with the expected market rates, it would be reasonable to conclude that the lease term is limited to the nine-month cancelable period. Therefore, the lease term is 12 months or less and Retailer applies the short-term lease exemption in accounting for the lease (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 ROU asset on its balance sheet).

**Connecting the Dots — Applying the Short-Term Lease Exemption**
While deliberating the new lease accounting standard, the FASB and IASB concluded that the inclusion of a balance sheet recognition exemption for short-term leases could reduce the cost and complexity of applying the new requirements. However, while a lessee can elect an accounting policy of not recognizing, on its balance sheet, liabilities and assets related to leases with a term of 12 months or less, the lessee must disclose in the notes to the financial statements its short-term lease expense. See **Section 15.2.4.3** for additional information.
Moreover, the recognition exemption for short-term leases is an accounting policy election that is applied at an asset class level. Once a lessee elects to apply (or not apply) the exemption for a particular asset class, any future leases with a term of 12 months or less within that asset class would have to be accounted for consistently. In addition, if a lessee would like to change its policy at a future date, it would need to evaluate the potential change in accordance with ASC 250.

**Connecting the Dots — Changing the Conclusion About the Short-Term Lease Exemption Is a One-Way Street**

Irrespective of whether a reassessment event causes the lease term to be less than 12 months, because an entity assesses its ability to apply the short-term lease exemption at lease commencement, an arrangement that previously did not qualify for the short-term lease exemption never would subsequently qualify for it. In other words, once a lease is recorded on the balance sheet, it cannot be derecognized as a result of a term reassessment, even if the revised term is 12 months or less. This would be the case irrespective of whether the lessee extends the term of a lease by exercising a renewal option whose exercise was not originally deemed reasonably certain or by extending the lease term by renegotiating an extension not included in the original contract terms (i.e., lease modifications not considered to be separate contracts).

**Q&A 8-1 Applying the Short-Term Lease Exemption to Leases With a Term Greater Than 365 Days**

A lessee, for tax or other business purposes, may enter into a lease agreement for a period approximating but exceeding one year. For example, in certain jurisdictions, a vehicle lease subject to a terminal rental adjustment clause often has a noncancelable period of 367 days. A lessee may question whether such a lease meets the definition of a short-term lease under ASC 842.

**Question**

Would a lease with a term of 367 days qualify for the short-term lease exemption under ASC 842?

**Answer**

No. The short-term lease exemption only applies to leases (1) with a term of 12 months or less and (2) that do not include a purchase option whose exercise by the lessee is reasonably certain. Because the lease term in the above scenario is greater than a year (i.e., 367 days), the short-term lease exemption would not apply in this case.

**Bridging the GAAP — Differences Between the Accounting for Short-Term Leases Under U.S. GAAP and That Under IFRS Standards**

The definition of a short-term lease under IFRS 16 differs slightly from that under ASC 842. Specifically, under IFRS 16, a lease that includes a purchase option would never qualify for the short-term lease exemption; however, under ASC 842, the short-term lease exemption would only be precluded if it is reasonably certain that the lessee will exercise the purchase option. As a result, more leases may qualify for the short-term lease exemption under U.S. GAAP than under IFRS Standards.
8.2.2 Accounting for Leases at a Portfolio Level

ASC 842 permits a lessee to account for its leases at a portfolio level provided that the leases commenced at or around the same time and the resulting accounting at this level would not differ materially from the accounting at the individual lease level. We therefore believe that this approach would be permitted when the portfolio includes leases that are (1) similar in nature (e.g., similar underlying assets) and (2) have identical or nearly identical contract provisions.

Connecting the Dots — Applying the Portfolio Approach

In applying the portfolio approach, a lessee will need to use judgment to conclude that the accounting for a group of assets at the portfolio level would not materially differ from the accounting for the leases in the portfolio on an individual lease basis. To reach such a conclusion, the lessee will need to critically assess the size and composition of the portfolio.

While it may appear that an entity would be required to perform a quantitative assessment to evaluate the appropriateness of applying the portfolio approach, the Background Information and Basis for Conclusions of ASU 2016-02 notes that such an assessment may not be necessary and that a more holistic evaluation could be appropriate. Specifically, paragraph BC120 of ASU 2016-02 states that the “Board indicated that 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.”

Further, paragraph BC121 of ASU 2016-02 notes, in part:

"The cost relief offered by applying the leases guidance at a portfolio level need not be limited to simply grouping contracts together. The cost relief also could be particularly high for certain aspects of the leases guidance for which entities need to make judgments and estimates, such as determining the discount rate or determining and reassessing the lease term."

See Section 7.2.5 for additional considerations related to determining a discount rate for a portfolio of leases and Section 8.3 below for more information about applying the lease classification criteria.

8.3 Lease Classification

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<tbody>
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<td>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. When an entity (that is, a lessee or lessor) is required to reassess lease classification, the entity shall reassess classification of the lease on the basis of the facts and circumstances (and the modified terms and conditions, if applicable) as of the date the reassessment is required (for example, on the basis of the fair value and the remaining economic life of the underlying asset as of the date there is a change in the lease term or in the assessment of a lessee option to purchase the underlying asset or as of the effective date of a modification not accounted for as a separate contract in accordance with paragraph 842-10-25-8).</td>
</tr>
</tbody>
</table>

8.3.1 Relevance of Classification Determination

From the lessee’s perspective, leases are classified as either finance or operating leases. While the determination of lease classification does not affect the initial measurement of the lease, it will have a direct impact on items such as subsequent measurement and financial statement presentation and disclosure.
8.3.2 Classification Date

Lease classification is assessed on the lease commencement date, which is defined as the date on which the lessor makes the underlying asset available for use by the lessee (see Section 8.4.1). After the lease commencement date, a lessee would only be required to reassess lease classification when there is a change in the lease term (see Section 8.5.1.2), a change in the conclusion about the lessee’s assessment of whether it is reasonably certain to exercise an option to purchase the underlying asset (see Section 8.5.1.2), or a lease modification that is not accounted for as a separate contract (see Section 8.6.3).

Changing Lanes — Classification Date

Unlike ASC 842, ASC 840 requires entities to classify leases on the basis of the facts and circumstances present at lease inception (i.e., the date of the lease agreement or commitment, if earlier) instead of at lease commencement (the date on which the lessor makes an underlying asset available to the lessee). For many entities, this is not a significant change, since there typically is not a significant lag between lease inception and lease commencement; however, in certain circumstances, the two dates significantly differ. In such cases, a lessee could theoretically arrive at different conclusions if facts and circumstances change between the dates (e.g., the fair value of the underlying asset or the discount rate). The diagram below illustrates the difference between lease inception and lease commencement.

8.3.3 Lease Classification Criteria

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
</table>

25-2 A lessee shall classify a lease as a finance 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.
8.3.3.1 Overview of the Classification Criteria

A lessee’s lease classification has a direct impact on the subsequent accounting for a lease. From the lessee’s perspective, a lease will be classified as a finance lease when it meets one or more of the five criteria in ASC 842-10-25-2. When none of these criteria are met, the lease will be classified as an operating lease. A lessee performs its lease classification assessment at lease commencement (i.e., when the lessee obtains the right to use the asset).

Bridging the GAAP — Dual-Model Versus Single-Model Approach for Lessees

ASC 842 includes a dual-model approach for lessees under which a lease is accounted for as either a finance lease or an operating lease in accordance with the lease classification criteria in ASC 842. In contrast, IFRS 16 prescribes a single-model approach for lessees under which all leases are accounted for in a manner similar to that under the U.S. GAAP accounting model for finance leases. Therefore, from the lessee’s perspective, lease classification is eliminated altogether under IFRS 16. See Appendix B for additional information about the differences between ASC 842 and IFRS 16.
8.3.3.2 *Decision Tree on Determining Classification*

1 Although ASC 842-10-55-3 indicates that an entity need not consider the fourth classification criterion if it is not “practical” to determine the fair value of the underlying asset, we believe that it would be unlikely for a lessee not to be able to determine the fair value of an underlying asset.
Q&A 8-2  Application of the Lease Classification Guidance at a Portfolio Level

**Question**
Is it appropriate to apply the lease classification guidance to a portfolio of leases?

**Answer**
It depends. Applying the lease classification criteria to a portfolio of leases under ASC 842 could be acceptable as long as the results do not materially differ from those achieved when the individual leases are classified on a lease-by-lease basis. We therefore believe that this approach would only be permitted when the portfolio includes leases that are (1) similar in nature (similar underlying assets) and (2) have identical or nearly identical lease terms.

See Section 8.2.2 for additional discussion of the application of the portfolio approach.

Q&A 8-3  Asymmetrical Lease Classification

**Question**
Could correct application of the lease classification criteria result in asymmetrical classification of the same lease by the lessor and the lessee?

**Answer**
Yes. By establishing the same five basic lease classification criteria for both lessors and lessees, the FASB attempted to achieve lease classification symmetry to a certain extent (i.e., a lease recorded as a finance lease by the lessee would generally be recorded as a sales-type lease by the lessor, or both parties would record an operating lease).

However, in certain circumstances, the lessor’s application of the lease classification criteria under ASC 842-10 may result in classification determinations that differ from those of the lessee and thus may lead to asymmetrical accounting. Circumstances in which such asymmetrical accounting may occur include:

- The lessee’s use of its incremental borrowing rate instead of the rate implicit in the lease.
- The inclusion in lease payments of third-party guarantees to the lessor.
- A penalty that, from the lessee’s perspective, makes renewal of the lease reasonably certain but that is not similarly perceived by the lessor.

8.3.3.3 Transfer of Ownership at the End of the Lease Term

**ASC 842-10**

25-2 A lessee shall classify a lease as a finance lease . . . when the lease meets any of the following criteria at lease commencement:

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

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.

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 lessee would “classify a lease as a finance lease” if ownership of the underlying asset is transferred to the lessee by the end of the lease term. For this criterion to be met, title must be transferred at little or no cost to the lessee shortly after the end of the lease term. In substance, such a transaction is akin to a financed purchase (i.e., the asset was purchased and financed through lease payments).

While the lessee accounting model has evolved since the issuance of FASB Statement 13 from a risks-and-rewards model (i.e., one based on benefits and risks) to a control-based model, certain of the underlying principles have not changed significantly. For example, when the lessee is required to pay only a nominal fee for title transfer, the lease would meet the criterion in ASC 842-10-25-2(a). If paying the fee (even when the fee is nominal) is optional, the lease would not explicitly meet this criterion but would still be evaluated under the criterion in ASC 842-10-25-2(b) — that is, the criterion indicating that the purchase option is reasonably certain to be exercised.

8.3.3.4 Purchase Option Reasonably Certain to Be Exercised

A lease would be classified as a finance lease if, at lease commencement, the lessee deems it to be reasonably certain that it will exercise a purchase option by the end of the lease term.

“Reasonably certain” is meant to be a high threshold. That is, it would be a higher threshold than “probable” under ASC 450. (See Section 5.2.2 for additional discussion of the application of the “reasonably certain” criteria.) ASC 842 includes certain factors that a lessee should evaluate when determining whether exercise of a purchase option is reasonably certain, including contract-based, asset-based, entity-based, and market-based factors. Generally speaking, after considering these factors, the lessee should evaluate whether it has an economic compulsion or incentive to exercise its purchase option, since this is a strong indicator that exercise of the option is reasonably certain.
ASC 842-10-55-26 includes a list of economic factors (not all-inclusive) for an entity to consider when evaluating whether the exercise of an option is reasonably certain. Such an evaluation must include an assessment of whether an economic compulsion exists.

The examples below demonstrate scenarios in which the lessee's exercise of its purchase option would be reasonably certain. In addition to the below discussion, Examples 23 and 24 in ASC 842-10 (reproduced in Section 8.9.2) illustrate the accounting for purchase options.

**Example 8-2**

Entity P leases a tractor that it may purchase for $10,000 at the end of the lease term. The fair value of the tractor is expected to be $20,000 when the lease term ends. Further, P has provided the lessor with a residual value guarantee of $25,000 in the event that P does not exercise the purchase option.

**Example 8-3**

Entity U leases an airplane in which it installs luxury seating and a gold-plated cocktail bar, both of which add significant value to the airplane. At the end of the lease term in three years, U may purchase the airplane for an amount that is commonly paid for an airplane that does not have luxury seating and a cocktail bar. The remaining useful life of the seating and bar assets extends 20 years after the noncancelable lease term.

### 8.3.3.5 Major Part of the Remaining Economic Life

**ASC 842-10**

25-2 A lessee shall classify a lease as a finance lease . . . when the lease meets any of the following criteria at lease commencement: . . .

   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. . . .

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. . . .

A lessee would “classify a lease as a finance lease [when the] lease term is for the major part of the remaining economic life of the underlying asset” (i.e., the economic life that remains on the commencement date versus the economic life when the asset is new). The ASC master glossary defines economic life as “[e]ither 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.” Note that a lease would not be subject to the “major part of the economic life” criterion if (1) the lease commences at or near the end of the economic life of the underlying asset (see discussion below in Section 8.3.3.5.1) or (2) the lease involves facilities owned by a government unit or authority and the remaining economic life of the underlying asset is indeterminate (see discussion in Section 8.3.5.3).
Q&A 8-4 Use of ASC 840’s Bright-Line Thresholds for Lease Classification

ASC 840 requires an entity to classify a lease on the basis of an evaluation of, among other things, certain quantitative bright-line thresholds. That is, under ASC 840, a lease would be classified as a capital lease if the lease term is 75 percent or more of the remaining economic life of an underlying asset or if the sum of the present value of the lease payments and the present value of any residual value guarantees amounts to 90 percent or more of the fair value of the underlying asset. However, when developing the lease classification guidance in ASC 842-10-25-2, the Board decided not to require the use of bright lines.

Question

Although entities are no longer required to assess certain quantitative bright-line thresholds when classifying a lease, are they permitted to use quantitative thresholds when classifying a lease under ASC 842?

Answer

Yes. The implementation guidance in ASC 842-10-55 states that a reasonable approach to applying the lease classification criteria in ASC 842 is to use the same bright-line thresholds as those in ASC 840. ASC 842-10-55-2 states the following:

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.

On the basis of this implementation guidance, we would not object if an entity were to apply ASC 840’s bright-line thresholds when classifying a lease under ASC 842. We would expect that under such an approach, an entity would classify a lease in accordance with the quantitative result. That is, if an entity applies ASC 840’s bright-line thresholds and determines that a lease term is equal to 76 percent of an asset’s useful life, the entity should classify the lease as a finance lease. The entity should not attempt to overcome the assessment with qualitative evidence to the contrary. Likewise, if the same entity determines that a lease term is equal to 74 percent of an asset’s useful life, the entity should classify the lease as an operating lease. We would expect that if an entity decides to apply the bright-line thresholds in ASC 840 when classifying a lease, the entity would apply those thresholds consistently to all of its leases.
Q&A 8-5  Estimated Economic Life Versus Depreciable Life

**Question**
Can an asset's depreciable life differ from its estimated economic life?

**Answer**
It depends. Generally, we would expect the economic life of an asset to correspond to its depreciable life used for financial reporting. In accordance with ASC 360, depreciable life is calculated on the basis of the asset's *useful life*, which is similar but not identical to the *economic life* an entity uses in performing the lease classification test.

The ASC master glossary defines useful life as the “period over which an asset is expected to contribute directly or indirectly to future cash flows” and economic life as “[e]ither 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.”

The objective of determining either the useful life or economic life of an asset is to identify the period over which the asset will provide benefit. The asset's useful life represents the period over which the *reporting entity* will benefit from use of the asset. In contrast, the economic life represents the period over which *one or more users* will benefit from use of the asset. Therefore, the asset's estimated depreciable life pertains to the intended use by the current owner, whereas the estimated economic life may encompass both the current and future owners of the asset.

This difference between the two definitions is not relevant in many cases since a single entity (the current owner) is often expected to use an asset for its entire life. However, depending on the facts and circumstances, it may sometimes be appropriate for an entity to use an estimated economic life for lease classification purposes that is longer than the asset's estimated depreciable life.

**Example**

Company X, an automobile lessor, routinely purchases automobiles that are economically usable for seven years. Company X leases the automobiles to lessees for three years and sells the automobiles after the end of the three-year lease term. Company X may have a supportable basis for using a three-year depreciable life (with a correspondingly higher salvage value) for financial reporting purposes but a seven-year economic life for lease classification purposes.

Q&A 8-6  Lease Classification — Estimated Economic Life Test

**Question**
Should the estimated economic life test be applied to a lease that only involves land?

**Answer**
No. Land has an infinite economic life and therefore could never meet the criterion in ASC 842-10-25-2(c).
8.3.3.5.1 At or Near the End of the Economic Life

When an underlying asset in a lease is at or near the end of its economic life, it is not subject to the economic life test. This is consistent with the guidance in ASC 842-10-25-2(c), which states, in part:

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.

Further, ASC 842-10-55-2 indicates that a “reasonable approach” to determining whether an underlying asset is at or near the end of its economic life would be evaluating whether the “commencement date . . . falls within the last 25 percent of the total economic life of the underlying asset.”

8.3.3.5.2 Considerations Related to the Predominant Asset

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>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).</td>
</tr>
</tbody>
</table>

A lease contract may include a single lease component that relies on the use of more than one underlying asset (see Chapter 4 for additional information on separate lease components). In such cases, an entity must consider the remaining economic life of the predominant asset in the overall lease component when applying the classification criterion in ASC 842-10-25-2(c).

**Q&A 8-7 Lease Agreement Covering a Group of Assets That Have Different Economic Lives**

A lease contract often includes a package of equipment. For example, an equipment lease may include virtually all pieces of equipment necessary to operate a store (e.g., refrigeration cases, air conditioning units, alarm and phone systems, cash registers, and store furniture).

**Question**

When pieces of equipment that have different remaining economic lives are leased in the aggregate, how should an entity determine the estimated economic life of the leased assets for lease classification purposes under ASC 842-10-25-2(c)?

**Answer**

When pieces of equipment that have different remaining economic lives are leased in the aggregate, an entity should consider the guidance in ASC 842-10-15-28, which states that a right to use an asset would be considered a separate lease component when it meets the following two criteria:

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.
Chapter 4 discusses, in detail, the guidance in ASC 842-10-15-28 on separating lease components.

If the conditions for separation are not met (i.e., if a single lease component contains more than one asset), an entity should consider the provisions of ASC 842-10-25-5, which indicates that “[i]f 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).” Regarding the assessment of the predominant asset in a lease component, paragraph BC74 of ASU 2016-02 states, in part:

The Board noted that assessing the predominant asset in a lease component that includes multiple underlying assets will be straightforward in most cases. That is, the assessment is a qualitative one that requires entities to conclude on what is the most important element of the lease, which should be relatively clear in most cases. The Board also noted that if an entity is unable to identify the predominant asset, it may indicate that there is more than one separate lease component in the contract.

### 8.3.3.6 Substantially All of the Fair Value of the Underlying Asset

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-2</strong> A lessee shall classify a lease as a finance lease . . . when the lease meets any of the following criteria at lease commencement:</td>
</tr>
<tr>
<td>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 . . .</td>
</tr>
<tr>
<td><strong>55-2</strong> 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: . . .</td>
</tr>
<tr>
<td>c. Ninety percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.</td>
</tr>
</tbody>
</table>

As noted above, a lessee would classify a lease as a finance lease if, at lease commencement, 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 . . . equals or exceeds substantially all of the fair value of the underlying asset.” When performing this classification test, the lessee should include any lease payments made to, or lease incentives received from, the lessor before or on the commencement date of the lease.

In the calculation of the present value of the lease payments and any residual value guaranteed by the lessee, the discount rate used by the lessee 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 (see Chapter 7 for additional information on a lessee’s determination of its discount rate).

### Connecting the Dots — Evaluating “Substantially All”

One of the most notable aspects of ASC 842 is the exclusion of “bright lines” (e.g., the 90 percent fair value test) from the lease classification tests. However, ASC 842-10-55-2 acknowledges that 90 percent may be an appropriate threshold for the “substantially all” criterion. See Q&A 8-4 for more information.
Connecting the Dots — Considerations Related to Residual Value Guarantees

The ASC master glossary defines a residual value guarantee as follows:

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.

Irrespective of what the fair value of the underlying asset is expected to be at the end of the lease term, a residual value guarantee should be included under this lease classification criterion at the maximum required deficiency that a lessee may be required to pay to the lessor at the end of the lease term.

In addition, there is a significant difference between residual guarantees related to determining lease payments for lease measurement purposes and those related to evaluating lease classification. For lease payments, a lessee would only include the amount that it is probable it will owe at the end of the lease term under a residual value guarantee. In contrast, for lease classification purposes, a lessee would include the entire residual value guarantee (i.e., both the portion of the residual value guarantee that is considered a lease payment and any residual value guaranteed by the lessee that is not already reflected in such payments).

Example 8-4

Company A enters into a lease agreement with Supplier for the use of a backhoe for a five-year period. Supplier estimates that the residual value of the backhoe at the end of the lease term will be $150,000, which is based on an expected 3,000 hours of use during the term. As part of the lease contract, A provides a residual value guarantee under which it is required to compensate the lessor for any difference if the value of the backhoe at the end of the lease is less than $140,000 (i.e., the maximum A could be required to pay under the residual value guarantee is $140,000). At lease commencement, A concludes that it expects to use the backhoe for an estimated 4,500 hours during the lease term and therefore expects the value of the backhoe at the end of the term, on the basis of the excess wear and tear from additional usage, to be $135,000. As a result, A determines that the amount that it is probable it will owe to Supplier at the end of the lease term is $5,000, which reflects the $140,000 that the lessee guaranteed less the expected value of $135,000 on the basis of the expected usage of the backhoe over the lease term.

Lease Payment Used for Lease Measurement Purposes

In accordance with ASC 842-10-30-5(f), $5,000 would be considered a lease payment for A, since this would be the amount that it is probable A would owe under the residual value guarantee.

Lease Classification

In accordance with ASC 842-10-25-2, A would include $140,000 in the “substantially all of the fair value” classification test when evaluating lease classification. The $140,000 represents the residual value of the backhoe that A is guaranteeing at the end of the lease term (i.e., this amount would include both the $5,000 included in the lease payments and the $135,000 of potential additional deficiency not included in the lease payments).
Q&A 8-7A  Impact of Portfolio Residual Value Guarantees on Lessee’s Lease Classification

Lessees often enter into lease agreements to lease multiple similar assets from lessors. In these circumstances, lessees will often guarantee the residual value for the group of assets being leased (e.g., the portfolio of underlying assets) rather than that for each individual underlying asset. ASC 842-10-55-10 states that a lessor should not consider residual value guarantees of a portfolio of underlying assets when evaluating the lease classification criteria, since “[r]esidual 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.” ASC 842 does not explicitly address whether a lessee should consider a PRVG when classifying individual leases within a portfolio.

Question 1

Should a lessee take the impact of a PRVG into account when classifying the individual leases within a portfolio?

Answer

Yes. When performing the lease classification test in ASC 842-10-25-2(d), the lessee should take into account “any residual value guaranteed by the lessee that is not already reflected in the lease payments.” This criterion reflects the maximum amount that the lessee could be obligated to pay under the lease arrangement, which should include residual value guarantees regardless of whether they are based on a portfolio or on an individual asset. If residual value guarantees were excluded, the lessee’s full potential obligation under the lease arrangement would not be depicted.

Question 2

How should a lessee apportion a PRVG to the individual leases within the portfolio when classifying a lease?

Answer

We believe that there are two acceptable approaches for a lessee’s apportionment of a PRVG: (1) the all-in approach and (2) the pro rata approach. The all-in approach is appropriate in all circumstances, while the pro rata approach is acceptable only if the leases are substantially similar in such a way that they meet the following criteria (these criteria are similar to those in Q&A 9-8B, which addresses PRVGs from a lessor’s perspective):

- The individual leases in the portfolio commence and end at the same time.
- The leased assets are physically similar to each other.
- The variability associated with the expected residual values is expected to be highly correlated (i.e., one asset’s residual value is expected to be similar to that of the other assets’ residual values).

2 See Q&A 9-8B for a discussion of circumstances in which it would be acceptable for a lessor to take a PRVG into account when assessing the classification of leases in a portfolio.
The following are some additional details about the all-in and pro rata approaches:

- **All-in approach** — This approach is predicated on the fact that the lessee has an unavoidable obligation to provide a residual value guarantee on the portfolio of leased assets. In addition, the lessee effectively has control of each individual asset through its unilateral right to choose which (or how much) of the underlying assets subject to the PRVG will be consumed in accordance with paragraph BC71(d) of ASU 2016-02. Under this approach, a lessee will allocate the **full** amount of the PRVG to **each** lease within the portfolio.

- **Pro rata approach** — Under this approach, the PRVG amount will be spread among the individual leases within the portfolio. That is, the lessee will apply the PRVG on a pro rata basis in relation to the expected residual value of each underlying asset at the end of the lease term, which should be a similar amount for each underlying asset, provided that the criteria above are met.

### Example

Lessee enters into a master lease of four substantially similar pieces of equipment. The following facts apply to each item of equipment at lease commencement (which is the same date for all equipment):

- Noncancelable lease term of five years.
- Fixed lease payments of $3,100 per year, payable in arrears.
- No transfer of ownership.
- No renewal, purchase, or termination options.
- Fair value of $24,000 for each piece of equipment.
- Total economic life of each piece of equipment is 10 years.
- Remaining economic life of each piece of equipment is eight years.
- There is an alternative use to Lessor at the end of the lease.
- The estimated residual value at the end of the lease is $7,500 per piece of equipment.
- Lessee’s incremental borrowing rate is 3.5 percent (the implicit rate cannot be readily determined).
- The present value of lease payments for each lease, excluding allocated residual value guarantees, is $13,997.
- There are no initial direct costs.

Lessee provides a guarantee that the residual value of the four pieces of equipment will be $30,000 in the aggregate at the end of the lease and uses the bright-line threshold of 90 percent when performing the present value test. The tables below illustrate the inclusion of the PRVG for lease classification by using the present value test under the (1) all-in approach and (2) pro rata approach.
### Example (continued)

#### All-In Approach

<table>
<thead>
<tr>
<th></th>
<th>Asset #1</th>
<th>Asset #2</th>
<th>Asset #3</th>
<th>Asset #4</th>
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</thead>
<tbody>
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<td>Fair value of equipment</td>
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<td>$24,000</td>
<td>$24,000</td>
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<td>Present value of lease payments</td>
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<td>Allocated PRVG</td>
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<td>30,000</td>
</tr>
<tr>
<td>Present value of allocated PRVG*</td>
<td>25,259</td>
<td>25,259</td>
<td>25,259</td>
<td>25,259</td>
</tr>
<tr>
<td>Present value for classification test**</td>
<td>39,256</td>
<td>39,256</td>
<td>39,256</td>
<td>39,256</td>
</tr>
<tr>
<td>Present value test***</td>
<td>Yes (over 100%)</td>
<td>Yes (over 100%)</td>
<td>Yes (over 100%)</td>
<td>Yes (over 100%)</td>
</tr>
<tr>
<td>Lease classification</td>
<td>Finance</td>
<td>Finance</td>
<td>Finance</td>
<td>Finance</td>
</tr>
</tbody>
</table>

* Net present value of allocated PRVG to be paid at the end of the lease term, discounted by using Lessee’s incremental borrowing rate of 3.5 percent.
** Present value of lease payments + present value of allocated PRVG.
*** Present value for classification test + fair value of equipment.

#### Pro Rata Approach

<table>
<thead>
<tr>
<th></th>
<th>Asset #1</th>
<th>Asset #2</th>
<th>Asset #3</th>
<th>Asset #4</th>
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<tr>
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<td>$24,000</td>
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<tr>
<td>Allocated PRVG</td>
<td>7,500*</td>
<td>7,500*</td>
<td>7,500*</td>
<td>7,500*</td>
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<tr>
<td>Present value of allocated PRVG**</td>
<td>6,315</td>
<td>6,315</td>
<td>6,315</td>
<td>6,315</td>
</tr>
<tr>
<td>Present value for classification test***</td>
<td>20,311</td>
<td>20,311</td>
<td>20,311</td>
<td>20,311</td>
</tr>
<tr>
<td>Present value test†</td>
<td>No (84.6%)</td>
<td>No (84.6%)</td>
<td>No (84.6%)</td>
<td>No (84.6%)</td>
</tr>
<tr>
<td>Lease classification</td>
<td>Operating</td>
<td>Operating</td>
<td>Operating</td>
<td>Operating</td>
</tr>
</tbody>
</table>

* PRVG of $30,000 ÷ 4 assets = $7,500 per asset.
** Net present value of allocated PRVG to be paid at the end of the lease term, discounted by using Lessee’s incremental borrowing rate of 3.5 percent.
*** Present value of lease payments + present value of allocated PRVG.
† Present value for classification test + fair value of equipment.
Q&A 8-7B  First-Dollar-Loss Residual Value Guarantee

The guidance in ASC 840-10-55-9 is clear that a lessee should include the maximum amount that it could be required to pay under a residual value guarantee when determining the minimum lease payments to be used in the assessment of lease classification in accordance with ASC 840-10-25-1(d). Specifically, ASC 840-10-55-9 states, in part:

If a lease limits the amount of the lessee’s obligation to make up a residual value deficiency to an amount less than the stipulated residual value of the leased property at the end of the lease term, the amount of the lessee’s guarantee to be included in minimum lease payments under paragraph 840-10-25-6(b) shall be limited to the specified maximum deficiency the lessee can be required to make up.

It is common for lease arrangements to limit (i.e., cap) the amount of residual value guarantee that the lessee would be required to pay. Such an arrangement, as described in the example below, is commonly referred to as a “first-dollar-loss residual value guarantee,” since any initial deficiency below the guaranteed residual value must first be borne by the lessee.

Example

A lessee and lessor enter into a lease arrangement for use of an office building. The lessee agrees to a residual value guarantee of $450,000, subject to a limit of $390,000 representing a first-dollar-loss residual value guarantee. At the end of the lease term, the lessee is only obligated to reimburse the lessor on a dollar-for-dollar basis for any shortfall below $450,000 in the amount received upon sale of the property up to $390,000. In other words, if the lessor cannot sell the property for $450,000 or more, the lessee would be required to compensate the lessor for each dollar below $450,000, up to a maximum of $390,000. The lessor only has a remaining residual risk in the property in the event that the sales price drops below $60,000.

Question

How should a first-dollar-loss residual value guarantee be considered for lease classification purposes under ASC 842?

Answer

ASC 840-10-55-9 states that for lease classification purposes, a lessee should include the maximum required deficiency that it may be required to pay to the lessor at the end of the lease term. First-dollar-loss residual value guarantees should be treated in the same manner in the assessment of lease classification under ASC 842 as they were under ASC 840. This conclusion is supported by the discussion in paragraph BC71(d) of ASU 2016-02. Therefore, the maximum payment that the lessee could be required to pay under the lease arrangement should be included in the lease classification test. Because the lessee will never be required to pay above $390,000 in the example above, only $390,000 should be included in the lease payments for lease classification purposes.

As discussed in Section 6.7, a lessee considers its full exposure under a residual value guarantee when classifying its leases; however, a lessee only considers the amount likely to be owed under the residual value guarantee when measuring its lease liabilities. This measurement approach represents a departure from ASC 840, which required the use of the full exposure for both classification and measurement (to the extent that a lease was classified as a capital lease).
Changing Lanes — Evaluating 89.9 Percent Lease Payments
Under ASC 840, there were many opportunities to create highly structured leases. Specifically, many leases were designed so that the present value of lease payments would be 89.9 percent of the fair value. Because the FASB has taken a more principles-based approach to classification in ASC 842, we do not believe that an 89.9 percent present value would necessarily result in an operating lease classification. However, this would depend on the entity's accounting policies (see Q&A 8-4), which should be consistently applied.

Changing Lanes — Consideration of Nonperformance-Related Default Provisions
Some lease agreements contain nonperformance-related default provisions that may require the lessee to purchase the leased asset or make another payment if the lessee is in default under such provisions. Common examples of these provisions include clauses related to bankruptcy, changes in control, and material adverse changes. Under ASC 840, these provisions needed to be carefully considered and often directly affected the classification of the lease. Specifically, ASC 840-10-25-14 listed four conditions that needed to be satisfied for the default provisions not to affect lease classification:

a. The default covenant provision is customary in financing arrangements.

b. The occurrence of the event of default is objectively determinable (for example, subjective acceleration clauses would not satisfy this condition).

c. Predefined criteria, related solely to the lessee and its operations, have been established for the determination of the event of default.

d. It is reasonable to assume, based on the facts and circumstances that exist at lease inception, that the event of default will not occur.

If any of the above conditions were not met under ASC 840, a lessee determining the lease classification was required to include, in its minimum lease payments, the maximum potential amount that it could owe under the default provision. This requirement applied to both the lessee's and the lessor's classification evaluation.

The guidance in ASC 840 on nonperformance-related default provisions was not carried over to ASC 842. Thus, an entity no longer has to include these amounts in its lease payments when determining its lease classification from the perspective of either the lessee or the lessor.

While these provisions are no longer expected to affect the classification of the lease, it will nonetheless be important to monitor compliance with the provisions since their occurrence can trigger payment obligations for the lessee. We believe that these payments will often represent variable lease payments given that they arise on the basis of changes in facts and circumstances occurring after the commencement date of the lease. See Section 6.9.1 for guidance on variable lease payments that do not depend on an index or rate and Section 6.10 for guidance on subsequent measurement of lease payments. The guidance on variable lease payments in that section is likely to apply when the default remedy is a one-time payment incurred in the period in which the default provision is violated. If, instead of a one-time payment, the remedy calls for increased payments over some future period (e.g., the remaining term of the lease), it will most likely be necessary to remeasure the lease. See Section 8.5.3 for a discussion of the accounting treatment when variable payments become lease payments on the basis of the resolution of a contingency.
ASC 842 diverges from ASC 840 in how both lessees and lessors allocate consideration and classify the land component of a lease arrangement when the entity accounts for the right to use land separately from the other components in the contract. For more information about how this guidance differs, see Section 4.2.2.

8.3.3.6.1 ImpRACTICABLE TO DETERMINe FAIR VAlue

We believe it would be unlikely that a lessee would not be able to determine the fair value of an underlying asset. Lessees that consider this paragraph to be applicable to their facts and circumstances should consult their accounting advisers.

Q&A 8-7C Lessee’s Determination of the Fair Value of a Portion of a Larger Asset

In determining whether to classify a lease as a finance lease, a lessee must determine whether “the present value of the sum of the lease payments . . . equals or exceeds substantially all of the fair value of the underlying asset” in accordance with ASC 842-10-25-2(d) (see Section 8.3.3.6). Accordingly, when classifying the lease (i.e., as a finance or operating lease), the lessee must determine the fair value of the underlying asset — for use in the fair value test — at the level associated with the identified lease component. This level could be a portion of a larger asset, such as a floor of an office building. If it is impracticable for a lessee to determine the fair value of an underlying asset in accordance with ASC 842-10-55-3, the lessee should assess the lease classification without considering the criterion in ASC 842-10-25-2(d). In this context, “practicable” means that fair value can be reasonably estimated without undue cost or effort.

Consider an example in which a lessee leases space on a cell tower (e.g., a hanger) from an owner/lessor. The individual hanger is the unit of account from a leasing perspective. A similar situation may arise when a lessee leases an individual floor of a building from an owner/lessor. As stated above, when classifying the lease, the lessee must determine the fair value of the underlying asset for use in the fair value test — which would be at the level of the individual hanger or individual floor in these examples — unless it is impracticable to do so.

**Question**

How should a lessee determine the fair value of a portion of a larger asset?
**Answer**

While ASC 842 does not address this issue, we believe that a lessee can use various methods to determine the fair value of a portion of a larger asset, depending on the facts and circumstances. To the extent that the lessee is able to determine the fair value of the entire larger asset (e.g., a cell tower or building, as described in the examples above), it may be appropriate to use an “allocation approach” to allocate the fair value of the larger asset to the respective portions of the larger asset that are being leased.

For example, the fair value of the larger asset could be proportionately allocated — on the basis of the perceived value of the individual leasable spaces — to the individual portions of the larger asset. When this method is used, other conditions that may be more representative of the fair value of the leased asset should be considered. In a building, for instance, higher floors are often more desirable, have a higher stand-alone selling price, and are leased at a higher cost to the lessee than lower floors. In such circumstances, use of an appropriate allocation method would result in the allocation of a greater fair value to the higher floors. Such an allocation would better represent the economics of the individual lease arrangements and better reflect the fair value of each respective portion.

Likewise, we believe that an entity that is estimating the fair value of a portion of a larger asset should consider the intended use of the asset. It is also important not to confuse relative fair value with relative construction or replacement costs. In the cell tower example described above, while the percentage of the costs for the individual hangers may not be disproportionately high compared with the cost of the overall structure, it is likely that the hangers in the aggregate account for most of the fair value of the tower since they represent its revenue-producing parts. In other words, we would sometimes expect the fair value of discrete portions of a larger asset to be disproportionately compared with that of the entire asset on a space or square-footage basis when the relative revenue-producing potential of the discrete portions is taken into account.

We believe that a lessee should generally be able to determine the fair value of a portion of an underlying asset. Further, we would expect that a lessee that can estimate the fair value of the larger asset (which will often be the case) would typically be able to reasonably allocate an appropriate percentage of that fair value to the portion being leased without undo cost or effort.

8.3.3.6.2 Investment Tax Credits

<table>
<thead>
<tr>
<th><strong>ASC 842-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-8</strong> 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 be reduced by any related investment tax credit retained by the lessor and expected to be realized by the lessor.</td>
</tr>
</tbody>
</table>

When an entity applies the “present value” test, the fair value of the underlying asset would be reduced by any investment tax credits since these are linked to the ownership of the asset and are retained by the lessor.

**Changing Lanes — Classification of the Land Component Under ASC 840**

ASC 842 diverges from ASC 840 in how both lessors and lessees allocate consideration and classify the land component of a lease arrangement when the entity accounts for the right to use land separately from the other components in the contract. For more information about how this guidance differs, see Section 4.2.2.
8.3.3.7 Underlying Asset Is Specialized and Has No Alternative Use to the Lessor at the End of the Lease Term

**ASC 842-10**

**25-2** A lessee shall classify a lease as a finance lease . . . when the lease meets any of the following criteria at lease commencement: . . .

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.

**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 lessee would “classify a lease as a finance lease” if, at lease commencement, 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 basis for this determination is that when an underlying asset has no alternative use to the lessor at the end of a lease term, it is presumed that the lessee will consume all (or substantially all) of the benefits of the asset.

**Changing Lanes — New Lease Classification Criterion**

The new lease classification criterion in ASC 842-10-25-2(e) has not been previously applied in practice under U.S. GAAP and is not expected to frequently be met in isolation. We do not believe that this criterion should be interpreted as applying to situations in which the underlying asset is near the end of its economic life and the lessee, by virtue of the lease, therefore has obtained all of the use of the asset so that it has “no alternative use.” Rather, the application of this criterion is intended to identify situations in which the lessee uses all of the asset's economic benefits because the asset is so specialized for that particular lessee that the lessor would not be expected to generate economic benefit from the asset's use outside of the lease.

**Connecting the Dots — Meeting the Criterion in ASC 842-10-25-2(e)**

It is unlikely that the criterion in ASC 842-10-25-2(e) would be met in isolation because a lessor economically would not enter into an arrangement in which it would not be compensated to obtain a worthless asset at the end of a lease term. However, if a lease is structured with entirely variable lease payments (and the lease therefore does not meet the criterion in ASC 842-10-25-2(d)), the lease may be more likely to meet the criterion in ASC 842-10-25-2(e) in isolation.
8.3.4 Classification Reassessment Requirements

After the lease commencement date, if a lease is modified and that modification is not accounted for as a separate contract, both the lessee and the lessor must reassess lease classification as of the effective date of the modification. Similarly, a lessee must also reassess lease classification when there is a change in the lease term or in the lessee’s conclusion about whether exercise of a purchase option is reasonably certain. When reassessing lease classification, an entity should consider the facts and circumstances that exist as of the reassessment date, as required by ASC 842-10-25-1 and ASC 842-10-25-9. For example, an entity would consider the fair value and the remaining economic life of the underlying asset as of the effective date of a modification not accounted for as a separate contract or (for a lessee) as of the date on which there is a change in the lease term or in the lessee’s conclusion regarding the exercise of a purchase option. See Q&A 8-7D below for considerations related to the fair value classification test upon a lease classification reassessment.

Q&A 8-7D Lease Classification Reassessment — How an Entity Considers Unamortized Balances When Performing the Fair Value Classification Test

When performing the fair value classification test in reassessing the classification of a lease, an entity should include all the remaining lease payments (as defined by ASC 842-10-30-5), along with any residual value guaranteed by the lessee that is not already reflected in the remaining lease payments, in accordance with ASC 842-10-25-2(d). However, questions have arisen regarding whether an entity, when performing the fair value classification test, should include in the lease payments the unamortized balances of any prepaid or accrued lease payments and the unamortized balance of any lease incentives.

Question

In reassessing lease classification, should an entity take into account the unamortized balance of any prepaid or accrued lease payments and the unamortized balance of any lease incentives when assessing whether the criterion in ASC 842-10-25-2(d) related to substantially all of the fair value of the underlying asset is met?

Answer

Yes. ASC 842-10-25-1 states, in part, “When an entity (that is, a lessee or lessor) is required to reassess lease classification, the entity shall reassess classification of the lease on the basis of the facts and circumstances (and the modified terms and conditions, if applicable) as of the date the reassessment is required.” The facts and circumstances as of the date of the lease classification reassessment include the unamortized balance of any prepaid or accrued lease payments and the unamortized balance of any incentives paid by the lessor to the lessee. That is, if the unamortized balances were not present (e.g., a prepaid lease payment did not exist or was never required to be paid), the modification would most likely have resulted in different negotiated terms. Accordingly, an entity should consider the unamortized balance of any prepaid items when performing the fair value classification test. As discussed in Section 8.3.3.6, an entity also considers such prepaid items when classifying a lease at commencement.
Example

Lessee enters into a 10-year lease of a nonspecialized asset. Lease payments are $50,000 per month, payable at the beginning of the month, plus a one-time payment at lease commencement of $1,000,000. The lease does not transfer ownership of the underlying asset or grant the lessee an option to purchase the underlying asset or renew the lease. At lease commencement, the remaining economic life of the underlying asset is 20 years, and the fair value of the underlying asset is $6,500,000. Lessee's incremental borrowing rate is 3 percent. At lease commencement, the sum of the present value of the lease payments (including the one-time payment at lease commencement) is $6,191,033, which is substantially all of the fair value of the underlying asset (i.e., 95.2 percent). Accordingly, the lease is classified as a finance lease.

At the beginning of year 2, the lease is modified in such a way that the monthly lease payments are reduced by 5 percent (i.e., remaining lease payments are $47,500 per month). The fair value of the underlying asset is $5,750,000. The unamortized balance of the prepaid lease payment (included in the ROU asset) is $900,000. Lessee's incremental borrowing rate is 3.1 percent. As of the effective date of the modification, the sum of the present value of the lease payments (including the unamortized balance of the prepaid lease payment) is $5,383,070, which is substantially all of the fair value of the underlying asset (i.e., 93.6 percent). Accordingly, the lease continues to be classified as a finance lease.

It would be inappropriate for the lessee to disregard the unamortized balance of the prepaid lease payment when determining the present value of the lease payments, since this balance is part of the consideration in the arrangement that is associated with the ongoing lease as of the effective date of the modification. The sum of the present value of the remaining lease payments (without considering the unamortized balance of the prepaid lease payment) is $4,483,070, which is not substantially all of the fair value of the underlying asset (i.e., 78 percent). Accordingly, if the lessee would have disregarded the unamortized balance of the prepaid lease payment, the lease classification would have inappropriately changed to an operating lease classification.

Connecting the Dots — Consideration of Facts and Circumstances Existing as of the Reassessment Date

ASU 2016-02, as originally drafted, was not clear on whether a lessee is required to reassess lease classification on the basis of the facts and circumstances existing as of the reassessment date. In response to stakeholder feedback on this matter, in July 2018, the FASB issued ASU 2018-10, which, among other amendments, added the following passage to ASC 842-10-25-1:

> When an entity (that is, a lessee or lessor) is required to reassess lease classification, the entity shall reassess classification of the lease on the basis of the facts and circumstances (and the modified terms and conditions, if applicable) as of the date the reassessment is required (for example, on the basis of the fair value and the remaining economic life of the underlying asset as of the date there is a change in the lease term or in the assessment of a lessee option to purchase the underlying asset or as of the effective date of a modification not accounted for as a separate contract in accordance with paragraph 842-10-25-8).

See Section 17.3 for additional information on FASB standard-setting activity related to ASC 842.

8.3.5 Other Considerations Related to Lease Classification

8.3.5.1 Lease of an Acquiree

ASC 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.
ASC 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)).

**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.

As noted above, for leases acquired as the result of “a business combination or an acquisition by a not-for-profit entity,” lease classification will not be revisited unless the lease contract is modified “and that modification is not accounted for as a separate contract.” If there is a modification as of or after the business combination, the acquiree will need to reevaluate lease classification in accordance with the lease modification guidance (see Section 8.6 for additional considerations).

**Q&A 8-8  Accounting for Leases Acquired in a Business Combination**

**Question**

How should an acquirer classify and recognize leases acquired in a business combination?

**Answer**

**Classification**

An acquiree’s classification of its leases is not reconsidered in a business combination unless the lease agreement is modified as part of the business combination and that modification is not accounted for as a separate contract. Therefore, the acquiree’s classification of its lease agreements generally carries over to the acquiring entity.

If the terms of a lease agreement are modified as part of the business combination and the modification is not accounted for as a separate contract in accordance with ASC 842-10-25-8, the lease is classified as of the acquisition date by using the modified terms.

**Recognition**

In accordance with ASC 805-20-25-28A, the acquirer should recognize assets and liabilities arising from leases (both operating and financing type) of an acquiree in accordance with ASC 842. Notwithstanding the requirement in ASC 805-20-25-28A, an acquirer may elect, as an accounting policy, not to recognize assets and liabilities arising from leases of an acquiree if both of the following conditions are met: (1) the acquiree is the lessee and (2) the remaining term of the lease, as of the acquisition date, is one year or less.
Measurement

The acquirer in a business combination should apply the guidance in paragraph BC415 of ASU 2016-02 when measuring the assets and liabilities resulting from leases (both operating and financing type) in which the acquiree is a lessee. Paragraph BC415 of ASU 2016-02 states:

The Board decided that when the acquiree in a business combination is a lessee, the acquirer should measure the acquiree’s lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the date of acquisition. Measuring the acquired lease as if it were a new lease at the date of acquisition includes undertaking a reassessment of all of the following:

- The lease term
- Any lessee options to purchase the underlying asset
- Lease payments (for example, amounts probable of being owed by the lessee under a residual value guarantee)
- The discount rate for the lease.

The acquiree's right-of-use asset should be measured at the amount of the lease liability, adjusted for any off-market terms (that is, favorable or unfavorable terms) present in the lease. Prepaid or accrued rent should not be recognized because such amounts do not meet the definition of an asset or a liability in Concepts Statement 6 under the acquisition method of Topic 805, Business Combinations. Instead, the remaining lease payments required under the terms of the lease are considered in evaluating whether the terms of the lease are favorable or unfavorable at the acquisition date.

Further, as discussed in paragraph BC416 of ASU 2016-02, the Board had considered whether, when the acquiree is a lessee, the acquirer should apply the general principle in ASC 805 and therefore measure the ROU assets and lease liabilities at fair value. However, the Board believed that the costs of obtaining information about fair value in such circumstances would outweigh the benefits. Rather, the Board decided that the acquirer should reassess the key inputs (i.e., lease term, purchase options, lease payments, and discount rate) as of the acquisition date to measure the ROU asset and lease liability.

For additional information on accounting for leases acquired in a business combination, see Section 4.3.11.1 of Deloitte's *A Roadmap to Accounting for Business Combinations*.

Q&A 8-8AA  Accounting for Leases Acquired in a Business Combination When It Is Reasonably Certain That the Acquirer Will Exercise a Purchase Option in an Acquired Operating Lease

As discussed in Q&A 8-8, the acquirer in a business combination retains the original classification of an acquired lease if the lease is not modified as a result of the acquisition. Upon acquisition, the acquirer should measure the acquired lease as if it were a new lease and recognize a lease liability and ROU asset in an amount determined, in part, on the basis of the remaining lease term and remaining lease payments. These payments include the lease payment associated with a purchase option that the acquirer is deemed reasonably certain to exercise, regardless of whether the acquiree concluded that such exercise was reasonably certain to occur at lease commencement. Thus, there may be circumstances in which exercise...
of a purchase option is determined to be reasonably certain but the lease is classified as an operating lease because it retains its legacy classification.\(^4\)

Consider the following scenario:

- Company P obtains control of Company D in an acquisition that is accounted for as a business combination under ASC 805-10.
- Acquired assets include an existing lease for office space in which D is the lessee.
- The office space lease has a fixed-price purchase option; D determined that exercise of the option at lease commencement was not reasonably certain.
- The lease is classified as an operating lease and the lease is not modified as a result of the business combination. Accordingly, P retains the operating lease classification in accordance with ASC 842-10-55-11.
- As of the acquisition date, the lease has a remaining contractual lease term of four years, with no termination options. The remaining useful life of the asset as of the acquisition date is 10 years.
- The annual lease payments are $50,000 for the lease’s remaining contractual term. The lease payments are deemed consistent with current market rates.
- The lease has a purchase option at the end of the contractual term for an amount of $150,000. Company P has determined that it is reasonably certain that it will exercise this purchase option upon completion of the contractual term.
- Company P’s incremental borrowing rate is 5 percent as of the acquisition date.

Upon acquisition, P will record a lease liability and ROU asset of $300,703 on the basis of the present value of the remaining annual lease payments and the exercise price of the purchase option. Because control of the leased asset will ultimately be transferred to P upon exercise of the purchase option, this lease would have been classified as a finance lease in the absence of the requirement to retain lease classification in a business combination. However, because the lease is not modified as a result of the acquisition, it retains its operating lease designation.

When it is reasonably certain that a purchase option will be exercised, a lessee will typically classify the lease as a finance lease and would thus amortize the asset in accordance with the framework for subsequent measurement of a finance lease. ASC 842-20-35-8 explains this subsequent measurement:

\[
\text{A lessee shall amortize the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the right-of-use asset to the end of the useful life of the underlying asset.}
\]

However, the concept of amortizing a ROU asset through the end of the useful life of an underlying asset that extends beyond the contractual term is not contemplated for operating leases under ASC 842, since a purchase option that the lessee is reasonably certain to exercise would typically disqualify the lease for operating lease treatment. Thus, questions have arisen

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\(^4\) While this Q&A addresses purchase options that an acquirer is reasonably certain to exercise, similar circumstances may arise when renewal options exist that, if exercised, would cause the lease to be classified as a finance lease if it were not for the guidance in ASC 842-10-55-11. Under ASC 805-20-30-24, such extension options constitute part of the acquirer’s “new” lease term if the exercise of such options is reasonably certain as of the acquisition date. Accordingly, both elements of the single lease expense (interest and amortization of the ROU asset) would be recognized over the extended term. With respect to straight-line expense recognition over that term, the lessee should apply one of the approaches described in Example 8-8.
regarding whether the ROU asset should be amortized over the remaining contractual term of the lease or over the remaining useful life of the underlying asset when an acquirer in a business combination concludes that it is reasonably certain to exercise a purchase option in an operating lease.

**Question 1**

Over what term should the ROU asset be amortized?

**Answer**

The ROU asset should be amortized over the remaining useful life of the underlying asset, which is 10 years in the scenario discussed above. While the remaining contractual term of the lease in the above example is only four years, the economic substance of the transaction is the acquisition of an asset with a 10-year useful life because it is reasonably certain that the purchase option will be exercised.

Further, ASC 842-10-30-1 through 30-3 describe what periods are considered to be within the lease term, stating that such periods include the noncancelable period and periods covered by an option to extend the lease when the exercise of such options is reasonably certain. An entity should evaluate purchase options in the same manner in which it considers options to extend or terminate the lease. The FASB explained this in paragraph BC218 of ASU 2016-02, which states:

> On reconsideration, in issuing the 2013 Exposure Draft, the Board decided that purchase options should be accounted for in the same way as options to extend the term of a lease (that is, the exercise price of a purchase option would be included in the measurement of lease assets and lease liabilities if the lessee had a significant economic incentive to exercise that option). Topic 842 affirms that decision but, instead, consistent with the Board’s decision about options to extend (or not to terminate) a lease, refers to whether the lessee is reasonably certain to exercise the purchase option on the basis of an evaluation of relevant economic factors. The Board concluded that a purchase option is the ultimate option to extend the lease term. 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. Accordingly, the Board decided that those two options should be accounted for in the same way. [Emphasis added]

Therefore, a lease that includes a purchase option that is reasonably certain to be exercised is similar to a lease containing optional renewal periods that are reasonably certain to be exercised and that would extend the lease to cover the remaining economic life of the asset. In other words, the economics of a lease with a four-year contractual term and a 10-year useful life of the underlying asset are the same regardless of whether the lessee has an option to purchase the asset at the end of the lease term or an option to extend the lease term for an additional six years. In both instances, the lessee is able to direct the use of and obtain benefit from using the asset for a 10-year period. Accordingly, the entity should amortize the ROU asset over 10 years when it is reasonably certain that it will exercise the purchase option.

**Question 2**

How should the amortization of the ROU asset be measured over the underlying asset’s useful life?
**Answer**

We believe that there are two acceptable approaches (described below) for measuring the amortization of the ROU asset over the useful life of the underlying asset when an acquirer in a business combination concludes that it is reasonably certain to exercise a purchase option in an operating lease. The election of either approach is a policy choice that should be consistently applied. Given the complexity of both approaches, entities are encouraged to consult with their accounting advisers in such situations.

**Approach 1: Amortize the ROU Asset by Calculating a Single Lease Expense for the Asset’s Entire Useful Life**

A “straight-line approach” is one way to measure the amortization of the ROU asset to record in each period. Under such an approach, a single lease expense is calculated and the same total expense (i.e., $35,000 in the example above)\(^5\) is recorded in each year of the underlying asset’s 10-year useful life. The amortization of the ROU asset would be lessened by interest expense throughout the contractual term in a manner consistent with the bifurcation of a single lease expense between its interest expense and amortization expense components under an operating lease framework. The remaining ROU asset would be reclassified to PP&E when the purchase option is exercised at the end of year 4. Once the asset is purchased, P should apply the guidance on depreciation in ASC 360-10. Under this approach, the ROU asset at the end of year 4 would have a carrying value of $210,000, which would be depreciated over the remaining six years of the asset’s useful life (or $35,000 per year).

Approach 1 results in greater amortization/depreciation of the asset in the years after the end of the contractual term of the lease. As a result, the carrying value of the asset upon execution of the purchase option may be higher than the purchase option price. While the asset could therefore be recorded at an amount higher than its actual cost (the carrying value of the asset is $210,000 in the above example, while the purchase price is $200,000), we believe that Approach 1 is consistent with the overall straight-line expense approach generally prescribed for operating leases and is acceptable as an application of the single lease cost model throughout the useful life of the asset.

The table below illustrates the straight-line expense approach.

<table>
<thead>
<tr>
<th>Years</th>
<th>Beginning ROU Asset/PP&amp;E Balance</th>
<th>Total Expense</th>
<th>Interest Expense</th>
<th>Amortization/Depreciation</th>
<th>Ending ROU Asset/PP&amp;E Balance</th>
<th>Payment</th>
<th>Beginning Liability Balance</th>
<th>Ending Liability Balance</th>
</tr>
</thead>
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<td>1</td>
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<td>$15,035</td>
<td>$19,965</td>
<td>$280,738</td>
<td>$50,000</td>
<td>$300,703</td>
<td>$265,738</td>
</tr>
<tr>
<td>2</td>
<td>280,738</td>
<td>35,000</td>
<td>13,287</td>
<td>21,713</td>
<td>259,025</td>
<td>50,000</td>
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<td>229,025</td>
</tr>
<tr>
<td>3</td>
<td>259,025</td>
<td>35,000</td>
<td>11,451</td>
<td>23,549</td>
<td>235,476</td>
<td>50,000</td>
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<td>190,476</td>
</tr>
<tr>
<td>4</td>
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<td>35,000</td>
<td>9,524</td>
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<td>—</td>
<td>35,000</td>
<td>105,000</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>9</td>
<td>70,000</td>
<td>35,000</td>
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<td>35,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>35,000</td>
<td>35,000</td>
<td>—</td>
<td>35,000</td>
<td>(0)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^5\) Calculated on the basis of the sum of the total fixed payments of $200,000 (annual fixed payments of $50,000 × 4-year lease term) and the purchase option of $150,000, divided by the 10-year useful life of the underlying asset.
Approach 2: Amortize the ROU Asset by Reference to the Outcome That Would Have Resulted From a Finance Lease

A second approach to measuring the amortization of the ROU asset would be to calculate the amortization in such a way that the ending ROU asset at the end of the contractual lease term (i.e., when the purchase option is exercised) would be the same ending balance as if the lease had been classified as a finance lease (in which case the ROU asset would be amortized on a straight-line basis over the useful life of the underlying asset). Once the purchase option is exercised, the carrying value would then be transferred to PP&E and depreciated in accordance with ASC 360-10. Although this approach results in the same ROU asset balance at the end of the lease term as if the lease were a finance lease, because the lease must be accounted for as an operating lease, P would need to adjust the relative amount of amortization taken during each year of the lease term to maintain an overall straight-line lease expense (including both interest and amortization) over the lease term. As a result of this approach, the entire financing component (i.e., interest) of the asset’s acquisition would be accounted for during the lease term while the single lease cost framework for the acquired operating lease would be preserved but would feature different straight-line expense amounts before and after the purchase of the underlying asset.

Under this approach, P will recognize a single lease expense over the four-year lease term that will result in the ending ROU asset balance of $180,422 ([$300,703 ÷ 10-year useful life] × 6-year life remaining) at the end of year 4. This balance would correspond to the ending balance of a ROU asset calculated under the finance lease expense methodology. However, although the average amortization of the ROU asset is $30,070 per year during the lease term, the amortization in each year is adjusted to maintain an overall straight-line lease expense during the lease term. As with Approach 1, the ROU asset would be reclassified to PP&E once the purchase option is exercised at the end of year 4 and would be depreciated over its remaining useful life in accordance with ASC 360-10. Provided that a straight-line depreciation method is selected, P would record depreciation expense of $30,070 each year over the remaining useful life of the asset (consistent with the average annual amortization during the lease term).

This approach results in recognition during the lease term of all of the interest expense, together with a proportional amount of the asset amortization/depreciation, while only the depreciation of the asset is recognized after the lease term. Accordingly, this approach results in a higher cost recorded during the contractual lease term than Approach 1. This second approach is illustrated in the table below.
### Years

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$300,703</td>
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<td>$15,035</td>
<td>$27,359</td>
<td>$273,343</td>
<td>$50,000</td>
<td>$300,703</td>
<td>$265,738</td>
</tr>
<tr>
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<td>42,395</td>
<td>13,287</td>
<td>29,108</td>
<td>244,236</td>
<td>50,000</td>
<td>265,738</td>
<td>229,025</td>
</tr>
<tr>
<td>3</td>
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<td>42,395</td>
<td>11,451</td>
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<td>50,000</td>
<td>229,025</td>
<td>190,476</td>
</tr>
<tr>
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<td>213,292</td>
<td>42,395</td>
<td>9,524</td>
<td>32,871</td>
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<td>(0)</td>
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<td>30,070</td>
<td>120,281</td>
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<tr>
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<td>30,070</td>
<td>90,211</td>
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<tr>
<td>8</td>
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<td>—</td>
<td>—</td>
<td>30,070</td>
<td>60,141</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>60,141</td>
<td>—</td>
<td>—</td>
<td>30,070</td>
<td>30,070</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>30,070</td>
<td>—</td>
<td>—</td>
<td>30,070</td>
<td>—</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Calculated on the basis of the sum of the ROU asset’s total amortization of $120,281 (average annual amortization of approximately $30,070 × 4-year lease term) and total interest expense of $49,297, divided by the 4-year lease term.

We believe that the approaches described and illustrated above are acceptable in these circumstances and are in keeping with the straight-line expense recognition guidance applicable to operating leases. ASC 842 does not explicitly acknowledge or address such a scenario; therefore, there may be other acceptable approaches. Companies contemplating an approach other than the two discussed above are encouraged to consult with their auditors or accounting advisers.

**Q&A 8-8A Determining Lease Classification When a Lease Is Acquired in an Asset Acquisition**

ASC 842 does not provide guidance on how an entity should determine lease classification when a lease is acquired in an asset acquisition. In the absence of guidance specific to asset acquisitions, entities have considered whether it is appropriate to retain the previous lease classification of the seller or to reassess the lease classification.

**Question**

How should an entity determine lease classification when a lease is acquired in an asset acquisition?

**Answer**

We believe that there are two acceptable alternatives: an entity can either (1) retain the previous classification of the seller or (2) reassess the lease classification. Application of more than one alternative in the same asset acquisition transaction would not be expected.
Retain Previous Lease Classification

We believe that it would be acceptable to analogize to the business combination guidance in ASC 842-10-55-11, which requires that the previous lease classification be retained unless there is a lease modification and that modification is not accounted for as a separate contract:

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 this alternative, an entity would not reassess the lease classification when a lease is acquired in an asset acquisition, provided that only the identity of the lessee or lessor, but not any other provisions of the lease, is changed. In these circumstances, an entity views the asset acquisition as a continuation of the historical lease agreement.

ASC 842-20-20 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.” We do not believe that a change only in the parties to a lease is contemplated in this definition, since such a change does not alter scope or consideration.

Reassess Lease Classification

We also believe that it would be acceptable to reassess lease classification by considering each lease acquired as a new lease on the date of the asset acquisition. The fact that the FASB provided specific guidance related to business combinations but did not extend that guidance to asset acquisitions may indicate that the Board did not intend for entities to use the same approach for asset acquisitions. In addition, unlike an acquiring entity in a business combination, an acquiring entity in an asset acquisition may not have the information necessary to determine the original classification of the lease. Under this alternative, an acquiring entity in an asset acquisition would reassess lease classification as of the acquisition date since that date marks the entity's first involvement with the lease (i.e., it is a new lease from the acquiring entity's perspective).

8.3.5.2 Related-Party Leases

As indicated in ASC 842-10-55-12, related-party leases (leases between parties under common control) should be classified in the same manner as leases between unrelated parties (i.e., on the basis of the legally enforceable terms and conditions of the lease). Specifically, ASC 842-10-55-12 states:

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.

See Section 13.2 for additional information on related-party leases.

Q&A 8-9 Accounting for Leases Between Parties Under Common Control

Parties under common control often enter into intercompany agreements, some of which could meet the definition of a lease under ASC 842 (regardless of whether they are formally documented).
The guidance in ASC 842 on accounting for related-party leases is limited to that in ASC 842-10-55-12 (see above) and paragraph BC374 of ASU 2016-02, which states:

The Board decided that the recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties on the basis of legally enforceable terms and conditions of the arrangement, acknowledging that some related party transactions are not documented and/or the terms and conditions are not at arm's length. In addition, lessees and lessors are required to apply the disclosure requirements for related party transactions in Topic 850. In previous GAAP, entities were required to account for leases with related parties on the basis of the economic substance of the arrangement, which may be difficult when there are no legally enforceable terms and conditions of the arrangement. Examples of difficulties include related party leases that are month to month and related party leases that have payment amounts dependent on cash availability. In these situations, it is difficult and costly for preparers to apply the recognition and measurement requirements. Even when applied, the resulting information often is not useful to users of financial statements.

While the guidance on accounting for related-party leases appears to be clear — that is, an entity would not impute provisions that do not legally exist or cannot be enforced — questions have arisen regarding whether terms that are outside of the lease agreement create legally enforceable terms and conditions that would be considered part of the lease.

**Question**

Would the “legally enforceable terms and conditions” of a lease between entities under common control include explicit or implicit terms that are outside of the formal lease contract (either written or oral)?

**Answer**

It depends. The accounting for a lease depends on the enforceable rights and obligations of each party as a result of the contract. This principle applies irrespective of whether such rights or obligations are included in the contract or explicitly or implicitly provided outside of the contract (i.e., there may be enforceable rights or obligations that extend beyond the written lease contract).

While it is clear that the FASB wanted to minimize the cost and complexity of the accounting for leases between parties under common control by limiting the application of the guidance in ASC 842 to rights and obligations that are enforceable (i.e., the parties would not impute any terms or otherwise be required to deviate from the enforceable terms to reflect the substance of the arrangement), we do not think that it would be appropriate to ignore any facts and circumstances related to rights and obligations outside of a lease contract. That is, terms and conditions not written in an agreement or that are included in contracts separate and apart from the lease contract may create enforceable rights and obligations for the parties subject to the lease. For example, while the term of an arrangement may be explicitly limited to six months, factors outside the contract may indicate that the term is longer.

The determination of whether terms and conditions not written in a lease agreement create enforceable rights and obligations to the parties subject to the lease involves judgment and, in some cases, may involve legal questions that should be evaluated with the assistance of legal counsel.

**Changing Lanes — Legally Enforceable Terms Versus Arrangement Substance**

Under ASC 842, leases between related parties are accounted for in a manner consistent with all other leases on the basis of the legally enforceable terms and conditions of the lease. This guidance differs from ASC 840, under which an entity considers not only the agreement’s legally enforceable terms and conditions but also its overall substance.
### 8.3.5.3 Leases Involving Facilities Owned by a Governmental Unit or Authority

**ASC 842-10**

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-13</td>
<td>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:</td>
</tr>
<tr>
<td>a.</td>
<td>The underlying asset is owned by a governmental unit or authority.</td>
</tr>
<tr>
<td>b.</td>
<td>The underlying asset is part of a larger facility, such as an airport, operated by or on behalf of the lessor.</td>
</tr>
<tr>
<td>c.</td>
<td>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.</td>
</tr>
<tr>
<td>d.</td>
<td>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.</td>
</tr>
<tr>
<td>e.</td>
<td>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.</td>
</tr>
<tr>
<td>f.</td>
<td>The underlying asset or equivalent asset in the same service area cannot be purchased or leased from a nongovernmental unit or authority. An equivalent asset in the same service area is an asset 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.</td>
</tr>
<tr>
<td>55-14</td>
<td>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.</td>
</tr>
</tbody>
</table>

Leases involving terminal space and certain other facilities owned by a governmental unit or authority (e.g., those at airports, bus terminals, and ports) may be subject to special lease classification considerations. For example, as discussed above, it may not be possible to identify the economic life of the underlying asset or practical to determine the fair value of the underlying asset. In such cases, the lease should be accounted for as an operating lease. As described above, the default to operating lease treatment is limited to leases of underlying assets that meet the specific conditions in ASC 842-10-55-13; otherwise, a lessee would apply the lease classification criteria that apply to leases of non-government-owned property.

### 8.3.5.4 Lessee Indemnification for Environmental Contamination

**ASC 842-10**

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-15</td>
<td>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.</td>
</tr>
</tbody>
</table>
Contracts that are or contain a lease may include a clause that will indemnify a lessor for any environmental contamination associated with the leased asset, irrespective of whether the contamination resulted from the lessee’s use of the underlying asset over the lease term or from a preexisting condition. This type of indemnification (1) would be considered variable and therefore has no impact on lease classification and (2) would signify that the lessee is retaining certain risks and rewards, which by themselves would not be indicative of control.

8.4 Recognition and Measurement

ASC 842 introduces a lessee model under which all leases except those subject to the short-term lease exemption are recognized on the balance sheet.

This section addresses phases 1 through 4 of the lease “life cycle.” That is, it provides an overview of the guidance that a lessee would evaluate when determining (1) the lease inception and commencement dates, (2) how to initially recognize and measure a lease, (3) how to subsequently measure a lease, and (4) how to account for the impairment of an ROU asset (when applicable).

### 8.4.1 Lease Inception and Lease Commencement

#### 8.4.1.1 Lease Inception

Lease inception is the date on which the terms of the contract are agreed to and the agreement creates enforceable rights and obligations. At lease inception, an entity must evaluate whether a contract is or contains a lease. See Chapter 3 for additional information on identifying a lease.

#### 8.4.1.2 Lease Commencement Date

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-19</strong> 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).</td>
</tr>
<tr>
<td><strong>55-20</strong> The contract may require the lessee to make lease payments only after construction is completed and the lessee begins operations. Alternately, 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.</td>
</tr>
<tr>
<td><strong>55-21</strong> 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.</td>
</tr>
</tbody>
</table>
The ASC master glossary defines the commencement date of the lease as the “date on which a lessor makes an underlying asset available for use by a lessee.” Although a contract may explicitly define a date that meets the legal definition of the “lease commencement date” with respect to identifying when rent will need to be paid, that date may not necessarily meet the accounting definition of the commencement date of the lease. This is because, from an accounting perspective, the lease commencement date is linked to when the underlying asset is made available for use by the lessee and this date may sometimes differ from the explicit contract commencement date and is not always aligned with the date on which payment commences.

**Example 8-5**

**Determining the Lease Commencement Date**

Retailer enters into an arrangement to lease retail space from Landlord for a period of 10 years. According to the legal contract terms, the commencement date of the lease will be June 30, 20X2. At that point, Retailer is expected to commence its retail operations and will begin making the contractually required lease payments. Landlord has agreed to give Retailer access to the property starting on March 1, 20X2, so that Retailer can make the necessary leasehold improvements to the space before commencing commercial operations.

In this scenario, although the contract explicitly defines the legal lease commencement as June 30, 20X2, the lease commencement date for accounting purposes would be March 1, 20X2, since Landlord has made the underlying asset available for Retailer’s use as of that date.

**Connecting the Dots — Recognition and Disclosure Requirements Before Lease Commencement**

Although there is no recognition or measurement of leases before lease commencement, ASC 842-20-50-3(b) requires the disclosure of “[i]nformation about leases that have not yet commenced but that create significant rights and obligations for the lessee.” See Section 15.2.2 for more information.

In addition, as indicated in paragraph BC182 of ASU 2016-02, “if the costs of meeting an obligation under the lease exceed the economic benefits expected from the lease, an entity should consider the guidance in Topic 450 on contingencies.” As a result, the lessee may be required to recognize a liability after lease inception but before the lease commencement date.

**Changing Lanes — Initial Measurement of a Lease**

A lease is initially recognized at lease commencement under ASC 840 and ASC 842. However, the inputs used to initially measure the lease under ASC 840 and ASC 842 are determined at different times. For example, under ASC 840, inputs such as discount rate and fair value, as well as the lease classification itself, are determined at lease inception; however, under ASC 842, the inputs and lease classification are determined at lease commencement. As a result, there could be differences between the initial recognition of a lease under ASC 842 and that under ASC 840.
8.4.2 Initial Recognition and Measurement of the Lease

<table>
<thead>
<tr>
<th>ASC 842-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-1 At the commencement date, a lessee shall recognize a right-of-use asset and a lease liability.</td>
</tr>
<tr>
<td>30-1 At the commencement date, a lessee shall measure both of the following:</td>
</tr>
<tr>
<td>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)</td>
</tr>
<tr>
<td>b. The right-of-use asset as described in paragraph 842-20-30-5.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>30-4 See Example 2 (paragraphs 842-20-55-17 through 55-20) for an illustration of the requirements on the discount rate.</td>
</tr>
<tr>
<td>30-5 At the commencement date, the cost of the right-of-use asset shall consist of all of the following:</td>
</tr>
<tr>
<td>a. The amount of the initial measurement of the lease liability</td>
</tr>
<tr>
<td>b. Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received</td>
</tr>
<tr>
<td>c. Any initial direct costs incurred by the lessee (as described in paragraphs 842-10-30-9 through 30-10).</td>
</tr>
<tr>
<td>30-6 See Example 3 (paragraphs 842-20-55-21 through 55-39) for an illustration of the requirements on lessee measurement of the lease term.</td>
</tr>
</tbody>
</table>

All leases (finance and operating leases), other than those that qualify for (and for which an entity elected to apply) the short-term recognition exemption, must be recognized as of the lease commencement date on the lessee’s balance sheet. Accordingly, at this time, a lessee will recognize a liability for its obligation related to the lease and a corresponding asset representing its right to use the underlying asset over the period of use. In addition to the below discussion of the initial determination of the lease liability and ROU asset, Example 3 in ASC 842 (reproduced in Section 8.9.1) illustrates the initial measurement of the lease liability and ROU asset for both finance and operating leases. Further, Example 4 in ASC 842 (reproduced in Section 8.9.1) comprehensively illustrates the initial measurement and subsequent measurement of the lease liability and ROU asset for an operating lease.

8.4.2.1 Initial Determination of the Lease Liability

Discount rate used to determine present value is either the rate implicit in the lease or the lessee’s incremental borrowing rate (see Section 7.2).
Irrespective of whether a lease is classified as an operating lease or a finance lease, a lessee must recognize a lease liability and measure this liability at the present value of lease payments not yet paid (see Chapter 6 for additional discussion of lease payments). This value should be discounted by using an appropriate discount rate. When calculating the discount rate used to initially measure the lease liability, the lessee must use information that is available as of the lease commencement date (see Chapter 7 for more information about the discount rate).

### 8.4.2.2 Initial Determination of the ROU Asset

In addition to recognizing the lease liability, a lessee will recognize a corresponding asset representing its right to use the underlying asset over the lease term. The ROU asset is initially measured as follows:

\[
\text{ROU Asset} = \text{Lease Liability} + \text{Initial Direct Costs} + \text{Prepaid Lease Payments} - \text{Lease Incentives Received}
\]

<table>
<thead>
<tr>
<th>ROU Asset Components</th>
<th>Description</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>Present value of lease payments not yet paid</td>
<td>8.4.2.1</td>
</tr>
<tr>
<td><strong>Plus: Initial direct costs</strong></td>
<td>Costs that are directly attributable to negotiating and arranging the lease that would not have been incurred had the lease not been executed (e.g., commissions paid, payments made to an existing tenant to incentivize that tenant to terminate its lease)</td>
<td>6.11</td>
</tr>
<tr>
<td><strong>Plus: Prepaid lease payments</strong></td>
<td>Any lease payments made to the lessor before or at the commencement of the lease</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Less: Lease incentives received</strong></td>
<td>Include both payments made by the lessor to or on behalf of the lessee and any losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party</td>
<td>6.2.2</td>
</tr>
</tbody>
</table>

**Changing Lanes — Consideration of Asset’s Fair Value**

ASC 840 explicitly prohibited the recognition of a capital lease asset in an amount greater than the fair value of the underlying asset. By contrast, lease measurement under ASC 842 may result in the recognition of an ROU asset whose carrying amount is greater than the fair value of the underlying asset. Therefore, insofar as a triggering event occurs that would cause a lessee to test the underlying asset for recoverability under ASC 360, the underlying asset or related asset group could be impaired. See Section 8.4.4 for a discussion of the requirements related to testing the ROU asset for impairment. Also see Q&A 16-4A in Section 16.3.1.1.2 for considerations related to the impact of “hidden” impairments upon adoption of ASC 842.
Example 8-6

Initial Measurement of the Lease Liability and ROU Asset

Lessee enters into a five-year contract with Supplier for the right to use specified machinery over the lease term. The contract meets the definition of a lease and only includes a single lease component. As a result, Lessee needs to determine the lease liability and ROU asset resulting from the lease at lease commencement.

The facts relevant to determining the initial measurement of the lease liability and ROU asset are as follows:

<table>
<thead>
<tr>
<th>Fixed payments</th>
<th>$15,000 per year paid in arrears (increasing by 2.5 percent each year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Renewal/termination/purchase option</td>
<td>None</td>
</tr>
<tr>
<td>Transfer of ownership</td>
<td>No</td>
</tr>
<tr>
<td>Residual value guarantee</td>
<td>None</td>
</tr>
<tr>
<td>Incremental borrowing rate*</td>
<td>6.5 percent</td>
</tr>
<tr>
<td>Initial direct costs</td>
<td>$750</td>
</tr>
<tr>
<td>Cash incentive received</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

* The discount rate used by a lessee should be the rate implicit in the lease unless this rate is not readily determinable, in which case the lessee would use its incremental borrowing rate. In this scenario, assume that the rate implicit in the lease is not readily determinable.

Lease Liability Calculation

At commencement, the initial measurement of the lease liability (regardless of lease classification) is calculated as the present value of the lease payments not yet paid by using the lease term and discount rate determined at lease commencement. As illustrated below, the information relevant to determining the lease liability is the lease term of five years, lease payments that increase by 2.5 percent in each period, and the lessee’s incremental borrowing rate.

<table>
<thead>
<tr>
<th>Year 1</th>
<th>$ 15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 2</td>
<td>15,375</td>
</tr>
<tr>
<td>Year 3</td>
<td>15,759</td>
</tr>
<tr>
<td>Year 4</td>
<td>16,153</td>
</tr>
<tr>
<td>Year 5</td>
<td>16,557</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 78,844</strong></td>
</tr>
</tbody>
</table>
Example 8-6 (continued)

**ROU Asset Calculation**

At commencement, the initial measurement of the ROU asset (regardless of lease classification) is calculated as the lease liability, increased by any initial direct costs and prepaid lease payments, reduced by any lease incentives received before commencement.

The information relevant to determining the ROU asset includes the lease liability of $65,328, increased by the initial direct costs of $750 and lease payments made before lease commencement (there are no prepayments in this example), and reduced by lease incentives received of $2,500.

\[
\text{ROU Asset} = \text{Lease Liability} + \text{Initial Direct Costs} - \text{Lease Incentives Received}
\]

\[
\begin{align*}
\text{ROU Asset} & = \$63,578 \\
\text{Lease Liability} & = \$65,328 \\
\text{Initial Direct Costs} & = \$750 \\
\text{Lease Incentives Received} & = \$2,500
\end{align*}
\]

**Recognizing the Lease Liability and ROU Asset (Journal Entries)**

As a result of the above calculations, at lease commencement the lessee would recognize the following amounts in its general ledger:

- ROU asset: $63,578
- Cash (for incentive): $2,500
- Cash (for initial direct costs): $750
- Lease liability: $65,328

Q&A 8-9A Accounting for Lease Incentives When Lease Payments Are Highly or Totally Variable

A lessor sometimes provides a lessee with a lease incentive to entice the lessee into leasing the underlying asset (e.g., the lessor may provide the lessee with funding for the construction of certain lessee-specific leasehold improvements). Lease incentives are a component of lease payments, which, as described in ASC 842-10-30-5(a), include “[f]ixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee” (emphasis added). ASC 842 also explicitly indicates that lease incentives that the lessee receives on or before the lease commencement date would be accounted for as a reduction of the ROU asset in accordance with ASC 842-20-30-5, which states:

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). [Emphasis added]
In certain arrangements, when the payment structure of the lease is such that the fixed lease payments are minimal or zero (e.g., a retail store lease in which the lessee pays the lessor a percentage of the gross sales as rent), the lease liability and ROU asset balance, as calculated at lease commencement, may not be significant or may equal zero. While ASC 842 clearly stipulates that lease incentives should be accounted for as a reduction of the ROU asset when the ROU asset is initially measured (either directly or through a reduction in the fixed lease payments), ASC 842 is silent on how an entity should account for lease incentives when the lease payments are highly or totally variable in such a way that reducing the ROU asset would result in a negative balance.

**Question**

How should a lessee account for lease incentives when the lease payments in the agreement are highly or totally variable in such a way that reducing the ROU asset would result in a negative balance?

**Answer**

To the extent that lease incentives received from the lessor are greater than the ROU asset balance (before adjusting for the lease incentives), a lessee should reduce the ROU asset down to zero and recognize the difference as a liability, because it would be inappropriate to recognize a negative ROU asset. This liability should be reversed on a straight-line basis over the lease term and should be recognized as a reduction of lease cost.

**Example**

Assume the following facts:

- Lessee enters into a lease agreement with Lessor for the use of building space for a 10-year term.
- According to the agreement, before the lease commencement date, Lessor will provide Lessee with a $1.25 million tenant incentive for Lessee to use in building out the space.
- Over the lease term, Lessee is not required to pay any fixed lease payments for use of the property; however, Lessee is required to pay 2 percent of gross sales, which is recognized as variable lease cost in each period.

In this example, because the payment structure is such that there are no fixed lease payments to be paid by Lessee, Lessee would not recognize a lease liability or ROU asset as of the lease commencement date. Rather, Lessee would be required to recognize a variable lease cost in the form of 2 percent of gross sales in each period. Because no ROU asset is recognized at lease commencement, the $1.25 million tenant incentive received would be recognized as a liability rather than as a reduction of the ROU asset. After lease commencement, the incentive liability would be reversed and recognized as a reduction of lease cost on a straight-line basis over the lease term. Lessee would therefore record the following journal entry for each year:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incentive liability</td>
<td>125,000</td>
</tr>
<tr>
<td>Lease cost</td>
<td>125,000</td>
</tr>
</tbody>
</table>

This Q&A is applicable regardless of whether the lease incentive is paid or payable at commencement or is contingent on a future event. See Q&A 8-13 for our views on acceptable approaches to estimating and accounting for contingent lease incentives. To the extent that the initial recognition of a contingent lease incentive would result in a negative ROU asset, the guidance in this Q&A would be applicable.
Q&A 8-9B  Lessee’s Accounting for Costs Related to Shipping, Installation, and Other Similar Items When the Lessor Does Not Provide Such Activities

After lease inception, a lessee may incur certain costs for shipping, installing, and performing other services to ready the leased asset for its intended use (e.g., site preparation). When the lessee pays the lessor to perform activities necessary to ready the leased asset for its intended use, such activities do not represent nonlease components in the contract, because the lessee is not receiving a separate service from the lessor in connection with these activities. Rather, these activities are necessary to fulfill the lease. Because these activities do not represent a nonlease component, any payments made by the lessee to the lessor should be included in the lessee’s lease payments (unless there are nonlease components in the contract to which a portion of the payments should be allocated).

Although ASC 842 provides guidance on how a lessee should account for payments made to a lessor to perform fulfillment activities necessary to ready the leased asset for its intended use, ASC 842 is less clear on how a lessee should account for such costs when it pays a third party (unrelated to the lessor) to perform these activities after lease inception.

Question 1

How should a lessee account for costs incurred to compensate a third party for shipping, installing, and performing other services to ready the leased asset for its intended use?

Answer

While ASC 842 provides guidance on how a lessee should account for initial direct costs, the definition of initial direct costs focuses on incremental costs that a lessee (or lessor) incurs to negotiate and obtain a lease (this focus is similar to that in the definition of incremental costs to obtain a contract with a customer in ASC 340-40). Because shipping and installation represent activities performed to ready the leased asset for its intended use and are incurred after the lease has been obtained, we generally do not believe that it is appropriate to apply the guidance on initial direct costs in ASC 842 to account for these costs.

On the basis of a technical inquiry with the FASB staff, we understand that, in the absence of explicit cost guidance in U.S. GAAP, including ASC 842, a lessee may elect to use either of the following approaches to account for these costs:

• **Approach A** — Analogize to the measurement guidance in ASC 360 and capitalize the costs as appropriate. ASC 360-10-30-1 states, in part:

  Paragraph 835-20-05-1 states that the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the **condition and location** necessary for its intended use. [Emphasis added]

  Because shipping, installation, and other similar activities are necessary to bring the leased asset to the condition and location necessary for its intended use, we believe that it is appropriate for a lessee to analogize to the guidance in ASC 360 when capitalizing costs incurred to compensate a third party for performing these services.

• **Approach B** — Expense the costs as incurred.

---

7 See ASC 842-10-15-30(b).
8 Although this Q&A focuses on the accounting for a lessee’s costs incurred to compensate a third party to perform these services, we believe that the same considerations would apply to internal costs incurred by a lessee to perform these activities on its own.
In the technical inquiry, the FASB staff indicated that lessees should apply the accounting policy election consistently on an entity-wide basis to all leases and should disclose the accounting policy elected, if material.

The above approaches are consistent with a speech given by Andrew Pidgeon, a professional accounting fellow in the SEC’s Office of the Chief Accountant, at the 2018 AICPA Conference on Current SEC and PCAOB Developments. Mr. Pidgeon stated, in part:

For example, a lessee may pay a party other than the lessor to ship a leased asset to the lessee's premises. Topic 360 would require capitalization of those costs if the lessee purchased the asset. Since the asset is leased, not purchased, the lessee could determine that the costs are in the scope of other GAAP, or it could determine recognition in current period earnings is appropriate. In lieu of recognizing those costs in current period earnings, the staff did not object to a lessee, as an accounting policy election, analogizing to Topic 360 to capitalize costs incurred to place a leased asset into its intended use. [Footnotes omitted]

Question 2
If a lessee applies Approach A above, where on the balance sheet should it present the capitalized costs associated with shipping, installing, and other similar services performed to ready a leased asset for its intended use?

Answer
On the basis of the technical inquiry with the FASB staff, we understand that a lessee may elect, as an accounting policy, to present the capitalized costs associated with shipping, installing, and other similar services performed to ready a leased asset for its intended use as either a separate asset within PP&E or as part of the related ROU asset (thereby increasing the ROU asset).

Regardless of the presentation elected by the lessee, we would not expect a difference in the total expense recognition pattern, and the capitalized costs should be included in the same asset group as the ROU asset when impairment testing is performed under ASC 360.

A lessee should apply its accounting policy consistently on an entity-wide basis to all leases and should disclose the accounting policy elected, if material.

8.4.3 Subsequent Measurement

While the requirements for initial recognition and measurement of the lease liability and ROU asset are the same for every lease regardless of whether it is classified as a finance lease or an operating lease, the subsequent measurement and related expense profile differ on the basis of the lease classification. That is, finance leases generally have a front-loaded expense recognition profile (see Section 8.4.3.1 for additional details) and operating leases have a straight-line expense recognition profile (see Section 8.4.3.2 for additional details). The following graph compares these two recognition profiles:
The discussion below describes the accounting requirements related to, and includes examples illustrating, the subsequent measurement of both finance and operating leases. Note that Section 8.9 also includes examples from ASC 842 that illustrate the subsequent measurement of finance and operating leases. Specifically, Example 3 (ASC 842-20-55-22 and ASC 842-20-55-30, reproduced in Section 8.9.1) and Example 4 (ASC 842-20-55-41 through 55-46, reproduced in Section 8.9.1), depict the initial and subsequent measurement of the lease liability and ROU asset.

**8.4.3.1 Subsequent Measurement of a Finance Lease**

**ASC 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.

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.

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.
ASC 842-20 (continued)

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.

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.

After lease commencement, a lessee measures its lease liability by using the effective interest rate method. That is, in each period, the liability will be increased to reflect the interest that is accrued on the related liability by using the appropriate discount rate, offset by a decrease in the liability resulting from the periodic lease payments.

The lessee's recognition of the ROU asset after lease commencement will be similar to that for other nonfinancial assets. That is, the lessee would generally recognize the ROU asset at cost, reduced by any accumulated amortization and accumulated impairment losses.

The ROU asset itself is amortized on a straight-line basis unless another systematic method better reflects how the underlying asset will be used by and benefit the lessee over the lease term. The period over which the underlying asset will be amortized is the shorter of (1) the useful life of the underlying asset or (2) the end of the lease term. Two exceptions to this principle are situations in which the lease agreement includes a provision that either (1) results in the transfer of ownership of the underlying asset to the lessee at the end of the lease term or (2) includes a purchase option whose exercise by the lessee is reasonably certain. In either of these scenarios, the ROU asset should be amortized over the useful life of the underlying asset.

Together, the interest and amortization expense components result in a front-loaded expense profile similar to that of a capital lease arrangement under ASC 840. Lessees would separately present the interest and amortization expenses in the income statement.

Example 8-7 illustrates the subsequent measurement of a finance lease. For an additional illustration of such measurement, see Example 3 in ASC 842 (ASC 842-20-55-27 and ASC 842-20-55-30, reproduced in Section 8.9.1).
Example 8-7

Subsequent Measurement of a Finance Lease

Assume the same facts as in Example 8-6. Further, assume that after evaluating the lease classification on the commencement date, Lessee concludes that the lease should be classified as a finance lease. As a result of this determination, Lessee would subsequently account for the lease liability and ROU asset in the following manner:

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Liability</th>
<th></th>
<th>ROU Asset</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Beginning Balance</td>
<td>Interest Expense</td>
<td>Lease Payment</td>
<td>Ending Balance</td>
</tr>
<tr>
<td>1</td>
<td>$65,328</td>
<td>$4,246</td>
<td>$(15,000)</td>
<td>$54,574</td>
</tr>
<tr>
<td>2</td>
<td>54,574</td>
<td>3,547</td>
<td>$(15,375)</td>
<td>42,746</td>
</tr>
<tr>
<td>3</td>
<td>42,746</td>
<td>2,778</td>
<td>$(15,759)</td>
<td>29,765</td>
</tr>
<tr>
<td>4</td>
<td>29,765</td>
<td>1,935</td>
<td>$(16,153)</td>
<td>15,547</td>
</tr>
<tr>
<td>5</td>
<td>15,547</td>
<td>1,010</td>
<td>$(16,557)</td>
<td>—</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.

Subsequent Measurement of Lease Liability

The lease liability at any given time is accounted for by using the effective-interest method. Under this approach, the liability is adjusted to reflect an increase for the periodic interest expense (calculated by using the discount rate determined at lease commencement), reduced by the lease payment.

In this example, the discount rate used to determine the interest expense for each given period is the lessee’s incremental borrowing rate of 6.5 percent.

Subsequent Measurement of ROU Asset

The ROU asset at the end of any given period is calculated as the ROU asset at the beginning of the period, reduced by the periodic amortization of the ROU asset. In a manner consistent with the amortization approach for other nonfinancial assets, the ROU asset is amortized in each period on a straight-line basis unless another systematic basis is more representative of the pattern in which the lessee expects to consume the ROU asset’s future economic benefits.

Journal Entries

As a result of the above calculations, during the first year of the lease, Lessee would recognize the following amounts in its general ledger (note that only year 1 entries have been included):

Year 1

| ROU asset amortization expense | 12,716 |
| ROU asset — accumulated amortization | 12,716 |
| Interest expense | 4,246 |
| Lease liability | 10,754 |
| Cash — lease payment | 15,000 |
8.4.3.2 Subsequent Measurement of an Operating Lease

ASC 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.

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.

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.

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.

After lease commencement, a lessee is required to measure its lease liability for each period at the present value of any remaining lease payments, discounted by using the rate determined at lease commencement. Effectively, this approach is consistent with the model used to calculate the liability related to the finance lease (i.e., lease liabilities are subsequently measured the same way regardless of lease classification). That is, in each period, the liability will reflect an increase for interest that is accrued on the related liability by using the appropriate discount rate, offset by a decrease resulting from the periodic lease payments.
For an operating lease, the subsequent measurement of the ROU asset is linked to the amount recognized as the lease liability (unless the ROU asset is impaired). Accordingly, the ROU asset would be measured as the lease liability adjusted by (1) accrued or prepaid rents (i.e., the aggregate difference between the cash payment and straight-line lease cost), (2) remaining unamortized initial direct costs and lease incentives, and (3) impairments of the ROU asset.

After lease commencement and over the lease term, a lessee would recognize, in the income statement, (1) a single lease cost calculated in a manner that results in the allocation of the remaining lease costs over the remaining lease term, either on a straight-line basis or another systematic or rational basis that is more representative of the pattern in which the underlying asset is expected to be used; (2) variable lease payments not recognized in the measurement of the lease liability in the period in which the related obligation has been incurred; and (3) any impairment of the operating lease ROU asset.

**Connecting the Dots — Overview of the “Plug” Approach**

While the ASU discusses subsequent measurement of the ROU asset arising from an operating lease primarily from a balance sheet perspective, a simpler way to describe it would be from the standpoint of the income statement. Essentially, the goal of operating lease accounting is to achieve a straight-line expense pattern over the term of the lease (provided that there is not a more representative pattern of consumption of the benefit). Accordingly, an entity effectively takes into account the interest on the liability (i.e., the lease obligation consistently reflects the lessee’s obligation on a discounted basis) and adjusts the amortization of the ROU asset to arrive at a constant expense amount. To achieve this, the entity first determines the straight-line expense amount by taking total payments over the life of the lease, net of any lessor incentives, plus initial direct costs, divided by the lease term. Then, the entity calculates the interest on the liability by using the discount rate for the lease and deducts this amount from the required straight-line expense amount for the period. This difference is simply “plugged” as amortization of the ROU asset. By using this method, the entity recognizes a single operating lease expense rather than separate interest and amortization charges, although the effect on the lease liability and ROU asset on the balance sheet reflects a bifurcated view of the expense. Under this method, the amortization of the ROU asset generally increases each year as the liability accretion decreases as a result of a declining lease liability balance.

Example 8-8 illustrates the subsequent measurement of an operating lease. For additional illustrations, see Example 3 (ASC 842-20-55-29 and 55-30, reproduced in Section 8.9.1.1) and Example 4 (ASC 842-20-55-41 through 55-46, reproduced in Section 8.9.1.2), which depict the subsequent (Example 3) and initial and subsequent (Example 4) measurement of the lease liability and ROU asset for an operating lease.
Example 8-8

Subsequent Measurement of an Operating Lease

Assume the same facts as in Example 8-6. Further, assume that upon evaluating the lease classification on the commencement date, Lessee concludes that the lease should be classified as an operating lease. As a result of this determination, Lessee would subsequently account for the lease liability and ROU asset by using one of two approaches, each of which results in the same outcome:

Approach A: ROU Asset Balance Derived From Lease Liability

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Cost</th>
<th>Lease Liability</th>
<th>ROU Asset Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Straight-Line Recognition</td>
<td>Present Value of Remaining Payments</td>
<td>A Liability Balance</td>
</tr>
<tr>
<td>1</td>
<td>$15,419</td>
<td>$54,574</td>
<td>$54,574</td>
</tr>
<tr>
<td>2</td>
<td>15,419</td>
<td>42,746</td>
<td>42,746</td>
</tr>
<tr>
<td>3</td>
<td>15,419</td>
<td>29,765</td>
<td>29,765</td>
</tr>
<tr>
<td>4</td>
<td>15,419</td>
<td>15,547</td>
<td>15,547</td>
</tr>
<tr>
<td>5</td>
<td>15,419</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.

* The prepaid/accrued lease payment balance at any given time is the aggregate total of the straight-line lease payment balance less the aggregate lease payment balance.
** The unamortized balance of initial direct costs at any given time equals the prior-year balance, adjusted by $150 (or 20 percent of the initial balance of initial direct costs).
*** The unamortized incentive balance at any given time equals the prior-year balance, adjusted by $500 (or 20 percent of the initial lease incentive balance).

Approach B: Application of the “Plug” Approach

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Liability</th>
<th>ROU Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A (Beginning Balance)</td>
<td>A (Ending Balance)</td>
</tr>
<tr>
<td>1</td>
<td>$65,328</td>
<td>$4,246</td>
</tr>
<tr>
<td>2</td>
<td>54,574</td>
<td>3,547</td>
</tr>
<tr>
<td>3</td>
<td>42,746</td>
<td>2,778</td>
</tr>
<tr>
<td>4</td>
<td>29,765</td>
<td>1,935</td>
</tr>
<tr>
<td>5</td>
<td>15,547</td>
<td>1,010</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.

Lease Cost

After lease commencement, a lessee would recognize a single lease cost in the income statement, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis unless there is another systematic and rational basis that better reflects how the benefits of the underlying asset are consumed over the lease term.
Example 8-8 (continued)

In this example, the total remaining lease cost on the commencement date would be $77,094, which is calculated as the total lease payments (including those that have been paid and those that have not yet been paid) increased by initial direct costs and reduced by any incentives paid or payable to the lessee (fixed payments of $78,844 plus the $750 in initial direct costs less the $2,500 incentive). Generally, the total lease payments would be adjusted by the prior-period lease costs (which are zero in this example).

The resulting remaining lease cost is recognized on a straight-line basis over the remainder of the lease term (i.e., Lessee would recognize $15,419\(^9\) in each period, which is calculated as $77,094 ÷ 5).

<table>
<thead>
<tr>
<th>Lease Payments</th>
<th>Remaining Lease Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1: $15,000</td>
<td>Total lease payments: $78,844</td>
</tr>
<tr>
<td>Year 2: 15,375</td>
<td>+ Unamortized initial direct costs: 750</td>
</tr>
<tr>
<td>Year 3: 15,759</td>
<td>- Lease incentives: (2,500)</td>
</tr>
<tr>
<td>Year 4: 16,153</td>
<td>- Prior-period lease costs: 0</td>
</tr>
<tr>
<td>Year 5: 16,557</td>
<td>Remaining Lease Cost: $77,094</td>
</tr>
<tr>
<td><strong>Total</strong> $78,844</td>
<td></td>
</tr>
</tbody>
</table>

Subsequent Measurement of Lease Liability

The lease liability for an operating lease at any given time is calculated as the present value of the lease payments not yet paid, discounted by using the rate that was established on the lease commencement date (unless the rate was adjusted as a result of a liability remeasurement event).

In this example, Lessee will measure the remaining lease payments at present value at the end of any given period by using the incremental borrowing rate of 6.5 percent, which was established at lease commencement.

Subsequent Measurement of ROU Asset (Approach A)

The ROU asset, at any given time, is measured as the amount of the lease liability, adjusted by (1) prepaid or accrued rents, (2) any unamortized initial direct costs, and (3) the remaining balance of any lease incentives received (gross amount received net of amount already recognized as part of the single lease costs).

In this example, Lessee will measure its ROU asset at the end of each period as the lease liability, adjusted by the prepaid/accrued rent, any unamortized initial direct costs, and any unamortized incentives received by the lessee.

Subsequent Measurement of ROU Asset (Approach B)

The ROU asset, at any given time, is measured as the ROU asset balance at the beginning of the period, adjusted by the current-period ROU asset amortization, which is calculated as the current-period lease cost adjusted by the lease liability accretion to the then outstanding lease balance (i.e., the increase in the liability as a result of applying the commencement-date discount rate).

In this example, which illustrates the accounting for period 1, Lessee will calculate the ROU balance of $52,405 at the end of period 1 in the following manner:

\[
\begin{align*}
\text{ROU Asset at the End of Period 1} &= \text{ROU Asset at the Beginning of Period 1} - \text{Straight-Line Lease Cost for Period 1} + \text{Lease Liability Accretion for Period 1} \\
&= \$52,405 - \$15,419 + \$4,246 \\
&= \$63,578
\end{align*}
\]

\(^9\) Answer is rounded.
Example 8-8 (continued)

**Journal Entries**

As a result of the above calculations, during the first year of the lease, Lessee would recognize the following amounts in its general ledger (note that only period 1 entries have been included):

<table>
<thead>
<tr>
<th>Period 1</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease cost</td>
<td>15,419</td>
</tr>
<tr>
<td>ROU asset reduction</td>
<td>11,173</td>
</tr>
<tr>
<td>Lease liability</td>
<td>4,246</td>
</tr>
<tr>
<td>Lease liability reduction</td>
<td>15,000</td>
</tr>
<tr>
<td>Cash</td>
<td>15,000</td>
</tr>
</tbody>
</table>

**Q&A 8-9C Subsequent Measurement of an Operating Lease When the ROU Asset Would Be Reduced Below Zero Because of Accrued Rent**

At lease commencement, the ROU asset is measured as the lease liability adjusted by (1) accrued or prepaid rents, (2) initial direct costs, and (3) lease incentives received. In subsequently measuring an operating lease, an entity must use an amortization method that achieves a straight-line expense profile. An accrued rent balance is established when escalating lease payments are present for a portion of the lease term (e.g., fixed lease payments in early years are lower than those in later years). In a long-term lease with escalating lease payments (e.g., a 40-year ground lease), the adjusting amount for accrued rent can be greater than the lease liability balance. Accordingly, a question arises about how to subsequently measure the ROU asset, since it would be reduced below zero. That is, the cumulative lease payments less the cumulative straight-line expense recognized (i.e., accrued rent) can be greater than the lease liability balance; as a result, the ROU asset is reduced below zero.

**Question**

When applying the subsequent-measurement guidance related to an operating lease, how should a lessee account for the ROU asset when the cumulative lease payments less the cumulative straight-line expense recognized (i.e., accrued rent) are greater than the lease liability?

**Answer**

We believe that when the ROU asset would be reduced below zero because the cumulative lease payments less the cumulative straight-line expense recognized (i.e., accrued rent) are greater than the lease liability, the ROU asset should be reclassified and presented as a liability and the straight-line expense should not be disrupted. Thereafter, when the balance of the ROU asset returns to a positive amount, the balance should be reverted to its original classification (i.e., should be presented again as an ROU asset). We think that this approach is appropriate because we do not believe that it is appropriate to present a negative ROU asset, thereby offsetting other positive ROU assets. Similarly, we do not believe that it would be appropriate to adjust the discount rate (i.e., impute a lower discount rate) in these situations to “solve” for this problem (i.e., disallow the ROU asset from becoming negative).

---

10 See **Q&A 16-3A** for a discussion of operating leases that would result in a negative ROU asset as of the date of initial application because of a large accrued rent balance.
Example

Lessee's Accounting for an Operating Lease When the ROU Asset Would Be Reduced Below Zero Because of Accrued Rent

Retail Co. enters into a 20-year agreement to lease land from Land Owner. According to the terms of the agreement, Retail Co. will pay $1,000 in year 1 and the lease payment will double in each subsequent year (i.e., increase by 100 percent compared with the prior year’s lease payment, so in year 2 a payment of $2,000 is due; in year 3, $4,000; in year 4, $8,000; etc.). Retail Co.’s incremental borrowing rate at lease commencement is 8 percent. (Note that Retail Co. cannot readily determine the rate implicit in the lease.) Assume that none of the criteria in ASC 842-10-25-2 are met and that Retail Co. classifies its lease as an operating lease.

At lease commencement, Retail Co. will recognize a lease liability and an ROU asset of $244,531,632, which is calculated as the present value of the remaining lease payments by using the incremental borrowing rate at commencement. In this scenario, the total lease payments over the lease term are $1,048,575,000 ($1,000 in year 1, with a 100 percent escalator each year). The recognition of the total lease payments evenly over the 20 years results in a straight-line rent expense of $52,428,750 per year.

At the end of year 11, the lease liability is equal to $567,935,936 while the embedded accrued rent balance is $574,669,250 ($2,047,000 cumulative lease payments less $576,716,250 cumulative straight-line expense recognized). As a result, at the end of year 11, without adjustment, the ROU asset would be negative $6,733,314 ($567,935,936 lease liability less $574,669,250 of embedded accrued rent). Therefore, in accordance with this Q&A, we believe that at the end of year 11, an adjustment to presentation is necessary. Accordingly, the ROU asset is presented as $0 and a liability of $6,733,314 is presented. See the illustration in the table below.

---

11 This example contains an extreme rent escalation to highlight the issue. While we would not expect such extreme rent escalations to be common in practice, this issue does arise with certain leases, particularly leases of land with long durations (e.g., 100 years).
## Example (continued)

### Large Deferred Balance — 20-Year Lease

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Payment</th>
<th>Straight-Line Recognition</th>
<th>Lease Liability Ending Balance</th>
<th>Cumulative Lease Payment</th>
<th>Cumulative Straight-Line Expense</th>
<th>Difference (i.e., Embedded Accrued Rent Balance)</th>
<th>ROU Asset Ending Balance</th>
<th>Liability Ending Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$1,000</td>
<td>$52,428,750</td>
<td>$244,531,632</td>
<td>$1,000</td>
<td>$52,428,750</td>
<td>$(52,427,750)</td>
<td>$211,665,412</td>
<td>$—</td>
</tr>
<tr>
<td>1</td>
<td>2,000</td>
<td>285,218,615</td>
<td>308,032,104</td>
<td>3,000</td>
<td>104,857,500</td>
<td>(104,854,500)</td>
<td>180,364,115</td>
<td>$—</td>
</tr>
<tr>
<td>2</td>
<td>4,000</td>
<td>332,666,673</td>
<td>392,524,115</td>
<td>7,000</td>
<td>157,286,250</td>
<td>(157,279,250)</td>
<td>150,752,854</td>
<td>$—</td>
</tr>
<tr>
<td>3</td>
<td>8,000</td>
<td>392,524,115</td>
<td>487,790,081</td>
<td>15,000</td>
<td>209,715,000</td>
<td>(209,707,000)</td>
<td>122,666,737</td>
<td>$—</td>
</tr>
<tr>
<td>4</td>
<td>16,000</td>
<td>437,627,064</td>
<td>593,095,434</td>
<td>31,000</td>
<td>262,143,750</td>
<td>(262,137,750)</td>
<td>97,151,257</td>
<td>$—</td>
</tr>
<tr>
<td>5</td>
<td>32,000</td>
<td>526,814,755</td>
<td>620,258,697</td>
<td>63,000</td>
<td>314,572,500</td>
<td>(314,564,500)</td>
<td>73,463,257</td>
<td>$—</td>
</tr>
<tr>
<td>6</td>
<td>64,000</td>
<td>617,426,755</td>
<td>679,880,888</td>
<td>127,000</td>
<td>367,001,250</td>
<td>(367,005,250)</td>
<td>52,072,257</td>
<td>$—</td>
</tr>
<tr>
<td>7</td>
<td>128,000</td>
<td>679,880,888</td>
<td>740,605,746</td>
<td>255,000</td>
<td>419,430,000</td>
<td>(419,428,000)</td>
<td>33,159,757</td>
<td>$—</td>
</tr>
<tr>
<td>8</td>
<td>256,000</td>
<td>740,605,746</td>
<td>800,504,708</td>
<td>511,000</td>
<td>471,858,750</td>
<td>(471,855,750)</td>
<td>16,917,764</td>
<td>$—</td>
</tr>
<tr>
<td>9</td>
<td>512,000</td>
<td>740,605,746</td>
<td>856,510,504</td>
<td>1,023,000</td>
<td>524,287,500</td>
<td>(524,285,500)</td>
<td>3,550,255</td>
<td>$—</td>
</tr>
<tr>
<td>10</td>
<td>1,024,000</td>
<td>856,510,504</td>
<td>953,734,258</td>
<td>2,047,000</td>
<td>576,716,250</td>
<td>(576,704,250)</td>
<td>6,733,314</td>
<td>$—</td>
</tr>
<tr>
<td>11</td>
<td>2,048,000</td>
<td>953,734,258</td>
<td>1,054,751,516</td>
<td>4,095,000</td>
<td>629,145,000</td>
<td>(629,133,000)</td>
<td>13,727,189</td>
<td>$—</td>
</tr>
<tr>
<td>12</td>
<td>4,096,000</td>
<td>1,054,751,516</td>
<td>1,162,967,036</td>
<td>8,191,000</td>
<td>681,573,750</td>
<td>(681,561,750)</td>
<td>17,250,114</td>
<td>$—</td>
</tr>
<tr>
<td>13</td>
<td>8,192,000</td>
<td>1,162,967,036</td>
<td>1,275,189,056</td>
<td>16,383,000</td>
<td>734,002,500</td>
<td>(734,000,500)</td>
<td>17,188,254</td>
<td>$—</td>
</tr>
<tr>
<td>14</td>
<td>16,384,000</td>
<td>1,275,189,056</td>
<td>1,397,573,112</td>
<td>32,767,000</td>
<td>786,431,250</td>
<td>(786,429,250)</td>
<td>13,582,504</td>
<td>$—</td>
</tr>
<tr>
<td>15</td>
<td>32,768,000</td>
<td>1,397,573,112</td>
<td>1,530,341,224</td>
<td>65,535,000</td>
<td>838,860,000</td>
<td>(838,858,000)</td>
<td>6,804,714</td>
<td>$—</td>
</tr>
<tr>
<td>16</td>
<td>65,536,000</td>
<td>1,530,341,224</td>
<td>1,686,900,238</td>
<td>131,071,000</td>
<td>891,287,750</td>
<td>(891,285,750)</td>
<td>2,088,159</td>
<td>$—</td>
</tr>
<tr>
<td>17</td>
<td>131,072,000</td>
<td>1,686,900,238</td>
<td>1,828,072,262</td>
<td>262,144,000</td>
<td>943,717,500</td>
<td>(943,715,500)</td>
<td>10,643,811</td>
<td>$—</td>
</tr>
<tr>
<td>18</td>
<td>262,144,000</td>
<td>1,828,072,262</td>
<td>2,090,216,325</td>
<td>524,287,000</td>
<td>996,146,250</td>
<td>(996,144,250)</td>
<td>13,592,602</td>
<td>$—</td>
</tr>
<tr>
<td>19</td>
<td>524,288,000</td>
<td>2,090,216,325</td>
<td>2,614,505,350</td>
<td>—</td>
<td>1,048,575,000</td>
<td>(1,048,573,000)</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

In the above illustration, it can be observed that at the end of year 13, the liability will reach its highest point of $17,250,114. Thereafter, the balance of the liability will begin to deplete. At the end of year 17, the lease liability will once again exceed the embedded accrued rent, thereby reinstating a positive ROU asset. That is, the lease liability is equal to $762,305,909, while the embedded accrued rent is $760,217,750. At this point, the liability will have a zero balance and the ROU asset is equal to $2,088,159. By the end of year 20 (i.e., the end of the lease term), the lease liability and ROU asset will appropriately reduce to zero. The total lease expense recognized over the lease term is $1,048,575,000, which is equal to the total lease payments over the term; further, the straight-line expense of $52,428,750 remained consistent each period.

### 8.4.3.3 Variable Payments Based on the Achievement of a Specified Target

**ASC 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.

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.
A lessee should recognize variable payments before achieving a specified target when the achievement of the target is deemed probable. Variable payments recognized in accordance with ASC 842-20-55-1 would be reversed when achievement of the specified target is no longer deemed probable. As illustrated in Q&A 8-10 below, we believe that this guidance applies when targets are based on cumulative performance during the lease term.

Q&A 8-10  Lessee Timing of Variable Payments

Many lease arrangements contain variable payments based on the use or performance of the underlying asset. Examples include (1) a retail store lease that requires the lessee to pay a percentage of store sales each month, (2) a car lease that requires the driver to pay for each mile driven, and (3) a PPA that requires the lessee (the off-taker) to buy all electricity produced by a weather-dependent generating plant such as a wind farm.

Under ASC 842, variable payments that do not depend on an index or rate are excluded from the initial measurement of the lease liability and ROU asset.

ASC 842-20-25-5(b) (for finance leases) and ASC 842-20-25-6(b) (for operating leases) both state that variable lease payments not included in the initial measurement of the lease should be recognized in profit or loss “in the period in which the obligation for those payments is incurred” (emphasis added). In addition, the implementation guidance in ASC 842-20-55-1 states that 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” (emphasis added).

Question

In a lease arrangement in which the lessee pays a variable amount based on usage or performance, is the lessee required to assess the probability of future performance throughout the lease term and record a charge (and a corresponding liability) for the variable lease payment amount assessed as probable?12

Answer

It depends. We believe that the guidance in ASC 842-20-55-1 on the probable achievement of variable lease payment targets is meant to be narrowly applied to scenarios involving discrete performance targets or milestones that will be achieved over time (e.g., a specified level of cumulative store sales) and, in those limited scenarios, is meant to require recognition in each period over the lease term at an amount that reflects an appropriate apportionment of the expected total lease cost. This guidance ensures that the cost of the lease is appropriately allocated to both the periods of use that contribute to the variable payment requirement and the periods of use in which the variable payment requirement has been met. Such allocation is necessary when performance targets are cumulative and have the potential to cross reporting periods.

---

12 “Probable” is defined as the “future event or events are likely to occur,” in a manner consistent with the term’s meaning in ASC 450 on contingencies.
We do not believe that the guidance on the probable achievement of variable lease payment targets is meant to otherwise require an assessment of a probable level of performance over the lease term and require a charge in advance of actual performance when the variability arises and is resolved within a reporting period. For example, in a vehicle lease, a variable charge per mile driven that starts with the first mile and continues throughout the lease term can be discretely measured and expensed in the reporting period in which the charge is incurred. That is, it is unnecessary to assess the probability of future mileage to ensure proper period attribution of the variable charges. Applying a probability model to this type of variable payment structure could lead to an inappropriate acceleration of variable expense attributable to future use.

The scenarios in the example below illustrate the difference between the treatment of variability when discrete cumulative targets exist and the treatment when the variability is resolved within the reporting period.

<table>
<thead>
<tr>
<th>Example</th>
</tr>
</thead>
</table>
| **Scenario A**  
Retailer X is a lessee in an arrangement in which it is required to pay $500 plus 3 percent of store sales each month over a five-year lease term. Retailer X is not required to forecast its sales over the lease term and accrue for a level of sales that is deemed probable to occur. Rather, each month, X will recognize variable lease expense equal to 3 percent of sales. |

| **Scenario B**  
Utility Y is a lessee in a PPA in which it purchases all of the output from a wind farm owned by an independent power producer (IPP) at a fixed price per MWh. Since the wind farm is 100 percent weather-dependent, Y’s lease payments are 100 percent variable (Y pays only for electricity produced). Studies performed before the wind farm was constructed indicate that there is a 95 percent likelihood that electrical output will equal or exceed 25,000 MWh per month. Despite the very high likelihood (95 percent is well above the “probable” threshold) of a minimum performance level, Y is not required to accrue for a corresponding amount of lease payments (i.e., an expectation of variable lease payments based on future production). Rather, Y will recognize variable lease expense each month as electricity is delivered and billed by the IPP. |

| **Scenario C**  
Retailer Z is a lessee in a five-year operating lease that requires it to pay base rent of $500 per month plus an additional $100 per month beginning when cumulative store sales exceed $100,000. Retailer Z believes that it is probable that this sales target will be achieved by the end of year 2 (i.e., rent will become $600 per month after the target is met).

Retailer Z should quantify the amount that it is probable for the entity to incur on the basis of its achievement of the target ($3,600, or $100 per month for 36 months) and should apportion that amount to each period beginning at commencement. That is, since eventual achievement of the cumulative sales target is deemed probable at commencement, the $3,600 should be recognized ratably over the five-year term (i.e., $500 per month for 24 months plus $600 per month for 36 months, resulting in an expense of $560 per month) even though the target has not yet been achieved. This is an appropriate accounting outcome because sales in years 1 and 2 contribute to the achievement of the target. Accordingly, years 1 and 2 should be burdened by an appropriate amount of the incremental lease expense.

On the basis of the above fact pattern, Z would recognize an incremental lease expense of $60 per month beginning at lease commencement (i.e., $3,600 divided by the 60 months of the lease term) to reflect the expected additional rent associated with the anticipated achievement of the sales target.
In addition, once the target is actually achieved, Z would remeasure the ROU asset and corresponding liability in accordance with ASC 842-10-35-4(b), since it would conclude that 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.”

Provided that Z achieves the sales target as planned at the end of year 2 (assume a 0 percent discount rate for simplicity), Z would recognize the following amounts in its financial statements:

**January 1, 20Y1 (Commencement)**

Initial recognition of the ROU asset and corresponding lease liability (calculated as $500 per month for a five-year period)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROU asset</td>
<td>30,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>30,000</td>
</tr>
</tbody>
</table>

**December 31, 20Y1**

Annual activity (reduction of ROU asset/lease liability and recognition of lease expense)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>6,000</td>
</tr>
<tr>
<td>Lease expense</td>
<td>6,000</td>
</tr>
<tr>
<td>ROU asset</td>
<td>6,000</td>
</tr>
<tr>
<td>Cash</td>
<td>6,000</td>
</tr>
</tbody>
</table>

Recognition and accrual of variable lease expense ($3,600 ÷ 60 months of term) × 12 months per year

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable lease expense</td>
<td>720</td>
</tr>
<tr>
<td>Lease liability — variable lease payments</td>
<td>720</td>
</tr>
</tbody>
</table>

**December 31, 20Y2**

Annual activity (reduction of ROU asset/lease liability and recognition of lease expense)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>6,000</td>
</tr>
<tr>
<td>Lease expense</td>
<td>6,000</td>
</tr>
<tr>
<td>ROU asset</td>
<td>6,000</td>
</tr>
<tr>
<td>Cash</td>
<td>6,000</td>
</tr>
</tbody>
</table>

Recognition and accrual of variable lease expense ($3,600 ÷ 60 months of term) × 12 months per year

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable lease expense</td>
<td>720</td>
</tr>
<tr>
<td>Lease liability — variable lease payments</td>
<td>720</td>
</tr>
</tbody>
</table>

Adjustment of ROU asset and corresponding liability (resolution of contingency)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROU asset</td>
<td>2,160</td>
</tr>
<tr>
<td>Lease liability — variable lease payments</td>
<td>1,440</td>
</tr>
<tr>
<td>Lease liability</td>
<td>3,600</td>
</tr>
</tbody>
</table>
Example (continued)

<table>
<thead>
<tr>
<th>Date</th>
<th>Activity Description</th>
<th>Lease Liability</th>
<th>Lease Expense</th>
<th>ROU Asset</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20Y3</td>
<td>Annual activity (reduction of ROU asset/lease liability and recognition of lease expense post-triggering event)</td>
<td>7,200</td>
<td>6,720</td>
<td>6,720</td>
<td>7,200</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Activity Description</th>
<th>Lease Liability</th>
<th>Lease Expense</th>
<th>ROU Asset</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20Y4</td>
<td>Annual activity (reduction of ROU asset/lease liability and recognition of lease expense post-triggering event)</td>
<td>7,200</td>
<td>6,720</td>
<td>6,720</td>
<td>7,200</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Activity Description</th>
<th>Lease Liability</th>
<th>Lease Expense</th>
<th>ROU Asset</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20Y5</td>
<td>Annual activity (reduction of ROU asset/lease liability and recognition of lease expense post-triggering event)</td>
<td>7,200</td>
<td>6,720</td>
<td>6,720</td>
<td>7,200</td>
</tr>
</tbody>
</table>

**Bridging the GAAP — Target Achievement Under U.S. GAAP Versus That Under IFRS Standards**

Under U.S. GAAP, a lessee is required to recognize costs from variable lease payments in annual and interim periods before the achievement of the specified target if the target is considered probable; however, this guidance does not exist under IFRS 16. Therefore, in such circumstances, the accounting outcome under U.S. GAAP could differ from that under IFRS Standards.

**8.4.3.4 Accounting for Leases With a Nonconsecutive Period of Use**

The ASC master glossary defines “period of use” as “[t]he 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).” Insofar as the lessee concludes that the contract is or contains a lease over the “period of use,” the lease liability and corresponding ROU asset initially would be measured on the basis of the present value of the remaining lease payments that will be received over that nonconsecutive period, discounted by using the appropriate rate at lease commencement (see Section 5.2.4.5 for additional information).
A lessee must also determine how it will subsequently measure the lease. ASC 842-20-25-6(a) states that after the commencement date, the lessee would recognize in profit or loss: "[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" (emphasis added).

Q&A 8-11 Subsequent Measurement for Leases That Include a Term Consisting of Nonconsecutive Periods of Use

**Question**

If a lease grants a lessee the right to use an asset over nonconsecutive periods and is determined to be an operating lease, should the lessee limit the recognition of lease costs to the periods in which it has the right to use the underlying asset?

**Answer**

Yes. The benefit that is expected to be derived from the lessee’s use of the underlying asset is linked directly to the “period of use” associated with the asset. When the period of use includes nonconsecutive periods, the benefit expected to be derived from the lessee’s use of the underlying asset would be recognized only in the periods in which it has the right to use the underlying asset. Therefore, in a manner consistent with the guidance in ASC 842-20-25-6(a), the lessee would recognize a single lease cost in the income statement, calculated so that the remaining cost of the lease is allocated on a straight-line basis over the lease term, which would include the sum of the nonconsecutive periods.

**Example**

**Lessee’s Accounting for an Operating Lease With Nonconsecutive Periods**

Retail Co. enters into a two-year lease agreement with Mall Owner under which Retail Co. will lease a specific store front in the mall from October through December for the holiday seasons ending December 31, 2019, and December 31, 2020.

According to the terms of the agreement, Retail Co. will pay $10,000 per month in each of the three months during those periods. Retail Co.’s incremental borrowing rate at lease commencement is 6 percent. (Note that Retail Co. cannot readily determine the rate implicit in the lease.)

At lease commencement, Retail Co. will recognize a lease liability and ROU asset of $57,679, which is calculated as the present value of the remaining lease payments by using the incremental borrowing rate at commencement (i.e., the $10,000 payments made during the months of October, November, and December for each of the two years ending on December 31, 2019, and December 31, 2020).

Since the underlying asset only benefits the lessee during the months of October, November, and December, it would be appropriate to only recognize a lease cost over these nonconsecutive periods. In this scenario, the total lease payments over the term of the lease term are $60,000 ($10,000 per month × 6 months). The recognition of the $60,000 evenly over the six, nonconsecutive periods of use (i.e., a lease cost of $10,000) results in a lease cost recognition pattern that is representative of the pattern in which the benefit is expected to be derived from the right to use the underlying asset.

See Section 5.2.4.5 for additional information on accounting for an operating lease with nonconsecutive periods and evaluating whether such a lease qualifies as a short-term lease.
### Example (continued)

<table>
<thead>
<tr>
<th>Period</th>
<th>Lease Cost</th>
<th>Lease Liability</th>
<th>ROU Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Straight-Line</td>
<td>Liability</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Recognition</td>
<td>Accretion</td>
<td>Reduction</td>
</tr>
<tr>
<td></td>
<td>Beginning Balance</td>
<td>Liability</td>
<td>Ending Balance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ending Balance</td>
<td></td>
</tr>
<tr>
<td>Oct 2019</td>
<td>$10,000</td>
<td>$57,680</td>
<td>$47,968</td>
</tr>
<tr>
<td></td>
<td>$288</td>
<td>(10,000)</td>
<td>$47,968</td>
</tr>
<tr>
<td>Nov 2019</td>
<td>10,000</td>
<td>47,968</td>
<td>47,968</td>
</tr>
<tr>
<td></td>
<td>240</td>
<td>(10,000)</td>
<td>(9,760)</td>
</tr>
<tr>
<td>Dec 2019</td>
<td>10,000</td>
<td>38,208</td>
<td>38,208</td>
</tr>
<tr>
<td></td>
<td>191</td>
<td>(10,000)</td>
<td>(9,809)</td>
</tr>
<tr>
<td>Jan 2020</td>
<td>—</td>
<td>28,399</td>
<td>28,399</td>
</tr>
<tr>
<td>Feb 2020</td>
<td>—</td>
<td>28,541</td>
<td>28,541</td>
</tr>
<tr>
<td>Mar 2020</td>
<td>—</td>
<td>28,683</td>
<td>28,683</td>
</tr>
<tr>
<td>Apr 2020</td>
<td>—</td>
<td>28,826</td>
<td>28,826</td>
</tr>
<tr>
<td>May 2020</td>
<td>—</td>
<td>28,971</td>
<td>28,971</td>
</tr>
<tr>
<td>Jun 2020</td>
<td>—</td>
<td>29,116</td>
<td>29,116</td>
</tr>
<tr>
<td>Jul 2020</td>
<td>—</td>
<td>29,262</td>
<td>29,262</td>
</tr>
<tr>
<td>Aug 2020</td>
<td>—</td>
<td>29,408</td>
<td>29,408</td>
</tr>
<tr>
<td>Sep 2020</td>
<td>—</td>
<td>29,555</td>
<td>29,555</td>
</tr>
<tr>
<td>Oct 2020</td>
<td>10,000</td>
<td>29,703</td>
<td>29,703</td>
</tr>
<tr>
<td></td>
<td>148</td>
<td>(10,000)</td>
<td>(9,852)</td>
</tr>
<tr>
<td>Nov 2020</td>
<td>10,000</td>
<td>19,851</td>
<td>19,851</td>
</tr>
<tr>
<td></td>
<td>99</td>
<td>(10,000)</td>
<td>(9,901)</td>
</tr>
<tr>
<td>Dec 2020</td>
<td>10,000</td>
<td>9,950</td>
<td>9,950</td>
</tr>
<tr>
<td></td>
<td>50</td>
<td>(10,000)</td>
<td>—</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.

### Lease Cost

In accordance with ASC 842, after lease commencement, a lessee would recognize a single lease cost in the income statement, calculated so that the remaining cost of the lease is allocated over the remaining lease term (but only those periods for which the right to use the asset exists) on a straight-line basis unless there is another systematic and rational basis that better reflects how the benefits of the underlying asset are consumed over the lease term.

Retail Co. recognizes the remaining lease cost equally over each of the six periods, since the sum of the nonconsecutive periods of use represents the lease term (i.e., Retail Co. recognizes $10,000 in each period, which is calculated as $60,000 ÷ 6).

### Subsequent Measurement of Lease Liability

The lease liability for an operating lease in any given period is calculated as the present value of the lease payments not yet paid, discounted by using the rate that was established on the lease commencement date (unless the rate was adjusted as a result of a liability remeasurement event).

In this example, Retail Co. measures the six lease payments at present value by using the commencement-date incremental borrowing rate of 6 percent on the basis of when the payments are paid. For each period, the liability is adjusted to reflect the effect of this discount rate on the outstanding liability. (Note that the liability is accreted each month.) Over the lease term, the lease payments are only applied to the lease liability, and this liability is only reduced, when payments are made (October, November, and December of each year).
8.4.4 Impairment of an ROU Asset

**ASC 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.

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.

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.

35-11 See Example 5 (paragraphs 842-20-55-47 through 55-51) for an illustration of the requirements for impairment of a right-of-use asset.

A lessee must test an ROU asset for impairment in a manner consistent with its treatment of other long-lived assets (i.e., in accordance with ASC 360). If the ROU asset related to an operating lease is impaired, the lessee would amortize the remaining ROU asset in accordance with the subsequent-measurement guidance that applies to finance leases — typically, on a straight-line basis over the remaining lease term (see Section 8.4.3.1). Thus, the operating lease would no longer qualify for the straight-line treatment of total lease expense. However, in periods after the impairment, a lessee would continue to present the ROU asset reduction and interest accretion related to the lease liability as a single line item in the income statement (see Q&A 14-2).
Q&A 8-11A  Impact of a Plan to Abandon the Underlying Leased Asset Before the End of the Lease Term

On January 1, 2020, Company S, a lessee, enters into a lease arrangement with a noncancelable lease term of 10 years and no renewal options. The lease is appropriately classified as an operating lease and therefore will have an overall straight-line expense profile (i.e., the amortization of the ROU asset will be “plugged” in each period to achieve an overall straight-line expense pattern, when combined with interest expense on the lease liability, over the 10-year term). At the end of year 1 (i.e., on January 1, 2021), S decides that it will abandon the leased asset on January 1, 2027, before the end of the lease term. Company S considers that the asset will be abandoned since it will no longer use the asset and does not have the intent and ability to sublease the leased asset (see Q&A 16-5A). We do not believe that it is appropriate to continue to recognize an ROU asset after abandonment because S is no longer obtaining economic benefits from the use of the underlying asset through use or sublease. However, S would still be required to recognize a lease liability equal to the present value of the remaining lease payments under the contract. Further, the ROU asset is part of a larger asset group that is not impaired.

Question
Should S revise the ROU asset’s remaining useful life as of January 1, 2021 (i.e., shorten the remaining useful life to six years)?

Answer
Yes. At the beginning of the second year, the lessee should shorten the remaining useful life of the ROU asset to equal the amount of time remaining before the planned abandonment date. The SEC staff has indicated that an entity should revisit a long-lived asset’s useful life to determine whether it should be adjusted (i.e., shortened to reflect the expected abandonment date). Specifically, ASC 360-10-S99-2 states, in part:

If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance with FASB ASC Topic 250, Accounting Changes and Error Corrections, to reflect the use of the asset over its shortened useful life.

While this guidance was issued in the context of owned assets, we believe that it applies equally to ROU assets.

In addition, paragraph BC255 of ASU 2016-02 contains language indicating that the ROU asset should be zero as of the abandonment date. Paragraph BC255 states, in part:

In the Board’s view, it would be inappropriate to continue to recognize a right-of-use asset from which the lessee does not expect to derive future economic benefits (for example, a right to use a building that the lessee has abandoned) or to recognize that asset at an amount the lessee does not expect to recover. [Emphasis added]

While the guidance is clear on the impact of impairments on the prospective amortization of operating lease ROU assets (see above), we do not believe that it is clear on how an entity should amortize the ROU asset over the shortened remaining useful life in the event of an abandonment plan. Some may view this scenario as akin to an impairment, in which case the remaining balance of the ROU asset on January 1, 2021, would be fully amortized on a straight-line basis over the remaining six years (i.e., the shortened useful life). This amortization profile for the ROU asset, when coupled with the interest expense on the liability (which, in the absence of an early termination of the lease, continues to be recognized by using an effective interest
method throughout the entire remaining lease term), will result in a front-loaded expense profile in a manner similar to that for a finance lease. Others believe that, in the absence of an impairment, S should be allowed to retain an overall straight-line expense profile for the period between the (1) date on which a decision is made regarding the abandonment and (2) actual abandonment date. This would be accomplished by “plugging” the ROU asset amortization amount in each period to achieve an overall straight-line expense recognition profile from January 1, 2021, through January 1, 2027, while ensuring that the ROU asset is fully amortized by that date.

We generally believe that a lessee in an operating lease should only be forced to lose overall straight-line expense recognition in the case of an impairment based on ASC 842-20-25-6. While neither of the approaches described above retains a straight-line expense profile over the full remaining term of the lease, the second approach allows the continuation of straight-line treatment (albeit at a higher amount than that in year 1) through the remaining useful life of the ROU asset. However, given the lack of explicit guidance addressing a planned abandonment scenario, we would accept either of the amortization approaches described in the preceding paragraph.

We are aware that, in practice, there are different views on the accounting implications of a planned abandonment; we therefore encourage affected entities to consult with their auditors and accounting advisers regarding this matter.

**Q&A 8-12  Considerations Related to the Impairment of an ROU Asset**

Under ASC 842, since operating and finance leases are both recorded on a lessee’s balance sheet, the ROU assets associated with both types of leases are subject to the impairment guidance in ASC 360-10-35. That is, when events or changes in circumstances indicate that an ROU asset’s carrying amount may not be recoverable (i.e., impairment indicators exist), an ROU asset (or asset group that includes the ROU asset, referred to interchangeably throughout as an “ROU asset”) should be tested to determine whether there is an impairment.

The impairment test is a two-step process as follows:

- **Step 1** — An entity compares the carrying value of the asset group with the undiscounted cash flows expected to be generated as a result of the asset group’s use and disposal to determine whether the asset group is recoverable (i.e., “the recoverability test”). If the recoverability test fails because the undiscounted cash flows are less than the carrying value of the asset group, the entity must perform step 2. Conversely, when the undiscounted cash flows exceed the carrying value of the asset group, the asset group is recoverable (i.e., there is no impairment) and therefore there is no need to determine whether the carrying value of the asset group exceeds its fair value.

- **Step 2** — An entity determines the fair value of the asset group and recognizes an impairment loss equal to the amount by which the carrying amount of an asset group exceeds its fair value (see ASC 360-10-35-17). However, the impairment loss recorded is limited to the carrying value of the long-lived assets in the asset group, and individual long-lived assets within the asset group cannot be written down below their individual fair values. An entity should determine the fair value in accordance with ASC 820-10 and use the perspective of a market participant.

Because a lessee is required to (1) recognize lease liabilities and ROU assets related to finance leases and operating leases under ASC 842 and (2) subject ROU assets related to both finance leases and operating leases to impairment testing under ASC 360-10, questions have arisen
regarding how a lessee should consider the respective lease liability in determining the carrying value and undiscounted expected future cash flows of the asset group when testing ROU assets for impairment.

**Question 1**

When applying steps 1 and 2 of the ASC 360 impairment test to an asset group that includes an ROU asset related to a finance lease (“finance lease ROU asset”), should a lessee exclude the associated lease liability (“finance lease obligation”) from the carrying value and undiscounted cash flows of the asset group?

**Answer**

Yes. Debt related to the financing of long-lived assets should generally be excluded from the asset group. The entity’s financing decisions should not affect the outcome of the recoverability test or the measurement of the fair value of an impaired long-lived asset. Because the finance lease obligation is excluded from the asset group that includes the finance lease ROU asset, the finance lease payments — both principal and interest — should not reduce the undiscounted expected future cash flows used to test the asset group for recoverability.

Therefore, when conducting the recoverability test for an asset group that includes a finance lease ROU asset, a lessee should exclude both (1) the finance lease obligation from the carrying value of the asset group and (2) the related lease payments from the undiscounted expected future cash flows. This approach is consistent with how an entity conducts the recoverability test for (1) capital lease assets recognized in accordance with ASC 840 and (2) owned long-lived assets financed with debt.

Further, if the asset group fails step 1 of the ASC 360 impairment test, a lessee should also exclude the finance lease obligation from the determination of the fair value of the asset group in step 2.

**Question 2**

When applying step 1 of the ASC 360 impairment test to an asset group that includes an ROU asset related to an operating lease (“operating lease ROU asset”), should a lessee exclude the associated lease liability (“operating lease obligation”) from the carrying value and undiscounted cash flows of the asset group?

**Answer**

Two views have emerged regarding how a lessee should determine the carrying value of an asset group in performing step 1 of the ASC 360 impairment test for its operating leases. We believe that either of the approaches described below is acceptable. Companies should choose an approach and apply it consistently.

- **View 1** — Exclude the operating lease obligation from the carrying value of the asset group. The basis for this view is that while the lease is classified as an operating lease, the arrangement is viewed as a financing transaction. (This view is similar to that when debt is used to acquire a long-lived asset.) Therefore, in a manner consistent with the treatment of the lease obligation for a finance lease (see Question 1 above), the operating lease obligation and related lease payments would be excluded from step 1 of the ASC 360 impairment test. Accordingly, the operating lease payments (both principal and interest)
would not reduce the undiscounted expected future cash flows used to test the asset group for recoverability.

- **View 2** — Include the operating lease obligation in the carrying value of the asset group. Because the lease is classified as an operating lease, the related liability is not considered to be a financial liability. Therefore, the operating lease obligation should be included in the determination of the carrying value of the asset group and the undiscounted expected future cash flows. Accordingly, the operating lease payments should be included as cash outflows in the determination of the undiscounted cash flows for the recoverability test in step 1.

In addition, since the total lease expense in an operating lease is presented as a single line item in the income statement, the lease payments include both an interest component and a principal component. As a result, there are questions regarding whether the cash outflows related to the operating lease obligation should include only the portion related to principal or both principal and interest (i.e., the full payment). The FASB discussed this topic at its November 30, 2016, meeting. The Board generally agreed that lessees should exclude interest payments from calculations of the undiscounted cash flows for step 1 purposes when assessing an asset group for impairment under ASC 360. However, some Board members noted that a lessee's decision to include interest in its impairment analysis could be viewed as an accounting policy election.

Therefore, in applying the ASC 360 recoverability test according to View 2, a lessee can take one of the following two approaches:

- **View 2A** — Include only the principal component of lease payments as cash outflows in the undiscounted cash flows of the asset group. This view takes into account how the undiscounted cash flows of a typical financial liability would be determined, which would only include the principal component of the payments. Therefore, in a manner consistent with ASC 360-10-35-29, a lessee would exclude the interest component of the lease payments from the asset group’s undiscounted cash flows. As indicated above, the Board generally agreed that lessees should exclude interest payments from calculations of the undiscounted cash flows when assessing an asset group for impairment under ASC 360.

- **View 2B** — Include the **total** operating lease payments as cash outflows in the undiscounted cash flows of the asset group. According to this view, the lease liability is not considered to be akin to a financial liability; therefore, in a manner similar to the income statement presentation of operating lease expense as a single lease cost, total operating lease payments are included in the undiscounted cash flows of the asset group.

**Question 3**

When a lessee is required to perform step 2 of the ASC 360 impairment test because the asset group that includes an operating lease ROU asset fails step 1, should the lessee determine the fair value of the asset group by using the same approach it used to apply step 1 (i.e., regarding inclusion or exclusion of the operating lease obligation)?
**Answer**

Yes. We believe that a lessee should apply the same approach (i.e., maintain consistency regarding the inclusion or exclusion of the lease liability) when calculating the fair value of the asset group in step 2 as was used to determine the carrying value of the asset group in step 1. Therefore, if a lessee in an operating lease excluded the lease liability when performing step 1 of the impairment test (i.e., View 1 in Question 2), the lessee should also exclude the lease liability when determining the fair value of the asset group in step 2 of the impairment test. Alternatively, if the lessee included both the ROU asset and lease liability when performing step 1 of the impairment test (i.e., View 2 in Question 2), the lessee should also include both the ROU asset and lease liability when determining the fair value of the asset group in step 2 of the impairment test. Importantly, regardless of whether an entity applied View 2A or 2B in Question 2 above when performing step 1, the total lease payments should be used for step 2 of the impairment test because the cash flows used to determine the asset group’s fair value will be discounted.

**Q&A 8-12A  Asset Group/Lease Component Considerations Related to Subleasing a Portion of a Larger ROU Asset**

**Question**

Should a lessee that leases an asset from a lessor (the “head lease”), and enters into a separate arrangement to sublease a discrete portion of the leased asset, reconsider the asset group and lease components related to the subleased portion of a larger ROU asset?

**Answer**

Yes. When a lessee subleases a discrete portion of a larger asset, the lessee’s reconsideration (as the head lessee/intermediate lessor) of the following may be warranted under the head lease: (1) the asset group for purposes of testing the ROU asset for impairment under ASC 360 and (2) whether there should be a separate ROU asset for the subleased portion of the larger asset (i.e., whether there is more than one lease component in the head lease).

**Example**

A lessee has an existing lease for 10 floors in an office building, which was classified as an operating lease. The lessee subsequently subleases one of the 10 floors to a third party. The sublease is also classified as an operating lease, and the head lessee/intermediate lessor is not relieved of its primary obligation under the head lease with respect to the subleased floor. Upon entering into the head lease, the lessee assumed that the unit of account for recognition of the lease liability and ROU asset was one asset encompassing all 10 floors in the office building. That is, the lessee accounted for the leased asset as one lease component but did not specifically evaluate whether there were one or more lease components, because accounting for the lease would not have differed in this case if multiple lease components had been identified. (See Section 4.2 for additional information related to the identification of lease components.) Because the unit of account is critical to determining an impairment under ASC 360 and allocating consideration under ASC 842, a head lessee/intermediate lessor that subleases a portion of a larger asset should consider whether (1) the subleased asset (one floor) would qualify as its own asset group for impairment testing and (2) the subleased asset should be treated as a separate lease component.
Chapter 8 — Lessee Accounting

The criteria for assessing asset groups for the ASC 360 impairment test differ from those for identifying separate lease components under ASC 842. The identification of an asset group focuses on separately identifiable cash flows that are largely independent of the cash flows of other groups of assets and liabilities. The identification of separate lease components is based on whether an entity meets the two criteria in ASC 842-10-15-28 related to (1) economically benefiting from the right of use on its own or together with other, readily available, resources and (2) whether the right of use is separately identifiable (see Section 4.2.1).

Asset Group Considerations

When a head lessee/intermediate lessor subleases a portion of a larger asset, the determination of the asset group for ROU asset impairment testing could be affected. If events or changes in circumstances indicate that the carrying amount of an ROU asset may not be recoverable (see ASC 360-10-35-21), a head lessee/intermediate lessor will assess the head lease ROU asset for impairment. A lessee is required to apply the guidance in ASC 360 on impairment of long-lived assets at an asset group level. The ASC master glossary defines an “asset group” as follows:

The unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.

The guidance in ASC 360 on impairment focuses on “identifiable cash flows” that are “largely independent,” including both cash inflows and cash outflows. Since a head lessee (lessor under the sublease) will receive separate cash flows under the sublease, the head lessee should consider whether the subleased portion of the larger asset represents its own asset group for impairment testing purposes. In doing so the head lessee will also need to consider whether the cash outflows due under the head lease (e.g., rent, CAM, taxes) are separately identifiable for the subleased portion of the larger asset. Therefore, when the sublease is executed, the determination of the original asset group should be revisited.

The assessment of whether the asset group is the subleased portion of the leased asset or the larger asset is important because a conclusion that the asset group is the subleased portion may be more likely to result in an impairment. Further, once an ROU asset related to an operating lease is impaired, a lessee can no longer recognize lease expense on a straight-line basis in its income statement in accordance with ASC 842-20-25-7. Rather, the single lease expense profile for the impaired ROU asset will become “front-loaded” in a manner similar to the treatment of a finance lease. See Q&A 8-12 for further discussion of impairment of an ROU asset.

Considerations Related to the Lease Component

A head lessee's/intermediate lessor's sublease of a portion of a larger asset (e.g., one floor of a 10-floor office building from the example above) may indicate that the subleased portion of the larger asset should be treated as a separate lease component in the head lease. Assume that the head lessee/intermediate lessor in the above example initially accounted for the 10-floor building lease as a single lease component or unit of account and, accordingly, recorded one ROU asset and lease liability for the arrangement. We believe that the head lessee in a sublease arrangement should generally reconsider whether the subleased asset should be deemed a separate lease component under the head lease. As a result, there could be two separate lease components and corresponding ROU assets and liabilities (i.e., for both the subleased asset and the remaining portion of the initial ROU asset). It is important for an entity to determine
the appropriate unit of account when applying the lessee or lessor accounting model in ASC 842, since implications include, but are not limited to, the allocation of consideration to the components in the contract. See Chapter 4 for additional information on components of a contract.

Changing Lanes — Lease Impairment Considerations

The requirements in ASC 842 for the impairment assessment of finance lease ROU assets are consistent with those for capital leases under ASC 840. However, the amounts that will ultimately be factored into the determination of the ROU asset may differ under ASC 842 since the guidance on this topic in ASC 842 differs from that in ASC 840 in certain respects (e.g., the ROU asset may be greater under ASC 842 because of the allocation between lease and nonlease components/executory costs). The difference between the carrying amount of the ROU asset under ASC 842 and that of the capital lease asset under ASC 840 may therefore have an impact on the overall carrying amount of the asset group as a whole and, in turn, may affect an impairment analysis.

In addition, ASC 842 introduces the concept of an operating lease ROU asset. Under ASC 840, operating leases were accounted for off the balance sheet in a manner similar to executory contracts and therefore were subject to the guidance in ASC 420. Specifically, rather than applying an ASC 360 impairment model, an entity recognized any costs related to terminating an operating lease, if certain criteria were met, in accordance with ASC 420 (i.e., the costs and a related liability were recognized as the difference between the remaining lease costs to be paid by the lessee, offset by the anticipated sublease income).

ASC 842 has eliminated the operating-lease-related guidance in ASC 420, instead requiring that a lessee use the ASC 360 impairment model to evaluate its ROU assets for impairment. This is a notable difference from the ASC 840 requirements in that rather than recognizing an operating lease termination cost on a lease-by-lease basis (when necessary), a lessee is required to apply the ASC 360 long-lived asset impairment guidance at an asset group level. Therefore, an impairment charge could potentially be recognized for an ROU asset even if there are no impairment indicators at the ROU asset level (as would be the case when an impairment is allocated to all assets in the asset group).

Connecting the Dots — Applicability of ASC 420 to Nonlease Components

As discussed above, after the adoption of ASC 842, operating leases are no longer within the scope of ASC 420 on exit or disposal cost obligations; rather, lessees must use the ASC 360 impairment model to evaluate their ROU assets for impairment. ASC 420-10-15-3, as amended, states that the scope of ASC 420 includes “costs to terminate a contract that is not a lease.” Therefore, questions have arisen regarding whether nonlease components within a contract that also contains one or more lease components should continue to be evaluated under ASC 420 after the adoption of ASC 842. Since ROU assets subject to the guidance in ASC 360 are related only to the lease component(s) in a contract, we believe that the amended scope of ASC 420 is only intended to exclude the lease component(s) and that lessees should therefore continue to evaluate any nonlease components under ASC 420.
The following example from ASC 842-20-55-48 through 55-51 illustrates the impairment of an ROU asset in an operating lease:

<table>
<thead>
<tr>
<th>ASC 842-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-47  Example 5 illustrates impairment of a right-of-use asset.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td>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:</td>
</tr>
<tr>
<td>a. Amortization of the right-of-use asset remaining after the impairment ($18,893 ÷ 7 years = $2,699 per year)</td>
</tr>
<tr>
<td>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%).</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
The following amortization schedule and related journal entries have been calculated on the basis of the facts in the example above:

<table>
<thead>
<tr>
<th>Period</th>
<th>Lease Cost/Other Expense</th>
<th>Beginning Balance</th>
<th>Liability Accretion</th>
<th>Lease Payment</th>
<th>Ending Balance</th>
<th>Beginning Balance</th>
<th>ROU Asset Reduction</th>
<th>Impairment Charge</th>
<th>Ending Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$10,000</td>
<td>$70,236</td>
<td>$4,916</td>
<td>$(10,000)</td>
<td>$65,152</td>
<td>$70,236</td>
<td>$(5,084)</td>
<td></td>
<td>$65,152</td>
</tr>
<tr>
<td>2</td>
<td>10,000</td>
<td>65,152</td>
<td>4,561</td>
<td>(10,000)</td>
<td>59,713</td>
<td>65,152</td>
<td>(5,439)</td>
<td>(35,000)</td>
<td>18,893</td>
</tr>
<tr>
<td>3</td>
<td>45,000</td>
<td>59,713</td>
<td>4,180</td>
<td>(10,000)</td>
<td>53,893</td>
<td>59,713</td>
<td>(5,820)</td>
<td></td>
<td>16,194</td>
</tr>
<tr>
<td>4</td>
<td>6,471</td>
<td>53,893</td>
<td>3,772</td>
<td>(10,000)</td>
<td>47,665</td>
<td>18,893</td>
<td>(2,699)</td>
<td></td>
<td>13,495</td>
</tr>
<tr>
<td>5</td>
<td>6,036</td>
<td>47,665</td>
<td>3,337</td>
<td>(10,000)</td>
<td>41,002</td>
<td>16,194</td>
<td>(2,699)</td>
<td></td>
<td>10,796</td>
</tr>
<tr>
<td>6</td>
<td>5,569</td>
<td>41,002</td>
<td>2,870</td>
<td>(10,000)</td>
<td>33,872</td>
<td>13,495</td>
<td>(2,699)</td>
<td></td>
<td>7,796</td>
</tr>
<tr>
<td>7</td>
<td>5,070</td>
<td>33,872</td>
<td>2,371</td>
<td>(10,000)</td>
<td>26,243</td>
<td>10,796</td>
<td>(2,699)</td>
<td></td>
<td>8,097</td>
</tr>
<tr>
<td>8</td>
<td>4,536</td>
<td>26,243</td>
<td>1,837</td>
<td>(10,000)</td>
<td>18,080</td>
<td>8,097</td>
<td>(2,699)</td>
<td></td>
<td>5,398</td>
</tr>
<tr>
<td>9</td>
<td>3,965</td>
<td>18,080</td>
<td>1,266</td>
<td>(10,000)</td>
<td>9,346</td>
<td>5,398</td>
<td>(2,699)</td>
<td></td>
<td>2,699</td>
</tr>
<tr>
<td>10</td>
<td>3,353</td>
<td>9,346</td>
<td>654</td>
<td>(10,000)</td>
<td>—</td>
<td>2,699</td>
<td>(2,699)</td>
<td></td>
<td>—</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.

A. As noted in ASC 842-20-55-49, at lease commencement, “Lessee determines the cost of the lease to be $100,000 (the total lease payments for the lease term)" and the “annual lease expense to be recognized is therefore $10,000 ($100,000 ÷ 10 years).” In period 3, Lessee recognizes a total expense of $45,000 related to the lease and the $35,000 impairment charges ($10,000 annual lease cost). After the impairment of the ROU asset, Lessee will continue to recognize a single lease cost in each period; however, the straight-line recognition pattern will be discontinued. Beginning in period 4, the lease cost will be the total of columns B and C.

B. The liability accretion balance is calculated by applying the 7 percent discount rate to the prior-period ending liability balance. The liability accretion balance is a component of the lease cost each period.

C. For an operating lease, the ROU asset reduction is usually calculated as the period lease cost less the liability accretion. This amount, when added to the liability accretion, will generally result in a straight-line expense profile for the lease cost over the lease term. However, once an impairment of the ROU asset is recognized (at the end of period 3 in this example), the straight-line expense profile is lost because the ROU asset is reduced on a straight-line basis for the remainder of the term after impairment. This ROU asset reduction, when added to the liability accretion, results in a single-line lease cost that diminishes over the remainder of the term.

D. As with other nonfinancial assets, the ROU asset is subject to the ASC 360 impairment analysis requirements. Therefore, as a result of the impairment assessment, in addition to the amounts recognized for the subsequent measurement of the lease liability and ROU asset, Lessee will recognize an impairment charge of $35,000 in period 3.
Journal Entries
In period 3, Lessee would record the following amounts in its general ledger (note that only period 3 entries have been included):

Period 3

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease cost</td>
<td>10,000</td>
</tr>
<tr>
<td>ROU asset reduction</td>
<td>5,820</td>
</tr>
<tr>
<td>Lease liability</td>
<td>4,180</td>
</tr>
<tr>
<td>Lease liability</td>
<td>10,000</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000</td>
</tr>
<tr>
<td>ROU asset impairment loss</td>
<td>35,000</td>
</tr>
<tr>
<td>ROU asset</td>
<td>35,000</td>
</tr>
</tbody>
</table>

Q&A 8-12AA  ROU Assets That Are Held for Sale — Amortization Considerations

A disposal group includes all long-lived assets, including ROU assets, expected to be disposed of as a group through a sale. Therefore, an ROU asset can be considered “held for sale” if it is part of a disposal group that is classified as held for sale (i.e., the disposal group meets the held-for-sale criteria in ASC 360-10-45-9).

Question 1
When an ROU asset is characterized as “held for sale,” should a lessee continue to amortize the ROU asset?

Answer
No. ASC 842 amended ASC 360-10-15-4 to clarify that ROU assets of lessees are within the scope of the guidance pertaining to the impairment or disposal of long-lived assets, including the accounting for assets held for sale.

Therefore, when a long-lived asset (or disposal group) is characterized as held for sale, the amortization of the ROU asset should cease in accordance with ASC 360-10-35-43, which states:

A long-lived asset (disposal group) classified as held for sale shall be measured at the lower of its carrying amount or fair value less cost to sell. If the asset (disposal group) is newly acquired, the carrying amount of the asset (disposal group) shall be established based on its fair value less cost to sell at the acquisition date. A long-lived asset shall not be depreciated (amortized) while it is classified as held for sale. Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale shall continue to be accrued. [Emphasis added]

Question 2
Does the answer to Question 1 depend on the classification of the lease (operating vs. finance)?
**Answer**

No. For both finance and operating leases, a lessee should stop amortizing the ROU asset at the point when the ROU asset is classified as held for sale. This answer applies to operating leases even though the lessee recognizes a single lease cost within operating expenses, since ROU asset amortization is a component of the single lease cost.

The resulting accounting impact on finance and operating lease ROU assets, respectively, would be that (1) the amortization of the finance lease ROU asset would cease and only the interest cost would be recognized going forward and (2) the amortization of the operating lease ROU asset would cease and only the liability accretion (interest cost) would be recognized as the single lease cost. For operating leases, the straight-line lease expense profile is no longer applicable; rather, the expense profile related to the interest cost while the ROU asset is held for sale would be similar to that of an impaired ROU asset as discussed above.

**Question 3**

How should a lessee account for a change in its plan to dispose of an ROU asset?

**Answer**

ASC 360-10-45-6 indicates that if circumstances change and an entity no longer plans to dispose of a long-lived asset (or disposal group), the asset would be reclassified from “held for sale” back to “held and used.” Further, ASC 360-10-35-44 states:

> If circumstances arise that previously were considered unlikely and, as a result, an entity decides not to sell a long-lived asset (disposal group) previously classified as held for sale, the asset (disposal group) shall be reclassified as held and used. A long-lived asset that is reclassified shall be measured individually at the lower of the following:
> 
> a. Its carrying amount before the asset (disposal group) was classified as held for sale, adjusted for any depreciation (amortization) expense that would have been recognized had the asset (disposal group) been continuously classified as held and used
> 
> b. Its fair value at the date of the subsequent decision not to sell.

Accordingly, ASC 360-10-35-44 requires the entity to adjust the carrying amount of the long-lived asset that is reclassified as “held and used” to the lower of (1) the asset’s fair value or (2) the asset’s carrying amount before it was classified as held for sale, adjusted for any depreciation that would have been recorded while the asset was classified as held for sale. For this adjustment to be made, there must be a catch-up of the depreciation that would have been recognized had the asset remained classified as held and used.

For both finance and operating lease ROU assets, the depreciation referred to above would equate to the ROU asset amortization not recorded while the asset was held for sale. The catch-up entry to record forgone amortization would align the ROU asset balance with what would have been recorded had the ROU asset remained classified as held and used. A normal amortization profile would then be reestablished for the ROU asset (e.g., for operating leases, a straight-line, single lease cost for the remaining lease term, provided that the ROU asset continues to be classified as held and used and has not been impaired, as discussed above).
8.5 Remeasurement of the Lease Liability

ASC 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.

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)).

This section addresses phase 5 of the lease “life cycle,” which discusses the guidance that a lessee would evaluate when accounting for the remeasurement of the lease liability.

After the commencement date of the lease, a lessee must remeasure the lease liability if there has been a change to the amounts deemed to be lease payments as described in ASC 842-10-35-4. (See Chapter 6 for additional information on amounts that meet the definition of lease payments, and see Q&A 8-14 for considerations related to changes in variable payments based on an index or a rate.) Generally, there will be a change in lease payments when certain discrete reassessment-related events occur or when a lease is modified and that modification is not accounted for as a separate contract.

However, some but not all of these events will necessitate an update to the discount rate used to measure the liability. When a modification is not accounted for as a separate contract, the discount rate must be based on a rate as of the remeasurement date. In addition, if there is a change in the lease term or in the assessment of whether the lessee will exercise a purchase option, the discount rate must be updated (i.e., a rate on the remeasurement date) unless the discount rate already reflects the options to extend or terminate the lease or purchase the underlying asset.

A remeasurement of the lease liability will result in an adjustment to the corresponding ROU asset. In addition, a remeasurement of the lease liability triggers the remeasurement of the consideration in a contract and reallocation of that consideration to the separate components (i.e., a lessee would reallocate the consideration in the contract to all lease and nonlease components).
Certain events that trigger a remeasurement of the lease liability also trigger a reassessment of the lease classification, as noted in Section 8.3.4 and discussed further in this section. Thus, in addition to a change in the lease liability amount, the presentation of this obligation may change (e.g., operating lease liability to finance lease liability or vice versa). In addition to the balance sheet implications, the income statement treatment may also change.

The table below summarizes the topics covered in the remainder of Section 8.5.

### Remeasurement of the Lease Liability

<table>
<thead>
<tr>
<th>What is updated?</th>
<th>Change in the lease term or assessment of purchase option exercise</th>
<th>Change in the amount probable of being owned by a lessee under a residual value guarantee</th>
<th>Variable payments become lease payments due to the resolution of a contingency</th>
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</thead>
<tbody>
<tr>
<td>Lease payments</td>
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</tr>
<tr>
<td>Contract consideration</td>
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<td>Consideration allocation</td>
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<tr>
<td>Stand-alone prices</td>
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</tr>
<tr>
<td>Discount rate</td>
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</tr>
<tr>
<td>Lease classification</td>
<td>Y</td>
<td>Y</td>
<td>N</td>
</tr>
</tbody>
</table>

**Note:** The remeasurement of a lease liability due to a lease modification that is not accounted for as a separate contract as well as the overall lessee modification guidance is discussed in Section 8.6 of this Roadmap.

### Changing Lanes — Liability Remeasurement Requirements

The requirement to remeasure the lease liability over the lease term upon the occurrence of certain reassessment events represents a wholesale change to the ASC 840 requirements. For example, under ASC 840, a capital lease liability is only remeasured when the lease is modified. Under ASC 842, the lease liability undoubtedly will be reassessed and remeasured more frequently.

### Q&A 8-12B  Circumstances in Which a Lessee Is Required to Update Stand-Alone Prices

ASC 842-10-15-33 requires that lessees allocate the consideration in a contract to the lease and nonlease components (and initial direct costs to the separate lease components) on the basis of the relative stand-alone price, as discussed in Section 4.4.1.2.

In accordance with ASC 842-10-15-36, a lessee must remeasure and reallocate the consideration in the contract when there is (1) a remeasurement of the lease liability or (2) a contract modification that is not accounted for as a separate contract (collectively, a “remeasurement event”). (See Section 4.4.1.3 for a discussion of remeasurement and reallocation of consideration in the contract.) Further, as discussed above, ASC 842-20-35-4

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11 The discount rate would not be updated in a scenario in which a change in lease term or the exercise of a purchase option was already reflected in the discount rate determination but the exercise of the option itself was not deemed reasonably certain at lease commencement.
specifies criteria for when and how to remeasure a lease liability and ASC 842-10-35-4 contains indicators of when a remeasurement event has occurred (see Section 6.10).

We believe that some may interpret the requirement related to reallocation of “the consideration in the contract” as indicating that the reallocation should be made by using the original allocation percentages identified when ASC 842-10-15-33 is initially applied. Others may interpret the guidance as indicating that an entity should determine new relative stand-alone prices. Accordingly, while the guidance explicitly specifies that the consideration in the contract will be remeasured and reallocated as a result of a remeasurement event, it is not clear on (1) whether, or in which cases, a lessee would need to reevaluate the stand-alone prices of each contract component as of the date of the remeasurement event or (2) whether it would be appropriate to retain the original relative stand-alone prices and thus carry forward the original allocation percentages.

**Question**

Is a lessee required to reevaluate stand-alone prices and revisit the relative stand-alone price allocation percentages when remeasuring and reallocating the consideration upon the occurrence of a remeasurement event?

**Answer**

It depends. We believe that the requirement for a lessee to revise the relative stand-alone price and related allocation percentages depends on the nature of the remeasurement event. That is, when the remeasurement event is limited to a subsequent-measurement adjustment (e.g., an incremental change in consideration) rather than an event in which the components in the contract are changed (added or subtracted), the lessee would not be required to revise the relative stand-alone price and the related allocation percentages assigned to the components in the contract. In effect, an entity would apply the guidance in ASC 842-10-15-42, which points to the guidance in ASC 606 associated with changes in transaction prices and states that “[i]f 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.”

ASC 606-10-32-42 through 32-45 indicate that after contract inception, the transaction price can change for various reasons, such as “resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled” (see Section 7.5 of Deloitte’s Revenue Roadmap). In these cases, the lessee would reallocate the updated consideration in the contract by using the original relative stand-alone price allocation percentages.

In addition, we believe that when a contract modification is accounted for as a separate contract, the original contract remains in effect and would also use the original stand-alone prices and allocations. Accordingly, a lessee should first determine whether the remeasurement event results only in a subsequent-measurement adjustment (e.g., a contingency is resolved in such a way that otherwise variable payments become fixed) or another change (e.g., an increase in consideration because the lease was modified to add an additional lease component and a related nonlease component).
Therefore, in an evaluation of the lessee remeasurement guidance in ASC 842-10-35-4 (see Section 6.10), if the following events outlined in ASC 842-10-35-4(b) and ASC 842-10-35-4(c)(3) occur in isolation, the lessee would not update the stand-alone prices or relative stand-alone price allocation and updates to the consideration in the contract would be allocated on the original basis:

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

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. . . .

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.

However, when any other condition in ASC 842-10-35-4 is met in isolation (e.g., a contract modification that is not accounted for as a separate contract) or in any instance in which the above guidance is combined with another condition in ASC 842-10-35-4, updated stand-alone prices should be established and consideration should be reallocated to the updated components. This stipulation generally is consistent with the view that when additional components (including extending the term of the contract) are added to (or subtracted from) the contract, new stand-alone prices should be established in connection with the remeasurement event. As a result, new estimates of stand-alone prices and reallocation would be required when the following remeasurement events outlined in ASC 842-10-35-4(a) and ASC 842-10-35-4(c)(1) and (c)(2) 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. . . .

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.

When a contract modification is accounted for as a contract that is separate from the original contract in accordance with ASC 842-10-25-8 (see Section 8.6.2), the stand-alone price of each contract component in the new contract would always need to be assessed, since the new contract is disassociated with the existing agreement at the time of the modification.
8.5.1 Change in the Lease Term or in the Conclusion About the Exercise of a Purchase Option

ASC 842-20

35-5 If there is a remeasurement of the lease liability [as a result of a change in lease payments], 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. . . .

8.5.1.1 Timing of Reassessment Related to Lease Term and Purchase Option

ASC 842-10-35-1 indicates that, upon the occurrence of certain discrete events, a lessee is required to reassess its conclusion about the lease term and the likelihood that it will exercise an option to purchase the underlying asset. See Section 5.4 for additional information.

As described below, when a lessee changes its conclusion about whether it will exercise a renewal, termination, or purchase option, it would generally (1) reassess lease classification in considering the facts and circumstances that exist as of the reassessment date, (2) remeasure the lease liability by using revised inputs as of the reassessment date, and (3) adjust the ROU asset. However, in certain circumstances, a lessee would not update its discount rate, such as when the discount rate already reflects the option.

8.5.1.2 Accounting for the Reassessment of the Lease Term and Purchase Option

If, as a result of a reassessment event, a lessee determines that the lease term has changed or changes its conclusion regarding whether it is reasonably certain that it will be exercising a purchase option, the lessee would update its lease payments to reflect the change and remeasure its lease liability. In remeasuring the lease liability, the lessee should remeasure variable lease payments based on an index or a rate by using the index or rate on the remeasurement date.

STEP 1
Remeasure and reallocate the consideration in the contract.

STEP 2
Remeasure the lease liability by using the revised lease payments and updated discount rate, if applicable.

STEP 3
Adjust the ROU asset by the amount of the remeasurement of the lease liability. The ROU asset cannot be reduced below zero; any excess will be recognized in net income.

STEP 4
Reassess lease classification as of the reassessment date on the basis of the facts and circumstances on that date.

STEP 5
Adjust the remaining lease cost recognition pattern and update the income statement and cash flow statement presentation on a prospective basis if there is a change in lease classification.
As shown in the graphic above, the lessee is required to do the following on the remeasurement date in the circumstances described above:

- Remeasure and reallocate the consideration in the contract to the remaining lease and nonlease components (see Chapter 4).

- Remeasure the lease liability on the basis of the revised lease payments (see Section 6.10). The discount rate is updated by using the assumptions on the remeasurement date unless the discount rate in use (i.e., the discount rate as of last lease commencement date) already reflects the option to extend or terminate the lease or purchase the underlying asset, in which case the discount rate in use continues to be employed (see Section 7.2.2).

- Adjust the ROU asset by the amount of the remeasurement of the lease liability. When the lease liability is reduced as the result of the remeasurement, the ROU asset would similarly be reduced. Note that the carrying amount of the ROU asset cannot be reduced below zero and any amounts in excess of the ROU asset balance are recognized in net income.

- Reassess lease classification as of the reassessment date on the basis of the facts and circumstances on that date. For example, the lessee should reassess classification on the basis of the fair value and remaining economic life of the underlying asset on the remeasurement date (see Section 8.3.4).

- If the classification of the lease changes as a result of the reassessment event, a lessee will prospectively adjust the remaining lease cost recognition pattern and update the income statement and cash flow statement presentation.

See Example 3 (ASC 842-20-55-31 through 55-39, reproduced in Section 8.9.1.1) for an illustration of the accounting for a change in the lease term caused by a change in a lessee's conclusion about whether it will exercise a renewal option.

### 8.5.2 Change in the Amount That It Is Probable That a Lessee Will Owe at the End of the Lease Term Under a Residual Value Guarantee

<table>
<thead>
<tr>
<th>ASC 842-20</th>
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| **35-5** If there is a remeasurement of the lease liability [due to a change in lease payments], 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: . . .  

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)). . . . |

### 8.5.2.1 Continual Reassessment of Amount That It Is Probable a Lessee Will Owe Under a Residual Value Guarantee

A lessee must continually evaluate the amount that it is probable the lessee will owe at the end of the lease term under a residual value guarantee. Any change in this amount is a reassessment event that would result in the remeasurement of the lease liability. See Section 6.7 for additional information.
8.5.2.2 Accounting for Changes in the Amount That It Is Probable a Lessee Will Owe Under a Residual Value Guarantee

When there is a change in the amount that it is probable the lessee will owe under a residual value guarantee, the lessee must remeasure its lease liability to reflect the change. In remeasuring the lease liability, the lessee should remeasure variable lease payments based on an index or a rate by using the index or rate on the remeasurement date.

As shown in the graphic above, the lessee is required to do the following on the remeasurement date in the circumstances described above:

- Remeasure and reallocate the consideration in the contract (see Chapter 4).
- Remeasure the lease liability on the basis of the revised lease payments by using the original lease-commencement-date discount rate (see Section 6.10).
- Adjust the ROU asset by the amount of the remeasurement of the lease liability. The ROU asset cannot be reduced below zero; any excess will be recognized in net income.

When the lease liability is remeasured to reflect the change in amounts that it is probable the lessee will owe under a residual value guarantee, the lessee does not reassess lease classification.

Changing Lanes — Residual Value Guarantees

Under ASC 840, the accounting for residual value guarantees from the lessee’s perspective depended on the lease’s classification. For an operating lease, amounts expected to be payable under a residual value guarantee were accrued for separately on the balance sheet. In contrast, for a capital lease, the full amount of the residual value guarantee was used to determine, and accounted for as part of, the capital lease obligation and related asset. Under ASC 842, the amount that it is probable a lessee will owe at the end of the lease term under a residual value guarantee is considered a lease payment and used to determine the lease liability for both operating and finance leases. Depending on the type of asset and the circumstances of the lease, the amount that it is probable the lessee will owe could be significantly less than the full guaranteed amount.
8.5.3 Variable Payments Become Lease Payments Because of the Resolution of a Contingency

**ASC 842-20**

35-5 If there is a remeasurement of the lease liability [due to a change in lease payments], 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: . . .

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)).

**8.5.3.1 Continual Reassessment of Whether Lease Payments Change Because of a Contingency Resolution**

A lessee must continually evaluate the nature of its variable lease payments to determine whether the variable payments at some point become fixed and would therefore meet the definition of lease payments. When a contingency by which some (e.g., payments pertaining to years 3–9 of a remaining 10-year lease term) or all (e.g., payments pertaining to all years remaining in the lease term) of the variable payments that will be paid over the remainder of the lease term has been resolved in such a way that the payments become fixed and now meet the definition of lease payments, a lessee must remeasure its lease liability to reflect this change.

**8.5.3.2 Accounting for a Change in Lease Payments Resulting From the Resolution of a Contingency**

When there is a resolution of a contingency that causes some or all of the variable payments to now meet the definition of lease payments (e.g., to become fixed for the remainder of the lease term), a lessee must remeasure its lease liability to reflect the change. In remeasuring the lease liability, the lessee should remeasure other variable lease payments that are based on an index or a rate by using the index or rate on the remeasurement date.

As shown in the graphic above, the lessee would be required to do the following on the remeasurement date in the circumstances described above:

- Remeasure and reallocate the consideration in the contract (see Chapter 4).
- Remeasure the lease liability on the basis of the revised lease payments by using the original lease commencement-date discount rate (see Section 6.10).
- Adjust the ROU asset by the amount of the remeasurement of the lease liability. The ROU asset cannot be reduced below zero; any excess will be recognized in net income (see Section 7.2.2).
• Adjust the ROU asset by the amount of the remeasurement of the lease liability. Note that the carrying amount of the ROU asset cannot be reduced below zero and any amounts in excess of the ROU asset balance are recognized in net income.

When the lease liability is remeasured to reflect a change in lease payments because of the resolution of a contingency, the lessee does not reassess lease classification.

Q&A 8-13  Accounting for Lease Incentives Not Paid or Payable at Commencement

A lessor sometimes provides a lessee with a lease incentive to entice the lessee into leasing the underlying asset (e.g., the lessor may provide the lessee with funding for the construction of certain lessee-specific leasehold improvements). Lease incentives are a component of lease payments, which, as described in ASC 842-10-30-5(a), include “[f]ixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee” (emphasis added). ASC 842 is also explicit that lease incentives that are received by the lessee on or before the lease commencement date would be accounted for as a reduction of the ROU asset in accordance with ASC 842-20-30-5.

While the guidance is clear on the accounting for incentives received on or before the lease commencement date, it is not clear on how a lessee should account for incentives that are included in the original lease contract but received after lease commencement (e.g., incentives paid to the lessee upon the completion of a certain activity, such as completion of construction of leasehold improvements after lease commencement). See Section 6.2.2 for more information on the definition of a lease incentive in ASC 842. In addition, see Q&A 6-5 for considerations related to incentive payments a lessor makes to a lessee after lease commencement.

Question

How would a lessee account for lease incentives that will be receivable only after a future event that is expected to occur after lease commencement?

Answer

It depends. While ASC 842 is silent on how a lessee should account for lease incentives that are only receivable after a future event (other than the passage of time) expected to occur after the lease commencement date, we believe that a lessee could use the following two-step approach:14

Step 1: Evaluate Whether It Is Appropriate to Estimate the Incentive at Lease Commencement

We believe that it would be appropriate for the lessee, on the lease commencement date, to estimate and include in its lease payments any lease incentive amounts based on future events when (1) the events are within the lessee’s control (e.g., construction of the leasehold improvements) and (2) the event triggering the right to receive the incentive is deemed reasonably certain to occur.

14 In addition, we believe that there may be other acceptable approaches, including an election to move directly to step 2 rather than estimating the lease incentive as of the commencement date.
If some or all of a recognized incentive is not ultimately received (i.e., the lessee does not become entitled to the incentives) or the amounts received are greater than the amounts previously estimated (i.e., the lessee becomes entitled to additional incentives not previously estimated), the change would be accounted for as a change in lease payments in a manner similar to the accounting described in step 2 below.

**Step 2: Account for the Incentive Amounts Triggered After Lease Commencement and Received That Were Not Previously Recognized (or That Were Different From the Amount Recognized at Commencement) as a Change in Lease Payments**

Any lease incentives that are received or become receivable after lease commencement and were not recognized at lease commencement or that differ from the amount recognized at lease commencement (i.e., by applying step 1) would result in the remeasurement of the lease payments once the triggering event occurs that provides the lessee with the right to the incentive. This view is by analogy to ASC 842-10-35-4(b), in which lease payments must be remeasured when 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.”

If the lease incentive received is greater than the amount recognized at lease commencement (or if no amount was recognized at lease commencement), this difference should be recognized as an adjustment (reduction) to the ROU asset.

If the lease incentive received is less than the amount recognized at lease commencement, the difference (amount by which the original lease liability was adjusted but that is no longer expected to be received) would result in an adjustment to the lease liability (an increase in the liability) and a corresponding adjustment to the ROU asset.

Further, under ASC 842-20-35-5(c), when remeasuring its lease liability, the lessee would not reassess lease classification or use an updated discount rate (i.e., the lessee would continue to use the discount rate that was used at lease commencement).

**Q&A 8-14  Implications of Index- or Rate-Based Payment Adjustments**

**Question**

Do index- or rate-based payment adjustments that establish a new floor represent a change in lease payments due to the resolution of a contingency?

**Answer**

No. Index- or rate-based payment adjustments that establish a new floor do not represent a resolution of a contingency that would result in a change in lease payments and would therefore not result in a liability remeasurement event.
This is consistent with the guidance in ASC 842-10-35-4(b), which was added by the Codification improvements in ASU 2018-10 and states, in part:

However, a change in a reference index or a rate upon which some or all of the variable lease payments in the contract are based does not constitute the resolution of a contingency subject to (b) (see paragraph 842-10-35-5 for guidance on the remeasurement of variable lease payments that depend on an index or a rate). [Emphasis added]

On the basis of this technical amendment, the guidance on remeasuring a lease liability after the resolution of a contingency is not meant to apply to index-based escalators even when those escalators serve to establish a new floor for the next lease payment. Therefore, even when the index or rate establishes a new floor (such as when the CPI increases and establishes a new rate that will be used as a benchmark for determining future lease payment increases), that adjustment would not result in a remeasurement of the lease liability and ROU asset. As a result, the additional payments for increases in the CPI will be recognized in the period in which they are incurred.

See Section 17.3.1.3 for additional information on FASB standard-setting activity.

**Q&A 8-15 Impact of Cotenancy Clauses on Determining Lease Payments**

Certain real estate leases may include a provision that would result in a decrease in the specified lease payments when there are specific changes to the occupancy structure in the broader real estate interest. For example, retail leases often include a cotenancy clause under which there will be a specified reduction in the required lease payments if an anchor tenant vacates or if the overall occupancy of the mall drops below a certain level.

**Question**

How would a lessee initially and subsequently account for the impact of a cotenancy clause in a lease agreement?

**Answer**

At lease commencement, the lessee would recognize a lease liability and ROU asset on the basis of amounts meeting the definition of lease payments as of the commencement date. This would exclude any amount associated with the variability that may result from the triggering of a cotenancy clause, since this clause is designed to be protective for the lessee and would not affect the payment terms until a triggering event occurs.

When facts and circumstances change or an event occurs that results in the triggering of a cotenancy clause in a real estate lease, we believe that it would be appropriate to apply one of the two approaches below to the subsequent accounting.
Approach 1: Cotenancy Clause Results in Negative Rent

Any change in facts and circumstances that results in the triggering of a cotenancy clause would not be considered a lease payment remeasurement event that would affect the lease liability and ROU asset. Therefore, rebates resulting from the triggering of a cotenancy clause would be treated as a variable lease payment (though a negative variable lease payment) not based on an index or rate. As a result, the lessee would recognize the difference between the periodic lease cost determined at lease commencement and the revised payments due to the cotenancy clause as variable rent (albeit negative rent) in the applicable period.

Approach 2: Cotenancy Results in the Resolution of a Contingency and Is a Lease Payment Reassessment Event

Any change in facts and circumstances that results in the triggering of the cotenancy clause would be considered a lease payment remeasurement event that would affect the lease liability and ROU asset. Thus, the lease liability and ROU asset would be remeasured to reflect the revised lease payment amounts through the end of the lease term. If the cotenancy issue is later resolved in such a way that the lease payments return to their original amounts, such resolution is another remeasurement event. Therefore, under this approach, the lease liability and ROU asset will continually be reassessed upon changes in facts and circumstances that result in the triggering of the cotenancy clause and the subsequent resolution of the condition that led to the triggering of the clause.

Some view this approach as consistent with the guidance in ASC 842-10-35-4(b). That is, the triggering of the cotenancy clause would be a resolution of a contingency in such a way that there is a change in some or all of the lease payments for the remainder of the lease term. While ASC 842-10-35-4(b) focuses on variable payments that subsequently become fixed and does not specifically describe fixed payments in an arrangement that subsequently become variable (or a lower fixed amount), we believe that it would be appropriate to apply such guidance by analogy.

8.6 Lease Modifications

8.6.1 Setting the Stage

ASC 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.

This section addresses phase 6 of the lease “life cycle,” which discusses guidance that a lessee would evaluate when determining how to account for a modified lease.

Connecting the Dots — Rent Concessions Provided as a Result of COVID-19

In response to the COVID-19 pandemic, the FASB provided both lessees and lessors with relief related to accounting for rent concessions resulting from COVID-19. An entity that elects to apply the relief to qualifying concessions may choose to account for the concessions by either
(1) applying the modification framework for these concessions in accordance with ASC 840 or ASC 842 as applicable or (2) accounting for the concessions as if they were made under the enforceable rights included in the original agreement and are thus outside of the modification framework. See Section 17.3.4 for more information.

8.6.1.1 Definition and Overview
A modification is a change in any of the terms and conditions of a contract. In accordance with ASC 842-10-15-6, when a contract is modified, the entity would need to reevaluate the contract to determine whether the modification affects its conclusions under ASC 842.

[Sections 8.6.1.1.1 and 8.6.1.1.2 have been deleted.]

Q&A 8-15AA Reassessment of Whether a Contract Is or Contains a Lease

ASC 842-10-15-6 states, “An entity shall reassess whether a contract is or contains a lease only **if the terms and conditions of the contract are changed**” (emphasis added). In contrast, the ASC master glossary defines a lease modification as follows:

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). [Emphasis added]

This difference in wording has led some to question what types of changes trigger a requirement to reassess whether a contract is or contains a lease.

This question is particularly significant for entities that, in making the transition to the new leasing standard, elected the practical expedient package in ASC 842-10-65-1(f) that allowed them to (among other things) not revisit whether a contract is or contains a lease under the definition in ASC 842. Therefore, if an entity that has adopted the new leasing standard is required to reassess whether such a “grandfathered” contract is or contains a lease under the definition in ASC 842, a change in that conclusion may be more likely than it would be if the initial assessment had taken place under ASC 842.

**Question 1**
When should an entity reassess whether a contract is or contains a lease?

**Answer**
We believe that an entity should reassess whether a contract is or contains a lease whenever a substantive\(^{15}\) change is made to the terms and conditions of the contract. Such changes are not limited to those that meet the definition of a lease modification, which is a specific type of modification characterized by a change in the scope of or consideration for a lease. When a modification does not meet the definition of a lease modification, an entity should reassess whether the contract is or contains a lease but would not apply the lease modification framework (as discussed in the remainder of Section 8.6 and in Section 9.3.4) if the conclusion regarding whether the contract is or contains a lease is unchanged.

\(^{15}\) In our answer, we are assuming that the change is substantive and has economic substance. We would not require or accept a reassessment based on changes that lack economic substance (e.g., insignificant changes designed to trigger a reassessment to achieve a desired accounting outcome). Consultation with auditors and accounting advisers is recommended in circumstances in which a modification appears to lack substance.
**Question 2**

How should an entity account for a change in its conclusion regarding whether a contract is or contains a lease?

**Answer**

If a contract formerly did not contain a lease but, after a modification, is deemed to contain one, the contract should be accounted for under ASC 842 as if it were a newly originated lease (see Sections 8.4.2 and 9.3.2). If, after a modification, a contract that formerly contained a lease is deemed to no longer contain one, the change should be accounted for as a lease termination (see Sections 8.7.2 and 9.3.5).

**Example**

Lessor and Lessee enter into a contract that conveys to Lessee the right to use an identified piece of equipment for five years. Both parties conclude that the contract contains a lease of the equipment. At the end of the third year, the parties agree to modify the terms and conditions of the contract to give Lessor a substitution right (no other changes are made). Provided that this modification has economic substance, both parties should evaluate whether the contract still contains a lease. If it does, the lease modification framework should **not** be applied since the scope of or consideration for the lease has not changed. However, if the contract no longer contains a lease, the modification should be accounted for as the termination of the lease and the parties should account for the modified contract in accordance with other applicable GAAP.
The following flowchart illustrates the concepts discussed in this Q&A:

1. **Have the terms and conditions of the contract been substantively changed?**
   - Yes: Reassess whether the contract contains a lease
     - No: No accounting impact
     - Yes: Did the contract contain a lease before the modification?
2. **Did the contract contain a lease before the modification?**
   - Yes: Account for the contract as a new lease (see Section 8.4.2 and Section 9.3.2)*
   - No: Does the contract contain a lease after the modification?
3. **Does the contract contain a lease after the modification?**
   - Yes: Did the change in the terms and conditions result in a change in the scope of or the consideration for the lease?**
     - Yes: Apply the lease modification framework (see Section 8.6.1.2 and Section 9.3.4)*
     - No: No lease accounting impact*
   - No: No lease accounting impact*

* Entities may also need to consider other U.S. GAAP to account for the modification of any non-lease components, if applicable.

** A change in the consideration for any component in a contract typically results in a change in the consideration for all components.
8.6.1.2 Decision Tree on Accounting for Modifications

Does the contract involve the use of PP&E?

- Yes
  - Is the modified contract a lease or does it contain a lease?
    - Yes
      - Does the modification grant the lessee the right to use an additional asset not included in the original contract that is priced in a manner consistent with the stand-alone price of the additional right of use?
        - Yes
          - Modified lease contract is accounted for as a separate contract (Section 8.6.2)
        - No
          - Modified lease contract is not accounted for as a separate contract (Section 8.6.3)
    - No
      - Contract is not subject to the ASC 842 requirements (no further action required)

- No
  - Other accounting guidance would apply if the original contract was not previously subject to ASC 842 guidance.
  - Lease termination guidance would apply if the original contract no longer meets the definition of a lease.

When a lease modification, other than through the exercise of an option, extends or reduces the term of an existing lease (Section 8.6.3.4)

- Lease classification is reassessed on the effective date of the lease modification.
- Consideration is remeasured and reallocated.
- The lessee would use the updated lease payments and discount rate to revise the lease liability and adjust the ROU asset on the basis of the difference.
- Since the change in the lease liability results in a direct adjustment to the ROU asset, there is no income statement impact.

When a lease modification grants the lessee an additional right of use not included in the original contract or accounted for as a separate contract (Section 8.6.3.5)

- Lease classification is reassessed on the effective date of the lease modification.
- Consideration is remeasured and reallocated.
- The lessee would use the updated lease payments and discount rate to revise the lease liability and adjust the ROU asset in a proportionate manner.
- Difference between the proportionate reduction of the ROU asset and lease liability is recognized in the income statement as a gain or a loss.

When a lease modification only results in a change to the consideration in the contract (Section 8.6.3.6)

- Lease classification is reassessed on the effective date of the lease modification.
- Consideration is remeasured and reallocated.
- The lessee would use the updated lease payments and discount rate to revise the lease liability and adjust the ROU asset in a proportionate manner.
- Difference between the proportionate reduction of the ROU asset and lease liability is recognized in the income statement as a gain or a loss.

When a lease modification reduces the scope of the lease through a full or partial termination (Section 8.6.3.7)

- Lease classification is reassessed on the effective date of the lease modification.
- Consideration is remeasured and reallocated.
- The lessee would use the updated lease payments and discount rate to revise the lease liability and adjust the ROU asset in a proportionate manner.
- Difference between the proportionate reduction of the ROU asset and lease liability is recognized in the income statement as a gain or a loss.
8.6.2 Modifications Accounted for as a Separate Contract

**ASC 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.

When the modification is considered a separate contract on the basis of the guidance in ASC 842-10-25-8, the lessee would account for the modified lease as if it were a stand-alone lease and apply the new requirements to the separate contract. Therefore, after the modification, the lessee would account for the agreement as two separate contracts: (1) the original, unmodified contract and (2) a separate contract for the additional right of use that is accounted for in a manner similar to the accounting for a new lease.

**Connecting the Dots — Accounting for a Modification as a Separate Contract**

One of the conditions in ASC 842-10-25-8 for accounting for a modification as a separate contract is that “[t]he modification grants the lessee an additional right of use not included in the original lease (for example, the right to use an additional asset).” The “additional right of use” needs to be an additional asset or lease component that differs from that included in the original contract (i.e., extension of the lease term for an asset already subject to the lease would not be considered an additional right of use).

This view is consistent with the discussion in paragraph BC176(b) of ASU 2016-02, which states, in part:

A modification of the type [that extends or reduces the term or an existing lease] does not grant an additional right of use. Rather, it merely changes an attribute of the lessee's existing right to use the underlying asset that it already controls. That is because the duration of the lessee's right of use (for example, 2, 5, or 10 years) is merely an attribute of that right of use in the same way that the specifications of a piece of equipment (for example, its color or functioning speed) are attributes of that tangible asset.

The Q&As below address common questions about accounting for a modification as a separate contract.

**Q&A 8-15AB Lease Modification With Additional Right of Use and Changes to Existing Right of Use**

**Question**

If a lessee and lessor agree to modify a lease to both (1) include an additional right of use at its stand-alone price and (2) change the scope of or consideration for the existing right of use in the lease, can the parties to the lease account for the additional right of use as a separate contract?
**Answer**

No. For an entity to be able to apply the guidance in ASC 842-10-25-8, the only change to the lease contract can be the addition of a right of use not included in the original contract, with a corresponding increase in the lease payments commensurate with the stand-alone price for the additional right of use. If there are any changes to the scope of or consideration for the existing right of use, the entity should apply the modification guidance discussed in Section 8.6.3 (for lessees) or Section 9.3.4 (for lessors).

**Q&A 8-15AC  Forward-Starting Lease for an Asset Subject to an Existing Lease**

**Question**

If a lessee has an existing lease and signs a separate lease contract for the same asset with the same lessor, which will commence when the existing lease expires (i.e., a “forward-starting lease”), can the lessee and lessor account for the forward-starting lease as a separate contract?

**Answer**

No. An extension of the duration of the right to use the same asset by definition cannot be an “additional asset” as that phrase is used in ASC 842-10-25-8. Therefore, any extension of the period of use of an asset subject to an existing lease, even if written as a separate contract, must be accounted for as a lease modification that extends the term of the existing lease rather than as a separate contract. A lessee effectively treats a modification that extends the term of an existing lease as a new lease that commences on the date of the modification (see Section 8.6.3.4 for additional information). See the Connecting the Dots in Section 9.3.4 for considerations related to how a lessor evaluates the extension of the term of an existing lease.

**Example**

Company Z signs a five-year lease for the right to use office space, with a commencement date of January 1, 2020. On January 1, 2024, Z signs a new three-year lease for the right to use the same office space with different payment terms and a commencement date of January 1, 2025 (i.e., the day after the expiration of the original five-year contract). Company Z does not treat the three-year forward-starting lease as a separate contract in accordance with ASC 842-10-25-8 (irrespective of whether the payments are at market). Rather, Z accounts for the forward-starting lease as an extension of the term of the original lease, which creates a “new” four-year lease that includes the last year of the first contract plus the additional three years in the extension. Accordingly, Z should remeasure the lease liability for the “new” four-year lease, as discussed in Section 8.6.3.4. Similarly, the lessor in the arrangement would account for the forward-starting lease as a modification of the existing lease rather than as a separate contract.
Chapter 8 — Lessee Accounting

The example below from ASC 842-10-55-160 and 55-161 illustrates a scenario in which a modification is accounted for as a separate contract.

**ASC 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.

**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.

**8.6.3 Modification Is Not Accounted for as a Separate Contract**

**ASC 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 in accordance with paragraph 842-10-25-1 as of the effective date of the modification.

**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.
8.6.3.1 Accounting by Modification Type

The table below summarizes the accounting for modifications that are not accounted for as a separate contract.

<table>
<thead>
<tr>
<th>Modification Type</th>
<th>Section</th>
<th>Lessee Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modification that extends or reduces the lease term of an existing lease (other than through exercise of an option)</td>
<td>8.6.3.4</td>
<td>The three modification types to the left will be accounted for in the following manner:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- The lessee should reassess the classification of the lease as of the effective date of the modification by using the modified terms and conditions (see Section 8.3.4).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- The lessee would use the updated lease payments and discount rate to remeasure the lease liability and would recognize any difference between the new lease liability and the old lease liability as an adjustment to the ROU asset.</td>
</tr>
<tr>
<td>Modification that grants the lessee an additional right of use not included in the original contract and that is not accounted for as a separate contract</td>
<td>8.6.3.5</td>
<td></td>
</tr>
<tr>
<td>Modification that only changes the consideration in the contract</td>
<td>8.6.3.6</td>
<td></td>
</tr>
<tr>
<td>Modification that decreases the scope of the lease through a full or partial termination</td>
<td>8.6.3.7</td>
<td>The modification type to the left will be accounted for in the following manner:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- The lessee should reassess the classification of the lease as of the effective date of the modification by using the modified terms and conditions (see Section 8.3.4).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- The lessee would adjust the lease liability by using the revised lease payments and an updated discount rate, derecognize a proportionate amount of the ROU asset, and recognize any difference as a gain/loss through earnings.</td>
</tr>
</tbody>
</table>

8.6.3.2 Accounting for Initial Direct Costs, Lease Incentives, and Other Payments Made in Connection With a Modification

ASC 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.

In a modification, as in a newly executed lease, a lessee may (1) incur initial direct costs, (2) be required to prepay a portion of the rent, or (3) receive an incentive from the lessor. In each of these cases, the lessee would account for these amounts in the same manner as it would account for them under a new lease.
Connecting the Dots — Considerations Related to Premodification Initial Direct Costs and Lease Incentives

The lessee modification guidance in ASC 842 has no impact on previously recognized initial direct costs and lease incentives since the amounts associated with these items are already reflected in the premodification ROU asset. Therefore, when a lease is modified, only those new, additional initial direct costs, prepaid rent, and lease incentives would result in an incremental adjustment to the ROU asset.

8.6.3.3 Modification in Which Classification Changes From Finance Lease to Operating Lease

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

While the interest expense and amortization expense components of a lease’s total cost are measured and presented independently of one another in a finance lease, expense in an operating lease is recognized on a straight-line basis over the lease term. Because total lease cost is recognized on a straight-line basis, the amortization component of total lease cost is interdependent with the amount of interest expense recorded in each period (see ASC 842-20-25-6 and Section 8.4.3.2 of this Roadmap for more information about subsequent measurement of an operating lease and determination of single lease cost). When an operating lease is initially measured, any difference in the lease liability and ROU asset balance, such as a prepaid lease or lease incentive, is accreted/amortized over the term of the lease through this straight-line lease expense.

ASC 842-10-25-14 states that when a lease previously classified as a finance lease becomes an operating lease as a result of a lease modification, “any difference between the carrying amount of the [ROU] asset after recording the adjustment required by paragraph 842-10-25-12 or 842-10-25-13 and the carrying amount of the [ROU] asset that would result from applying the initial operating [ROU] asset measurement guidance in paragraph 842-20-30-5” is treated similarly to a lease incentive or rent prepayment. Differences between the lease liability and ROU asset as of the effective date of the modification are likely to exist given expense recognition patterns for a finance lease, since the ROU asset is generally amortized on a straight-line basis whereas the lease liability is accreted by using the effective interest rate method (see Section 8.4.3.1 for more information about subsequent measurement of a finance lease). In effect, this guidance dictates that the difference between the lease liability and ROU asset immediately before the modification is accreted through the revised straight-line lease expense in a manner similar to how the difference between the ROU asset and lease liability as a result of lease incentives or prepayments is treated in the subsequent measurement of a new operating lease. This accretion serves to reduce the straight-line expense recognized for the operating lease after the modification and reflects the fact that the pre-modification classification led to a front-loaded expense pattern (the front-loaded amount serves to reduce the operating lease expense and is spread evenly over the remaining lease term to preserve a straight-line pattern after the modification).
Example 8-9 below illustrates the subsequent measurement of a lease that is initially classified as a finance lease but subsequently classified as an operating lease as a result of a lease modification.

### Example 8-9

On January 1, 20X1, Company P (the lessee) enters into an agreement with Company D (the lessor) to lease office equipment for six years. In addition, P has an option to renew the lease for one additional year and determines that it is reasonably certain to exercise this option. Lease payments are made annually in arrears for fixed amounts of $10,000, and P uses an incremental borrowing rate of 8 percent. The arrangement does not contain any termination or purchase options, and there are no residual value guarantees. Further, there are no lease incentives, rent prepayments, or variable lease payments. The economic life of the leased asset is eight years, and the fair value of the leased asset is $70,000 at commencement.

Given that the renewal option at commencement is reasonably certain, P determines that the lease term is seven years. In a manner consistent with the approach outlined in ASC 842-10-55-2(a), P concludes that 75 percent or more of the remaining economic life of the underlying asset represents a major part of its remaining economic life. Accordingly, P determines that the criterion in ASC 842-10-25-2(c) is met and classifies the lease as a finance lease, since the lease represents 87.5 percent of the asset’s remaining economic life (seven-year term divided by eight-year economic life). Company P determines that no other criteria in ASC 842-10-25-2 are met that would result in a finance lease classification.

At lease commencement, P calculates a lease liability and ROU asset of $52,064 on the basis of the present value of the lease payments. Company P records annual interest expense and amortization in the following manner:

| Year | Lease Liability | ROU Asset |
|------|----------------|
|      | Beginning Balance | Interest Expense | Payments | Ending Balance | Beginning Balance | Amortization | Ending Balance |
| 0    | $ 52,064 | $ 52,064 |
| 1    | $ 52,064 | $ 4,165 | $ 10,000 | $ 46,229 | $ 52,064 | $ 7,438 | $ 44,626 |
| 2    | 46,229 | 3,698 | 10,000 | 39,927 | 44,626 | 7,438 | 37,188 |
| 3    | 39,927 | 3,194 | 10,000 | 33,121 | 37,188 | 7,438 | 29,751 |
| 4    | 33,121 | 2,650 | 10,000 | 25,771 | 29,751 | 7,438 | 22,313 |
| 5    | 25,771 | 2,062 | 10,000 | 17,833 | 22,313 | 7,438 | 14,875 |
| 6    | 17,833 | 1,427 | 10,000 | 9,259 | 14,875 | 7,438 | 7,438 |
| 7    | 9,259 | 741 | 10,000 | — | 7,438 | 7,438 | — |

On January 1, 20X3, P and D agree to reduce the term of the lease to five years (three years remaining as of January 1, 20X3) and eliminate the renewal option. No other terms of the original lease agreement are amended by the modification, and no additional payments are made. Because no additional right of use is granted through the lease modification, the modification is not accounted for as a separate contract under ASC 842-10-25-8. Company P’s incremental borrowing rate on the effective date of the modification remains at 8 percent. The lease liability and ROU asset balance immediately before the lease modification are $39,927 and $37,188, respectively.
Example 8-9 (continued)

Company P remeasures the lease liability on the basis of the remaining payments of $10,000 per year for the revised lease term of three years and determines that the modified lease liability equals $25,771. Thus, P reduces its lease liability by $14,156 and records an offsetting entry to the ROU asset balance; accordingly, P’s ROU asset balance is reduced to $23,032 as a result of the modification. The related journal entry is as follows:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>14,156</td>
<td></td>
</tr>
<tr>
<td>ROU asset</td>
<td>14,156</td>
<td></td>
</tr>
</tbody>
</table>

Company P performs a lease classification test as of the modification date and determines that the major part of the economic life criterion is no longer met, since the revised lease term of three years only represents 50 percent of the remaining economic life (three-year term divided by six-year remaining economic life). Because P determines that no other criteria in ASC 842-10-25-2 that would result in finance lease classification are met, P classifies the modified lease as an operating lease.

Company P measures its revised lease cost commensurate with the straight-line recognition expense profile for operating leases. This amount is calculated on the basis of the total remaining lease payments of $30,000, adjusted for the difference between the carrying amount of the ROU asset balance after the adjustment for ASC 842-10-25-12 is recorded (i.e., the $14,156 reduction as a result of the remeasured lease liability from the reduction in the lease term) and what the carrying amount of the ROU asset would have been after applying the initial measurement guidance is applied in accordance with ASC 842-20-30-5 (i.e., the initial measurement of a new ROU asset). As shown below, this amount reduces the remaining cost in the lease by $2,739 for a total straight-line lease expense of $9,087 per year.

| Carrying amount of the ROU asset after the modification in accordance with ASC 842-10-25-12 | $ 23,032 |
| Carrying amount of the ROU asset after the initial measurement guidance is applied in accordance with ASC 842-20-30-5 | 25,771 |
| Difference | ($2,739) |

| Total remaining lease payments | $30,000 |
| Less: difference calculated above | ($2,739) |
| Remaining cost in the lease | 27,261 |
| Remaining lease term (years) | 3 |
| Straight-line lease expense | $9,087 |

16 Lessee records the difference between the pre-modification lease liability and post-modification lease liability as an adjustment to the ROU asset in accordance with ASC 842-10-25-12, since the modification is a reduction of lease term in accordance with ASC 842-10-25-11(b).

17 In our example, the measurement of the ROU asset under ASC 842-20-30-5 would equal the initial measurement of the modified lease liability of $25,771 described above, since there are no prepaid lease payments, lease incentives, or initial direct costs.
Example 8-9 (continued)

As a result, P will account for the lease liability and ROU asset balances after the effective date of the modification as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Straight-Line Recognition</th>
<th>Lease Liability</th>
<th>ROU Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Beginning Balance</td>
<td>Beginning Balance</td>
<td>Amortization</td>
</tr>
<tr>
<td></td>
<td>Interest Expense</td>
<td>Interest Expense</td>
<td>Amortization</td>
</tr>
<tr>
<td></td>
<td>Payments</td>
<td>Payments</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Modification</td>
<td>(14,156)</td>
<td>(14,156)</td>
</tr>
<tr>
<td>3</td>
<td>$ 9,087</td>
<td>$ 25,771</td>
<td>$ 2,062</td>
</tr>
<tr>
<td>4</td>
<td>$ 9,087</td>
<td>$ 17,833</td>
<td>$ 1,427</td>
</tr>
<tr>
<td>5</td>
<td>$ 9,087</td>
<td>$ 9,259</td>
<td>$ 741</td>
</tr>
</tbody>
</table>

8.6.3.4 Modification That Extends or Reduces the Lease Term of an Existing Lease (Other Than Through Exercise of an Option)

ASC 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: . . .

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) . . .

25-12 In the case of [(b)] 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.

When a lease modification extends or reduces the lease term (other than through the exercise of options included in the lease), a lessee must remeasure and reallocate the consideration of the contract (see Chapter 4). In addition, the lessee would reassess lease classification on the basis of the relevant assumptions that exist as of the effective date of the modification (see Section 8.3.4).

As a result of the modification, the lessee would remeasure its lease liability and recognize the amount resulting from the remeasurement of the lease liability as an adjustment to the corresponding ROU asset. That is, the lessee would recognize the difference between remeasured lease liability and the pre-modification lease liability as an adjustment to the ROU asset.

Since the remeasurement amount is directly recognized as an adjustment to the ROU asset, there is no income statement impact associated with this type of modification.

---

18 A company may apply one of two approaches to subsequently account for an operating lease, each of which results in the same outcome. The table below illustrates the subsequent measurement of an operating lease by using the “plug” approach described in Example 8-8 in Section 8.4.3.2 (Approach B), which presents amortization activity net for the adjustment to the ROU asset. See Approach A in the aforementioned example for an illustration of how a company would amortize this adjustment when the adjustment is tracked separately from the ROU asset balance.
Scenarios in which a lessee extends or reduces the lease term through the exercise of a renewal or termination option already included in the lease are not considered lease modifications (see Section 8.5.1 for additional discussion).

8.6.3.4.1 Illustrative Example — Modification Extends Lease Term but No Change in Lease Classification

ASC 842-10

Example 16 — Modification That Increases the Lease Term
Case A — No Change in Lease Classification

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.

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).

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.

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).

Below is an additional analysis of certain aspects of the FASB’s example above.

Remeasurement of the Lease Liability

The new lease liability is calculated as the present value of the revised lease payments for the extended 10-year term. The calculation results in a lease liability of $772,594; therefore, a $351,358 adjustment is recorded as an increase to the premodification liability balance of $421,236 at the beginning of year 6. In addition, in a manner consistent with the guidance in ASC 842-10-25-12, the lessee would similarly recognize an increase to the ROU asset. The resulting entry is as follows:

ROU asset                  351,358
Lease liability            351,358
**Determining the Revised Lease Cost**

In a manner consistent with ASC 842-20-25-8, the lessee calculates the remaining lease cost of the operating lease as of the modification date as the total lease payments (both paid and not yet paid), adjusted by the periodic lease cost recognized in prior periods. The resulting revised lease cost is recognized on a straight-line basis over the remaining lease term. The following table illustrates these calculations:

<table>
<thead>
<tr>
<th>Total lease payments</th>
<th>$1,600,000</th>
<th>([100,000 × 5] + [110,000 × 10])</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior-period lease cost</td>
<td>(500,000)</td>
<td>$100,000 for first five years</td>
</tr>
<tr>
<td>Remaining lease cost</td>
<td>1,100,000</td>
<td></td>
</tr>
</tbody>
</table>

8.6.3.4.2 Illustrative Example — Modification Extends Lease Term and Lease Classification Changes

**ASC 842-10**

*Example 16 — Modification That Increases the Lease Term*

**Case B — Change in Lease Classification**

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).

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.

Below is an additional analysis of certain aspects of the FASB’s example above.
**Remeasurement of the Lease Liability**

The new lease liability is calculated as the present value of the revised lease payments for the extended 10-year term. The calculation results in a lease liability of $772,594, resulting in the need for a $351,358 adjustment to the premodification liability balance of $421,236 at the beginning of year 6. In addition, in a manner consistent with the guidance in ASC 842-10-25-12, the lessee would similarly recognize an adjustment to the premodification ROU asset balance of $421,236 at the beginning of year 6. The resulting entry is as follows:

| ROU asset | 351,358 |
| Lease liability | 351,358 |

**Revised Expense Recognition Pattern**

As a result of the modification, the lease classification changed from an operating lease to a finance lease. Therefore, as opposed to the recognition of lease expense (presented as a single line item) on a straight-line basis, the subsequent measurement as a finance lease results in the separate recognition of interest expense and amortization expense. These two amounts would be presented in a manner consistent with interest from debt and amortization or depreciation of other nonfinancial assets.

In this example, the lessee would recognize the following interest and amortization expense each period:

<table>
<thead>
<tr>
<th>Period</th>
<th>Total Interest and Amortization</th>
<th>Interest Expense</th>
<th>Amortization Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>$131,341</td>
<td>$54,082</td>
<td>$77,259</td>
</tr>
<tr>
<td>7</td>
<td>127,427</td>
<td>50,167</td>
<td>77,260</td>
</tr>
<tr>
<td>8</td>
<td>123,238</td>
<td>45,979</td>
<td>77,259</td>
</tr>
<tr>
<td>9</td>
<td>118,757</td>
<td>41,498</td>
<td>77,259</td>
</tr>
<tr>
<td>10</td>
<td>113,962</td>
<td>36,702</td>
<td>77,260</td>
</tr>
<tr>
<td>11</td>
<td>108,831</td>
<td>31,572</td>
<td>77,259</td>
</tr>
<tr>
<td>12</td>
<td>103,341</td>
<td>26,082</td>
<td>77,259</td>
</tr>
<tr>
<td>13</td>
<td>97,467</td>
<td>20,207</td>
<td>77,260</td>
</tr>
<tr>
<td>14</td>
<td>91,181</td>
<td>13,922</td>
<td>77,259</td>
</tr>
<tr>
<td>15</td>
<td>84,455</td>
<td>7,195</td>
<td>77,260</td>
</tr>
<tr>
<td>Total</td>
<td>$1,100,000</td>
<td>$327,406</td>
<td>$772,594</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.
8.6.3.5 Modification Granting the Lessee an Additional Right of Use Not Included in the Original Contract or Accounted for as a Separate Contract

ASC 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) . . .

25-12 In the case of [(a)] 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.

When a lease modification grants the lessee an additional right of use that is not included in the original contract and that does not meet both of the criteria to be accounted for as a separate contract, a lessee must remeasure and reallocate the consideration in the contract (see Chapter 4). In addition, the lessee would reassess lease classification on the basis of the relevant assumptions that exist as of the effective date of the modification (see Section 8.3.4).

As a result of the modification, the lessee would remeasure its lease liability and recognize the amount resulting from the remeasurement of the lease liability as an adjustment to the corresponding ROU asset. That is, the lessee would recognize the difference between the remeasured lease liability and the premodification lease liability as an adjustment to the ROU asset.

Since the remeasurement amount is directly recognized as an adjustment to the ROU asset, no income statement impact is associated with this type of modification.

The example below from ASC 842-10-55-168 through 55-176 illustrates a modification in which an additional right of use is granted.

ASC 842-10

Example 17 — Modification That Grants an Additional Right of Use

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.

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.

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).
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.

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.

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.

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.

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).

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.

Below is an additional analysis related to the FASB’s example above, including the key calculations, amortization schedule, and journal entries. Assume that the space per square foot is economically similar in nature such that each square foot should receive an equal allocation of the revised contract consideration.
Evaluating Contract Components

As noted in ASC 842-10-55-170, Lessee accounts for the modified contract as two separate lease components:

- **Component 1** — “[T]he original 10,000 square feet of office space.”
- **Component 2** — “[T]he 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.”

The modified contract does not include any nonlease components. The total lease payments, after the modification, are $700,000 (1 payment of $100,000 + 4 payments of $150,000).

Allocating Consideration in the Contract

**Determining Relative Stand-Alone Price**

In accordance with ASC 842, Lessee would allocate the consideration to the separate lease components in the contract on a relative stand-alone price basis. The following table illustrates how to determine the allocation percentages that will be used to allocate the consideration in the contract in the example above for each of the two components in the contract (see details in ASC 842-10-55-171):

<table>
<thead>
<tr>
<th>Remaining Year</th>
<th>Component 1 (Sq. Footage)</th>
<th>Component 2 (Sq. Footage)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>2</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>3</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>4</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>5</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Total</td>
<td>50,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Allocation %</td>
<td>(50,000/90,000)</td>
<td>(40,000/90,000)</td>
</tr>
</tbody>
</table>

**Determining the Remaining Lease Cost for Each Component**

ASC 842-10-55-171 notes that, in this scenario, 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.” The graphic below shows the related calculations.

<table>
<thead>
<tr>
<th>Remaining Year</th>
<th>Remaining Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$100,000</td>
</tr>
<tr>
<td>2</td>
<td>150,000</td>
</tr>
<tr>
<td>3</td>
<td>150,000</td>
</tr>
<tr>
<td>4</td>
<td>150,000</td>
</tr>
<tr>
<td>5</td>
<td>150,000</td>
</tr>
<tr>
<td>Total</td>
<td>700,000</td>
</tr>
</tbody>
</table>

Component 1 allocation of (50,000/90,000) $388,889
Component 2 allocation of (40,000/90,000) $311,111
Accounting for Component 1

For this component, lease classification did not change as a result of the lease modification. As noted in ASC 842-10-55-171, “Lessee remeasures the lease liability for the original space lease as of the effective date of the modification.” This remeasurement is based on the following facts:

- “A remaining lease term of 5 years.”
- “Annual allocated lease payments of $77,778 in Years 6 through 10” (calculated as the total consideration allocated of $388,889 divided by the five-year term), which are recognized on a straight-line basis over the remaining five years.
- “Lessee’s incremental borrowing rate at the effective date of the modification of 7 percent.”

As indicated in ASC 842-10-55-172, “[t]he remeasured lease liability for the original space lease equals $318,904,” which is calculated as the present value of the lease payments allocated to Component 1, discounted by using the 7 percent discount rate as of the effective date of the modification. Further, “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.”

The resulting calculations for Component 1 are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Cost</th>
<th>Lease Liability</th>
<th>ROU Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Beginning Balance</td>
<td>Liability Accretion</td>
</tr>
<tr>
<td>1</td>
<td>$100,000</td>
<td>$736,009</td>
<td>$44,160</td>
</tr>
<tr>
<td>2</td>
<td>100,000</td>
<td>680,169</td>
<td>40,810</td>
</tr>
<tr>
<td>3</td>
<td>100,000</td>
<td>620,979</td>
<td>37,259</td>
</tr>
<tr>
<td>4</td>
<td>100,000</td>
<td>558,238</td>
<td>33,494</td>
</tr>
<tr>
<td>5</td>
<td>100,000</td>
<td>491,732</td>
<td>29,504</td>
</tr>
</tbody>
</table>

Modification adjustment: $421,236

Lease Liability and ROU Asset Remeasurement

The resulting journal entry to reflect the change in the lease liability and ROU asset is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability (Component 1)</td>
<td>102,332</td>
</tr>
<tr>
<td>ROU asset (Component 1)</td>
<td>102,332</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.
The liability is reduced in this example because the additional right of use is priced at a discount and this discount is effectively split between the two postmodification lease components.

**Lease Cost Recognition and Year 6 Payment Allocation**

For the remainder of the lease term (i.e., years 6–10), Lessee recognizes a lease cost of $77,778 for Component 1. As discussed in ASC 842-10-55-173, in year 6, Lessee is required to make a lease payment of $100,000, which represents $77,778 of lease cost related to Component 1 for year 6 and $22,222 related to a prepayment of Component 2. That is, Lessee records the following journal entry:

| Lease cost (Component 1) | 77,778 |
| Prepaid rent (Component 2) | 22,222 |
| Cash | 100,000 |

**Accounting for Component 2**

Lessee determined that this lease component is classified as an operating lease. As noted in ASC 842-10-55-174, “[a]t 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.” This measurement and recognition are based on the following facts listed in ASC 842-10-55-174:

- “A lease term of 4 years.”
- “Four allocated annual payments of $72,222 ([allocated lease payments of $311,111 − $22,222 rent prepayment] ÷ 4 years).” Note that in year 6, before the commencement of the lease for Component 2, the lessee made a payment of $100,000, of which $77,778 was allocated to Component 1 and $22,222 was allocated to Component 2.
- “Lessee’s incremental borrowing rate at the commencement date of the separate lease component for the additional office space of 7.5 percent.”

As indicated in ASC 842-10-55-175, the ROU asset equals $264,118, which is calculated as the lease liability of $241,896 plus the prepaid rent asset of $22,222.

The resulting calculations for Component 2 are as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Lease Cost</th>
<th>Lease Liability</th>
<th>ROU Asset</th>
<th>Ending Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Beginning Balance</td>
<td>Liability Accretion</td>
<td>Lease Payment</td>
<td>Ending Balance</td>
</tr>
<tr>
<td>7</td>
<td>$77,778</td>
<td>$241,896</td>
<td>$18,142</td>
<td>$(72,222)</td>
</tr>
<tr>
<td>8</td>
<td>77,778</td>
<td>187,816</td>
<td>14,087</td>
<td>(72,222)</td>
</tr>
<tr>
<td>9</td>
<td>77,777</td>
<td>129,681</td>
<td>9,725</td>
<td>(72,222)</td>
</tr>
<tr>
<td>10</td>
<td>77,777</td>
<td>67,184</td>
<td>5,038</td>
<td>(72,222)</td>
</tr>
</tbody>
</table>

Prepayment: 22,222

<table>
<thead>
<tr>
<th>Beginning Balance</th>
<th>ROU Asset Reduction</th>
<th>Ending Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>264,118</td>
<td>(59,636)</td>
<td>204,482</td>
</tr>
<tr>
<td>204,482</td>
<td>(63,691)</td>
<td>140,791</td>
</tr>
<tr>
<td>140,791</td>
<td>(68,052)</td>
<td>72,739</td>
</tr>
<tr>
<td>72,739</td>
<td>(72,739)</td>
<td>—</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.
Chapter 8 — Lessee Accounting

Lease Liability and ROU Asset Recognition

The resulting journal entry is recorded at the beginning of period 7 to reflect the recognition of the lease liability and ROU asset related to Component 2:

\[
\begin{align*}
\text{ROU asset (Component 2)} & \quad 241,896 \\
\text{Lease liability (Component 2)} & \quad 241,896 \\
\text{ROU asset (Component 2)} & \quad 22,222 \\
\text{Prepaid rent (Component 2)} & \quad 22,222
\end{align*}
\]

Lease Cost Recognition

For the remainder of the lease term (i.e., years 7–10), Lessee recognizes a lease cost of $77,778 for Component 2.

Lease Payment Allocation (Years 7–10)

As discussed in ASC 842-10-55-176, Lessee allocates $77,778 of the $150,000 annual lease payment to Component 1 and $72,222 to Component 2.

8.6.3.6 Modification That Changes Only the Consideration in the Contract

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
</table>
| **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: . . .  
  d. Changes the consideration in the contract only.  |
| **25-12** In the case of [(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.  |

When a lease modification changes only the consideration in the contract, a lessee must remeasure and reallocate the consideration in the contract (see Chapter 4). In addition, the lessee would reassess lease classification on the basis of the relevant assumptions that exist as of the effective date of the modification (see Section 8.3.4).

As a result of the modification, the lessee would remeasure its lease liability and recognize the amount resulting from the remeasurement of the lease liability as an adjustment to the corresponding ROU asset. That is, the lessee would recognize the difference between the remeasured lease liability and the premodification lease liability as an adjustment to the ROU asset.
Since the remeasurement amount is directly recognized as an adjustment to the ROU asset, no income statement impact is associated with this type of modification.

The example below from ASC 842-10-55-186 through 55-189 illustrates a modification in which only the lease payments are changed.

**Example 19 — Modification That Changes the Lease Payments Only**

**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.

**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.

**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 $402,061 ($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.

**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.

<table>
<thead>
<tr>
<th></th>
<th>Lease Liability</th>
<th>Right-of-Use Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 7</td>
<td>$ 251,816</td>
<td>$ 241,316</td>
</tr>
<tr>
<td>Year 8</td>
<td>$ 174,443</td>
<td>$ 166,443</td>
</tr>
<tr>
<td>Year 9</td>
<td>$ 90,654</td>
<td>$ 86,154</td>
</tr>
<tr>
<td>Year 10</td>
<td>$ –</td>
<td>$ –</td>
</tr>
</tbody>
</table>
The following table summarizes the calculations related to the lease liability and ROU asset in the example above.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Cost</th>
<th>Lease Liability</th>
<th>ROU Asset</th>
<th>Modification adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$99,500</td>
<td>Beginning Balance</td>
<td>Liability Accretion</td>
<td>Lease Payment</td>
</tr>
<tr>
<td>1</td>
<td>99,500</td>
<td>728,811</td>
<td>43,728</td>
<td>(95,000)</td>
</tr>
<tr>
<td>2</td>
<td>99,500</td>
<td>677,539</td>
<td>40,653</td>
<td>(96,000)</td>
</tr>
<tr>
<td>3</td>
<td>99,500</td>
<td>622,192</td>
<td>37,331</td>
<td>(97,000)</td>
</tr>
<tr>
<td>4</td>
<td>99,500</td>
<td>562,523</td>
<td>33,751</td>
<td>(98,000)</td>
</tr>
<tr>
<td>5</td>
<td>99,500</td>
<td>498,274</td>
<td>29,897</td>
<td>(99,000)</td>
</tr>
<tr>
<td>6</td>
<td>92,500</td>
<td>388,965</td>
<td>27,228</td>
<td>(93,000)</td>
</tr>
<tr>
<td>7</td>
<td>92,500</td>
<td>323,193</td>
<td>22,623</td>
<td>(94,000)</td>
</tr>
<tr>
<td>8</td>
<td>92,500</td>
<td>251,816</td>
<td>17,627</td>
<td>(95,000)</td>
</tr>
<tr>
<td>9</td>
<td>92,500</td>
<td>174,443</td>
<td>12,211</td>
<td>(96,000)</td>
</tr>
<tr>
<td>10</td>
<td>92,500</td>
<td>90,654</td>
<td>6,346</td>
<td>(97,000)</td>
</tr>
</tbody>
</table>

Modification adjustment: $(40,206)

Note that certain amounts in the table are subject to rounding differences.

Before the modification, the annual lease cost is the sum of all lease payments ($995,000) allocated on a straight-line basis over the 10-year lease term.

Remeasurement of the Lease Liability and ROU Asset

The new lease liability on the effective date of the modification is calculated as the present value of the revised lease payments for the remaining lease term. The calculation results in a lease liability of $388,965; therefore, a $40,206 adjustment is needed at the beginning of year 6. In addition, in a manner consistent with the guidance in ASC 842-10-25-12, the lessee would recognize an offsetting entry in the amount of the remeasurement of the lease liability for the modified lease as an adjustment to the corresponding ROU asset. The lessee records the following journal entry:

Lease liability 40,206
ROU asset 40,206

Determining the Revised Lease Cost

In a manner consistent with ASC 842-20-25-8, the lessee would calculate the remaining lease cost of the operating lease as of the modification date as the total lease payments (both paid and not yet paid), adjusted by the periodic lease cost recognized in prior periods. The resulting revised lease cost would be recognized on a straight-line basis over the remaining lease term.
In this example, the calculation of the remaining lease cost would be as follows:

<table>
<thead>
<tr>
<th>Total lease payments</th>
<th>$960,000</th>
<th>$(485,000 [Y1–Y5]) + (475,000 [Y6–Y10])</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior-period lease cost</td>
<td>(497,500)</td>
<td>$99,500 for each of the first five years</td>
</tr>
<tr>
<td>Remaining lease cost</td>
<td>462,500</td>
<td></td>
</tr>
</tbody>
</table>

\[
\text{Revised Period Lease Cost} = \frac{\text{Remaining Lease Cost}}{\text{Remaining Lease Term}} = \frac{462,500}{5 \text{ years}} = 92,500
\]

### 8.6.3.7 Modification Decreases the Scope of the Lease (a Full or Partial Termination)

**ASC 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: . . .

   c. Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease) . . . .

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.

When a lease modification reduces the scope of a lease through a full or partial termination of the lease (i.e., reduces the underlying asset that is available for use by the lessee — for example, by reducing the square footage leased in a building or by removing a lease component from an arrangement containing multiple lease components), a lessee must remeasure and reallocate the consideration in the contract (see Chapter 4). In addition, the lessee would reassess lease classification on the basis of the relevant assumptions that exist as of the effective date of the modification (see Section 8.3.4). The resulting accounting for a lease modification that reduces the scope of a lease depends on whether it is a full or partial termination:

- **Accounting for a full termination** — In the case of a full termination, the lessee would derecognize the lease liability and ROU asset. The difference would be recognized in the income statement as a gain or loss.

- **Accounting for a partial termination** — In the case of a partial termination, the lessee would first remeasure its lease liability and reflect the change as an adjustment to the premodification lease liability. The lessee would then reduce the ROU asset on a proportionate basis. Any difference between the proportionate reduction in the ROU asset and corresponding lease liability is recognized in the income statement as a gain or a loss on the effective date of the modification.
Connecting the Dots — Full or Partial Termination of One or More (but Not All) Lease Components

Entities often enter into lease contracts that include multiple underlying assets accounted for as separate lease components in accordance with ASC 842-10-15-28. As discussed in Section 8.6.3.5, when a lease modification grants a lessee an additional right of use that is not included in the original contract (provided that the lease payments do not increase in a manner commensurate with the stand-alone price), the lessee must apply modification accounting to all the lease components in the contract. Similarly, a change in the terms or conditions of a contract with several lease components that results in a full or partial termination of one or more (but not all) of the lease components constitutes a modification of the entire contract. Therefore, the lessee would reallocate the consideration in the contract on the basis of modification-date stand-alone prices and would reassess lease classification and remeasure the lease liability for all the remaining lease components.

According to the implementation guidance in ASC 842, there are two alternative approaches for reducing the ROU asset when a modification results in the reduction of the scope of the lease.

Approach 1: Remeasure the ROU Asset on the Basis of the Liability Change

Under this approach, the lessee would first remeasure its lease liability on the basis of the revised lease payments. The lessee would then determine the percentage reduction in the lease liability by comparing the remeasured liability with the premodification liability. The resulting percentage would be applied to the premodification ROU asset, and any difference between the lease liability adjustment and the resulting ROU asset adjustment amount would be recognized in the income statement as a gain or loss.

Approach 2: Remeasure the ROU Asset on the Basis of the ROU Asset Reduction

Under this approach, the lessee would first remeasure its lease liability on the basis of the revised lease payments. The lessee would then determine the percentage reduction in the physical space or productive capacity that resulted from the lease modification. In the determination of the postmodification carrying amount, the resulting percentage would be applied to the premodification liability and premodification ROU asset, resulting in both of the following:

- Any difference between the change in the premodification liability and postmodification liability and the change in the premodification ROU asset and postmodification ROU asset would be recognized in the income statement as a gain or loss.
- Any difference between the remaining lease liability and the remeasured lease liability, calculated by using the proportionate change resulting from the reduction of the physical right of use and the present value of the postmodification lease payments, would be recognized as an adjustment to the ROU asset, reflecting the change in the consideration paid for the lease and the revised discount rate.

Connecting the Dots — Modifications That Decrease the ROU Asset

The implementation guidance in ASC 842 provides two viable approaches for remeasuring a ROU asset as a result of a lease modification that decreases the scope of the lease. We believe that the approach for remeasuring the ROU asset as a result of a modification that decreases the scope of a lessee’s right of use is an accounting policy election and, therefore, should be applied consistently to all similar types of modifications. In addition, we believe that a lessee should disclose its elected accounting policy if the impact of this policy is material to its financial statements.

Although written from the perspective of a lessee, the concepts described in this Connecting the Dots also apply to lessors.
Q&A 8-15AD  Penalty for a Partial Termination

The parties in an existing lease may agree to terminate the lessee's right to use (1) some of the assets under the lease (e.g., discrete pieces of equipment) or (2) a portion of an asset (e.g., one of several leased floors in an office building). In some cases, the lessee might agree to increase the lease payments for the remaining portion of the lease. Previously, under ASC 840, lessees were required to evaluate whether such an increase in lease payments was, in substance, a termination penalty (which would be recognized as an expense immediately) or only a modification of future lease payments (which would be accounted for prospectively over the remaining lease term).

However, ASC 842 does not contain similar guidance and instead requires both parties to apply the new modification framework. Likewise, ASC 842 does not contain explicit guidance on how a lessee should account for a termination penalty paid to a lessor upon a partial termination of a lease.

**Question 1**

How should a lessee account for an increase in lease payments for the remaining portion of a lease upon a partial termination of the lease?

**Answer**

The lessee should treat the increased lease payments as part of the revised consideration in the modified contract and allocate the payments to the remaining lease and nonlease components.

ASC 842-10-35-4 and ASC 842-10-25-11 state that upon a modification that is not accounted for as a separate contract, including a partial termination, a lessee must “remeasure the lease payments” and “reallocate the remaining consideration in the contract and remeasure the lease liability.” Importantly, ASC 842-10-25-11 neither requires nor permits entities to allocate a portion of the remaining consideration to the terminated component(s) of the contract. Instead, the remaining consideration is entirely allocated to the remaining components in the contract.

We believe that the Board intended this outcome, since it would often be highly complex and costly to determine what portion of the revised lease payments is related to the terminated components of a contract rather than to the remaining components. Similarly, this complexity was part of the Board's basis for its prospective approach to modifications in ASC 606, as described in paragraph BC78 of ASU 2014-09:

The Boards also decided that a contract modification should be accounted for prospectively when the goods or services to be provided after the modification are distinct from the goods or services already provided (see paragraph 606-10-25-13(a)). The Boards decided that this should be the case regardless of whether the pricing of the additional promised goods or services reflected their standalone selling prices. This is because accounting for those types of modifications on a cumulative catch-up basis could be complex and may not necessarily faithfully depict the economics of the modification because the modification is negotiated after the original contract and is based on new facts and circumstances. Therefore, this approach avoids opening up the accounting for previously satisfied performance obligations and, thus, avoids any adjustments to revenue for satisfied performance obligations. [Emphasis added]
The Board intentionally aligned many of the principles in the ASC 842 modification framework with those in ASC 606. Paragraph BC169 of ASU 2016-02 explains this alignment:

The guidance on lease modifications in Topic 842 was developed principally with the following in mind:

a. The accounting for lease modifications in previous GAAP was generally considered to be very complex (often explained only by flowchart). In the Board’s view, the lease modifications guidance in Topic 842 is less complex and more intuitive to apply than the previous guidance.

b. Contracts that contain leases frequently contain nonlease components (that is, other goods or services). This was particularly important to the Board’s considerations about lease modification accounting for lessors because Topic 606 contains a robust framework for accounting for modifications of contracts with customers to provide nonlease goods and services (for example, supplies for use with leased equipment or services such as maintenance or operation of the underlying asset).

Therefore, we believe that allocating the revised consideration in the contract prospectively only to the remaining components, even if such allocation does not reflect the economic substance of the revised payments, is consistent with the Board’s intent in (1) aligning the modification framework in ASC 842 with that in ASC 606 and (2) reducing the complexity of accounting for lease modifications.

**Question 2**

How should a lessee account for a termination penalty paid to the lessor upon a partial termination of a lease?

**Answer**

ASC 842-10-30-5 states, in part:

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: . . .

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.

Therefore, a termination penalty is considered to be a form of a lease payment and is included in the consideration allocated to the components in the contract. As discussed in Question 1, the revised consideration in the contract should be allocated only to the remaining components, rather than in part to the terminated component(s). As a result, the full amount of the termination penalty is recognized prospectively.

We believe that the basis for this outcome is appropriately consistent with that in Question 1. Frequently, a lessee and lessor may negotiate a termination payment in conjunction with a renegotiation of the ongoing lease payments or in contemplation of the existing ongoing lease payments, and the lessor may be economically satisfied with a lower termination payment than it would otherwise accept (or may require a higher termination payment than it would otherwise accept) because of the ongoing lease payments. Therefore, it would be highly complex and costly to differentiate between, for example, a termination penalty related to a terminated lease component and a prepayment for the remaining lease components. In other cases, the parties may simply choose to finance the termination penalty over the remaining lease term by adjusting the remaining lease payments. As discussed in Question 1 above, the modification treatment appears clear when future lease payments are adjusted and we do not believe that the timing of the payment should dictate the accounting outcome.

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21 Although this Q&A focuses on termination penalties paid to the lessor, we believe that the conclusion reached would also apply to any consideration received by the lessee from the lessor upon a partial termination of a lease.
In contrast to a partial termination, a termination penalty paid as part of a full termination of a lease (i.e., when there are no remaining components in the contract) should be included in the determination of the gain or loss upon termination in accordance with ASC 842-20-40-1 and ASC 842-20-40-3. However, as discussed in Q&A 8-15A below, the guidance on full terminations only applies when the lessee’s right of use ceases contemporaneously with the execution of the modification (e.g., assets are immediately returned to the lessor or space is immediately vacated), which we believe will occur infrequently for leases of certain types of assets (e.g., real estate) because of the time and administrative burden that typically accompany relocating.

Example

On September 15, 2019, Lessee enters into a 15-year lease for six floors of an office building for a total of $6 million per year, with no termination or renewal options. On September 15, 2024, Lessee and Lessor agree to immediately terminate the lease of two of those six floors while retaining the lease of the other four floors for the remaining 10-year lease term. Lessee also agrees to pay Lessor a $4 million termination penalty, which is determined by comparing the remaining lease payments related to the two floors being terminated with current market rates. That is, the $4 million represents the “in-the-money” portion of the terminated lease components.

In accordance with ASC 842-10-35-4 and ASC 842-10-25-11, Lessee should remeasure the lease liability for the remaining lease components (i.e., the four remaining floors) by remeasuring the lease payments and allocating those lease payments to the remaining components in the contract. Although $4 million is contractually specifically related to the terminated space, the $4 million termination penalty should be included in those revised lease payments — and thus deferred as part of the ROU asset for the remaining floors — rather than being recorded as part of any gain or loss upon termination. Lessee should then apply the guidance in ASC 842-10-25-13 (by using one of the approaches discussed above) to determine the gain or loss to be recognized as a result of the partial termination.

Q&A 8-15A  Reduction in Lease Term Versus Lease Termination

The guidance in ASC 842-10-25-11(c) applies to full or partial terminations and results in potential gains or losses when the lease is remeasured. On the other hand, ASC 842-10-25-11(b) applies to lease term extensions or reductions and requires the lessee to recognize the amount of the remeasurement of the lease liability for the modified lease as an adjustment to the corresponding ROU asset, which generally does not result in a gain or a loss.

Question 1

If a modification results in a reduced lease term for part of the leased asset (e.g., a reduced term for a percentage of the leased space), does the guidance in ASC 842-10-25-11(c) apply?

Answer

No. Although the guidance in ASC 842-10-25-11(b) does not explicitly address this issue, we believe that this guidance applies to reductions in the lease term of either the entire leased asset or part of the leased asset. That is, regardless of whether the term is reduced for the entire lease or for only a part or a percentage of the lease (e.g., 20 percent of the leased space), the lessee would apply the guidance in ASC 842-10-25-11(b).
Question 2
If a modification results in the termination of all or part of a lessee's right of use after a specified period (rather than immediate termination), does the guidance in ASC 842-10-25-11(c) apply?

Answer
No. If a termination only takes effect after a specified period, the lessee still has the right to use the leased asset for that period; therefore, the modification consists of a reduction in the lease term rather than a full or partial termination and the lessee would apply the guidance in ASC 842-10-25-11(b). The only time that the guidance on full or partial terminations applies is when all or part of the lessee's right of use ceases contemporaneously with the execution of the modification (e.g., assets are immediately returned to the lessor or space is immediately vacated).

The example below from ASC 842-10-55-177 through 55-185 illustrates two approaches to measuring an ROU asset in a scenario in which a modification decreases the scope of a lease.

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 18 — Modification That Decreases the Scope of a Lease</strong></td>
</tr>
</tbody>
</table>
| **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. |
| **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. |
| **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. |
| **55-180** The remeasured lease liability equals $306,098. |
| **Case A — Remeasuring the Right-of-Use Asset Based on Change in Lease Liability** |
| **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. |
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

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).

Fifty percent of the premodification right-of-use asset is $257,218 (50% × $514,436). Fifty percent of the premodification lease liability is $295,384 (50% × $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.

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.

Below is a summary of the two different approaches to remeasuring the ROU asset in this example.

Approach 1 — Remeasuring the ROU Asset on the Basis of the Percentage Change in Lease Liability

Under this approach, the lessee calculates the percentage decrease in the lease liability as a result of the modification. This percentage is applied to the premodification ROU asset to determine the postmodification ROU asset balance. The difference between the change in the postmodification ROU asset and the postmodification lease liability represents a gain or loss that is recognized in the income statement as of the date of the modification. See ASC 842-10-55-181 and 55-182 above for details related to the calculation of the gain and the adjustments to the ROU asset under Approach 1.

Journal Entries

As a result of the calculations detailed in ASC 842-10-55-181 and 55-182, the lessee records the following journal entry to account for the remeasurement of the lease liability, ROU asset, and gain related to the modification.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>284,669</td>
</tr>
<tr>
<td>ROU asset</td>
<td>247,888</td>
</tr>
<tr>
<td>Gain related to modification</td>
<td>36,781</td>
</tr>
</tbody>
</table>
**Determining the Revised Lease Cost**

In a manner consistent with ASC 842-20-25-8, the lessee calculates the remaining lease cost of the operating lease as of the modification date as the total lease payments (both paid and not yet paid) and any adjustments resulting from a lease modification (including amounts attributable to a gain or loss from the modification), less the periodic lease cost recognized in prior periods. In other words, the remaining lease cost is calculated as the sum of (1) the postmodification balance for the ROU asset and (2) the expected future accretion of the liability (i.e., the difference between the total future lease payments and the postmodification lease liability balance). The resulting revised lease cost is then recognized on a straight-line basis over the remaining lease term.

The following table illustrates the calculations related to the remaining lease cost:

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total lease payments</td>
<td>$928,306</td>
</tr>
<tr>
<td>Prior-period lease cost</td>
<td>$(628,895)</td>
</tr>
<tr>
<td>Modification adjustment</td>
<td>$36,781</td>
</tr>
<tr>
<td>Remaining lease cost</td>
<td>$336,192</td>
</tr>
</tbody>
</table>

Approach 2 — Remeasuring the ROU Asset on the Basis of the Percentage Change in the Right of Use

Under this approach, the lessee calculates the percentage decrease in the physical space subject to the right of use as a result of the modification. This percentage is applied to the premodification ROU asset to determine the postmodification ROU asset balance. The difference between the change in the premodification balance and postmodification balance and the lease liability adjustment represents a gain or loss that is recognized in the income statement as of the date of the modification.

See ASC 842-10-55-183 through 55-185 above for details related to the calculation of the gain and the adjustments to the ROU asset under Approach 2.

**Journal Entries**

As a result of the calculations detailed in ASC 842-10-55-183 through 55-185, the lessee records the following journal entries to account for the partial derecognition of the lease liability, ROU asset, and gain related to the modification. In addition, the lessee records, as an adjustment to the ROU asset, the difference between the premodification lease liability of $295,384 (50 percent of $590,767) and the modified lease liability of $306,098.

- Lease liability 295,384
- ROU asset 257,218
- Gain related to modification 38,166
- ROU asset 10,714
- Lease liability 10,714
**Determining the Revised Lease Cost**

In a manner consistent with ASC 842-20-25-8, the lessee will calculate the remaining lease cost of the operating lease as of the modification date as the total lease payments (both paid and not yet paid) and any adjustments resulting from a lease modification (including amounts attributable to a gain or loss from the modification), less the periodic lease cost recognized in prior periods. In other words, the remaining lease cost is calculated as the sum of (1) the postmodification balance for the ROU asset and (2) the expected future accretion of the liability (i.e., the difference between the total future lease payments and the postmodification lease liability balance). The resulting revised lease cost is then recognized on a straight-line basis over the remaining lease term.

The calculation of the remaining lease cost would be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total lease payments</td>
<td>$928,306 (552,563 [Y1–Y5]) + (375,743 [Y6–Y10])</td>
</tr>
<tr>
<td>Prior-period lease cost</td>
<td>(628,895) $125,779 for each of the first five years</td>
</tr>
<tr>
<td>Modification adjustment</td>
<td>38,166 (lease liability adjustment – ROU asset adjustment)</td>
</tr>
<tr>
<td>Remaining lease cost</td>
<td>337,577</td>
</tr>
</tbody>
</table>

\[
\text{Revised Period Lease Cost} = \frac{\text{Remaining Lease Cost}}{\text{Remaining Lease Term}} = \frac{337,577}{5\text{ years}} = 67,515
\]

### 8.6.4 Other Scenarios Related to Lease Modifications

#### 8.6.4.1 Lease Modifications in Connection With the Refunding of Tax-Exempt Debt

**ASC 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.

Governmental authorities often use tax-exempt debt to finance the construction of a facility (e.g., a plant or a hospital) that they will lease to another entity. As noted above, the payment terms of the lease generally mirror, with respect to both amount and timing, “those required by the tax-exempt debt.” Such a lease “may serve as collateral for the guarantee of payments equivalent to those required to service the tax-exempt debt.”

If the governmental authority enters into a refunding arrangement that replaces the existing tax-exempt debt with new debt (as would be the case if the authority wanted to take advantage of lower interest rates), the resulting change in the debt service payments may result in a reduction of the corresponding...
lease payments. This reduction of lease payments would be accounted for as a modification. See Section 8.6.3.6 for additional discussion of modifications that result only in a change to consideration in the contract.

### 8.6.4.2 Applying the Modification Guidance to a Master Lease Agreement

As described in Section 13.4, a master lease agreement may specify that the lessee will obtain control over multiple underlying assets (e.g., equipment) at various times during the term of the agreement. In accordance with ASC 842-10-55-17, the lessee's accounting in such cases depends on whether it is obligated or committed to use, and therefore obtain control of, “a minimum number of units or dollar value of equipment.” If so, the lessee should take into account this minimum quantity when separating lease components and allocating the consideration in the contract to the separate lease components. Because the minimum quantity is factored into the initial separation of and allocation to the lease components, the lessee's attainment of control of the underlying assets throughout the term of the master lease agreement does not result in a lease modification. However, because the lessee may obtain control of the underlying assets at different times during the master lease agreement, the separate lease components may have different lease commencement dates, as explained in ASC 842-10-55-22. Note that if a lessee obtains control of underlying assets in addition to the minimum quantity or value specified in the master lease agreement, there would be a lease modification.

In addition, ASC 842-10-55-18 stipulates that if the lessee is not obligated or committed to use a minimum quantity of equipment, the attainment of control over each underlying asset must be accounted for as a lease modification in accordance with ASC 842-10-25-8 through 25-18. Depending on the terms of the arrangement, the resulting modification may result in accounting for each new asset as a separate lease or in a remeasurement of the existing lease. Because the equipment is not subject to a minimum commitment, the entity would not include the equipment in the initial separation of and allocation to the lease components in the contract. See Section 13.4 for additional information on accounting for master lease agreements.

### 8.6.4.3 Lease Modifications That Involve More Than One Change

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>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:</td>
</tr>
<tr>
<td>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)</td>
</tr>
<tr>
<td>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)</td>
</tr>
<tr>
<td>c. Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease)</td>
</tr>
<tr>
<td>d. Changes the consideration in the contract only.</td>
</tr>
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<td>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.</td>
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<td>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.</td>
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When a lease modification is not accounted for as a separate contract, a lessee must reallocate the remaining consideration in the contract and remeasure its lease liability. If the modification extends or reduces the lease term of an existing lease (see Section 8.6.3.4), provides the lessee with an additional right of use not accounted for as a separate contract (see Section 8.6.3.5), or changes the consideration in the contract (see Section 8.6.3.6), the lessee should recognize the amount resulting from the remeasurement of the lease liability as an adjustment to the corresponding ROU asset. If the modification reduces the scope of a lease through a full or partial termination of the lease, the lessee should instead record a proportionate reduction in the ROU asset as well as a gain or loss for any difference between the decrease in the lease liability and the decrease in the ROU asset (see Section 8.6.3.7).

While the guidance in ASC 842 is clear on the accounting for a lease modification that results in a single change, some lease modifications may include multiple changes that need to be accounted for in different ways on the basis of the nature of the change. ASC 842 does not clearly address how to account for these types of lease modifications.

Q&A 8-15B  Lease Modifications That Involve More Than One Change

Question
How should a lessee account for a lease modification that involves more than one change?

Answer
It depends. A lessee’s approach to modifications involving more than one change will typically depend on the nature of the changes and whether they would individually lead to different accounting treatments upon remeasurement of the lease liability (i.e., all adjustments recognized on the balance sheet versus potential for gain or loss in the income statement). We generally believe that the lessee should account for each change included in the modification in accordance with the guidance applicable to that change rather than view one change as predominant. That is, the lessee should generally not simply adjust the ROU asset for the total remeasurement in the lease liability by using the modification guidance applicable to the most significant change.

To properly account for each change, it may be helpful for a lessee to bifurcate the original lease into the portions that are subject to the different remeasurement rules in ASC 842-10-25-12 and 25-13.

For example, we believe that in dealing with a modification involving an immediate termination of part of a lessee’s right of use coupled with a lease term extension for the remaining right of use, it would be reasonable for the lessee to first bifurcate the existing lease liability and ROU asset on the basis of the portion of the lease affected by each change. The bifurcation between the two portions should be on the basis of the relative stand-alone prices.

Once the lease liability and ROU asset have been allocated between the two portions, the lessee would apply the modification guidance in ASC 842-10-25-11 through 25-13 to the balances allocated to each portion. The lessee would thus derecognize the balances allocated to the terminated portion of the lease (with a corresponding gain or loss) and would remeasure the lease liability allocated to the retained portion of the lease (with a corresponding adjustment to the ROU asset) by using the remaining lease term and incremental borrowing rate determined as of the effective date of the modification. The lessee would also reassess the classification of the lease as of the effective date of the modification.
Example

Lessee has an existing lease for 5,000 square feet of office space with a remaining lease term of three years. Lessee and Lessor agree to modify the lease to (1) immediately terminate the lease of 1,000 square feet of the office space and (2) extend the lease term for the remaining 4,000 square feet to five years. On the basis of the relative stand-alone prices, Lessee bifurcates the ROU asset and lease liability into the portion subject to the immediate termination (1,000 square feet) and the portion subject to the lease term extension (4,000 square feet). Lessee then (1) applies the guidance in ASC 842-10-25-13 to the portion of the ROU asset and lease liability associated with the immediate termination (i.e., derecognizes those balances and records a gain or loss for the difference) and (2) applies the guidance in ASC 842-10-25-12 to the portion of the ROU asset and lease liability associated with the lease term extension (i.e., remeasures the lease liability and makes a corresponding adjustment to the ROU asset).

8.7 Derecognizing a Lease

8.7.1 Setting the Stage

This section addresses phase 7 of the lease “life cycle,” which discusses the guidance that a lessee would evaluate when determining how it will derecognize a lease.

8.7.2 Lease Termination

ASC 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.

When a lease is fully terminated before the expiration of the lease term, irrespective of whether the lease is classified as a finance lease or an operating lease, the lessee would derecognize the ROU asset and corresponding lease liability. Any difference would be recognized as a gain or loss related to the termination of the lease. Similarly, if a lessee is required to make any payments or receives any consideration when terminating the lease, it would include such amounts in the determination of the gain or loss upon termination.

When a lease is partially terminated before the expiration of the lease term, the lessee would account for the partial termination as a lease modification (see Section 8.6.3.7 for more information). If a lessee is required to make any payments or receives any consideration when terminating the lease, it would include such amounts in the determination of the revised consideration in the modified contract (see Q&A 8-15AD for more information).

22 A partial termination occurs when the parties in an existing lease agree to terminate the lessee’s right to use (1) some of the assets under the lease (e.g., discrete pieces of equipment) or (2) a portion of an asset (e.g., one of several leased floors in an office building).
8.7.3 Purchase of the Underlying Asset

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<tr>
<th>ASC 842-20</th>
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<tr>
<td>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.</td>
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The lessee’s purchase of the underlying asset is not a lease termination under ASC 842-20-40-1. Rather, when a lessee purchases the underlying asset, it would reclassify the ROU asset balance and adjust the carrying value of the purchased asset by the difference between the purchase price of the asset and the lease liability immediately before the purchase.

Underlying assets that are acquired as part of a business combination are not subject to the accounting guidance in ASC 842-20-40-2. Rather, these assets would be initially measured at fair value in accordance with ASC 805.

8.7.4 Subleasing When Original Lessee Is Relieved of Primary Obligation

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<th>ASC 842-20</th>
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<td>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.</td>
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Under ASC 842, a head lessee that enters into a sublease with another party must consider whether (1) it has subleased the asset to the other party or (2) it has extinguished its head lease as a result of its arrangement with the other party. This determination is governed by whether the lessee is relieved of its primary obligation under the head lease, as described in ASC 842-20-40-3. Scenarios in which a head lessee subleases the asset to another party are addressed in Section 12.3.

In a sublease scenario, when the intermediate lessor is relieved of its obligations under the head lease (i.e., the original lease that a lessee has with a third-party lessor), the transaction would be considered a termination of the head lease. In a manner consistent with the discussion in Section 12.3.2, the lessee/intermediate lessor would derecognize the ROU asset and lease liability arising from the head lease and would recognize any difference in profit or loss. Any additional consideration received or paid on termination that was not already included in the lease payments would generally be included in the calculation of the gain or loss resulting from the termination (e.g., a termination penalty not included in the determination of the original lease liability).
When a sublease results in the termination of the original head lease and the original lessee remains secondarily liable in the lease agreement, the lessee would recognize a guarantee obligation in accordance with ASC 405. Specifically, ASC 405-20-40-2 states that “in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor.” As a result, the guarantee obligation would be measured at fair value, with an offsetting adjustment to the gain or loss recognized on terminating the lease.

In each scenario in which an intermediate lessor is relieved of its primary obligation under the original head lease, the intermediate lessor would not be subject to sublease accounting. See Chapter 12 for additional information about subleases.

**8.8 Other Lessee-Related Matters**

**8.8.1 Master Lease Agreements**

A master lease agreement may specify that the lessee will obtain control over multiple underlying assets (e.g., equipment) at various points during the term of the agreement. In these cases, the lessee’s accounting will depend on whether the master lease agreement obligates or commits the lessee to use, and therefore obtain control of, a minimum quantity (units or dollars) of equipment. (See Sections 13.4.1 and 13.4.2, respectively, for additional information about situations in which a lessee is or is not obligated or committed to use a minimum quantity of equipment.)

When a lessee obtains control over the use of additional underlying assets that are subject to a master lease agreement and that agreement specifies a minimum quantity or dollar amount, the lessee’s taking of control over the additional assets would not be accounted for as a modification unless the minimum quantity has already been achieved. In contrast, if the agreement does not specify a minimum quantity or dollar value, the lessee’s taking of control over the additional assets would always be accounted for as a lease modification. See Section 8.6.4.2 for more information on the modification of master lease agreements.

**8.8.2 Leases Denominated in a Foreign Currency**

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<th>ASC 842-20</th>
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<tr>
<td><strong>55-10</strong> 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.</td>
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Irrespective of lease classification, a lease liability represents a monetary liability and an ROU asset represents a nonmonetary asset. Therefore, in accordance with ASC 830-10, a lease liability and ROU asset denominated in a foreign currency that are remeasured into an entity’s functional currency would be accounted for in the following manner:

- **Lease liability** — Remeasured by using the current-period exchange rate, with changes recognized in net income in a manner consistent with other foreign-currency-denominated liabilities (see guidance in ASC 830-20-35 for additional considerations).
- **ROU asset** — Remeasured by using the historical exchange rate as of the commencement date, provided that the lease has not been modified. Questions have arisen regarding the exchange rate to be applied when a lease has been modified and the modification was not accounted for as a separate contract. See Q&A 8-16A for further details.
Q&A 8-16  Foreign Exchange Rate Considerations Related to the Single Lease Cost in an Operating Lease

**Question**

How would a lessee recognize, in its functional currency, the single lease cost associated with an operating lease that is denominated in a foreign currency?

**Answer**

The lease cost consists of two components: (1) the expense associated with the accretion of the lease liability and (2) the amount associated with the reduction of the ROU asset. Therefore, a reasonable approach to recognizing the single lease cost would be to bifurcate the cost into its two separate components (monetary and nonmonetary) and account for the resulting amounts in accordance with ASC 830.

**Lease Liability Accretion — Monetary Liability**

In a manner consistent with the accounting for other foreign-currency-denominated monetary liabilities, when remeasuring the time-value-of-money component of the lease cost related to the lease liability accretion, it would be appropriate for the lessee to use the average exchange rate for the period.

**ROU Asset Reduction — Nonmonetary Asset**

In a manner consistent with the accounting for other nonmonetary assets, when measuring the component of the lease cost representing the change in the ROU asset in each period, it would be appropriate for the lessee to use the historical exchange rate that was used when the ROU asset was initially recognized. That is, the ROU asset functional currency amount would be determined by using the foreign currency rate that was in effect as of the date on which the ROU asset was initially recognized (i.e., the latter of the date of initial application of ASC 842 or the lease commencement date). Therefore, in each period, the component of the lease cost representing the change in the ROU asset balance is no longer considered a foreign-currency-denominated amount; therefore, in each subsequent period, this amount would be calculated by using the exchange rate employed to initially determine the ROU asset and would not change unless an impairment is recognized or the ROU asset is updated as a result of a liability remeasurement event (e.g., a lease modification).

Q&A 8-16A  Foreign Exchange Rate Considerations Related to Lease Modifications and Remeasurements

When an entity applies modification accounting under ASC 842, the modification can be accounted for either as the addition of a separate contract (see Section 8.6.2) or as a change to the original lease (see Section 8.6.3). As discussed further in Section 8.6.2, when a modification is considered a separate contract, the lessee accounts for the separate contract as if it were a stand-alone lease and applies the requirements of ASC 842 to that discrete unit of account. Accordingly, in such circumstances, a new lease liability and ROU asset are established for the new separate contract and the exchange rate on the date of modification would be applied to the new separate ROU asset resulting from the modification.

On the other hand, if the modification is not accounted for as a separate contract, the lessee would effectively account for the modified arrangement as a new lease. That is, the lessee would reassess the classification of the lease as of the effective date of the modification by using...
the modified terms and conditions and would remeasure the lease liability and, in most cases (excluding partial terminations of a lease), recognize any difference between the new lease liability and the old lease liability as an adjustment to the ROU asset (see Section 8.6.3.1). As stated in ASC 842-20-55-10, a lease liability represents a monetary liability and is remeasured by using the current-period exchange rate. Therefore, when a modification is not accounted for as a separate contract, the lessee would continue remeasuring the lease liability by using the current-period exchange rate.

However, an ROU asset represents a nonmonetary asset and should therefore be remeasured by using the historical exchange rate as of the commencement date. Questions have arisen regarding what rate should be used — and how it should be used — to remeasure the postmodification ROU asset and whether (1) the ROU asset, in its entirety, should be remeasured by using the exchange rate as of the “new” lease commencement date (i.e., the date of the lease modification) or (2) the historical exchange rate as of the original lease commencement date should be applied to the ROU asset established before the modification and the exchange rate as of the date of the lease modification should be applied to any increase in the ROU asset resulting from the modification (i.e., a bifurcated approach to foreign currency remeasurement).

Similarly, questions have arisen regarding what exchange rate should be used upon the occurrence of any of the lease remeasurement events described in ASC 842-10-35-4. As discussed in Section 8.5 and Q&A 8-12B, some lease remeasurement events are accounted for in a manner similar to lease modifications (“Category A remeasurement events”), while others do not result in a reassessment of lease classification, discount rate, or stand-alone prices (“Category B remeasurement events”):

- **Category A remeasurement events** — Change in the (1) lease term or (2) assessment of whether the lessee is reasonably certain to exercise a purchase option.
- **Category B remeasurement events** — (1) Change in the amount that it is probable the lessee will owe under a residual value guarantee or (2) resolution of a contingency, as a result of which future variable lease payments become fixed.

**View 1 — Exchange Rate as of “New” Lease Commencement Date Applied to Full ROU Asset for Modifications and Category A Remeasurement Events; Historical Exchange Rate Applied to ROU Asset for Category B Remeasurement Events**

Proponents of View 1 observe that paragraph BC173 of ASU 2016-02 states that “[w]hen a modification does not meet the criteria to be accounted for as a separate contract, the lessee remeasures the lease liability for the modified, existing lease as of the effective date of the modification as if the modified lease were a new lease that commences on that date.” That is, paragraph BC173 of ASU 2016-02 indicates that a modification results in accounting in which the modified lease is treated as the termination of the old lease and the creation of a new lease. An entity could thus interpret this paragraph as indicating that the effective date of the modification represents the new lease commencement date. Therefore, the exchange rate as of the effective date of the modification would represent the exchange rate in effect as of the commencement date and should be used to remeasure the ROU asset, in its entirety, on a go-forward basis. Application of the updated rate to the entire ROU asset will most likely result in a corresponding foreign exchange gain or loss as of the date of the modification.
As discussed in Section 8.5, stand-alone prices, discount rates, and lease classification are all reassessed upon the occurrence of Category A remeasurement events, which are economically similar to lease modifications and thus accounted for in a similar manner under ASC 842. On the other hand, Category B remeasurement events do not result in the reassessment of stand-alone prices, discount rates, or lease classification. Proponents of View 1 argue that Category B remeasurement events represent an updated measurement of an existing lease rather than the creation of a new lease. Therefore, according to this view, upon the occurrence of a Category A remeasurement event, an updated exchange rate (as of the remeasurement date) should be applied to the ROU asset in the same manner as a lease modification; however, upon the occurrence of a Category B remeasurement event, the historical exchange rate should continue to be applied to the entire ROU asset, including to any increases or decreases in the ROU asset as a result of the remeasurement event.

View 2 — Historical Exchange Rate Applied to ROU Asset Established Before Modification/Remeasurement and Updated Exchange Rate Applied to Increases Resulting From Modification/Remeasurement

Proponents of View 2 note that an entity that applies View 1 will recognize a foreign exchange gain or loss to bring the ROU asset to the new exchange rate. However, paragraph BC175 of ASU 2016-02 (shown below) indicates that a modification other than a full or partial termination should not result in a gain or a loss because there has been no actual “termination, fully or partially, of the original lease.” Therefore, while paragraph BC173 of ASU 2016-02 indicates that an entity should account for a modification as if the original lease were terminated, paragraph BC175 of ASU 2016-02 indicates that a termination has not truly occurred and that an entity therefore should not recognize any gain or loss. Paragraph BC175 of ASU 2016-02 states:

> The Board concluded that for the types of modifications in paragraph BC174(a), a lessee should not recognize a gain or loss from the modification because there has been no termination, fully or partially, of the original lease. Instead, the modification solely changes the cost of the right-of-use asset resulting from the original lease. Consequently, the amount of the remeasurement of the lease liability for the modified lease is recorded as an adjustment to the right-of-use asset and, no amount is recognized in profit or loss. In deliberating this guidance, the Board noted that a lease may be modified even if the stated terms of the modification do not change the stated terms of the lease. For example, a stated change in the consideration to be paid for a nonlease component may change the remaining lease payments because the lessee must allocate that change in consideration on the same basis as the original consideration in the contract was allocated. [Emphasis added]

As a result, proponents of View 2 believe that it is inappropriate to apply the exchange rate as of the lease modification date to the full ROU asset, since doing so would result in recognition of a gain or loss upon modification and paragraph BC175 of ASU 2016-02, while not directly addressing foreign currency remeasurement, appears to suggest that the FASB did not intend for this outcome to occur. Instead, proponents of View 2 believe that the exchange rate as of the modification date should only be applied to any increase in the ROU asset resulting from the modification. In a manner consistent with paragraph BC175 of ASU 2016-02, View 2 would not result in recognition of a gain or loss upon modification. According to View 2, each subsequent increase in the ROU asset as a result of a modification that is not accounted for as a separate contract would be subject to the same remeasurement model, and any subsequent decrease in the ROU asset as a result of a modification would need to be evaluated to determine the “layer(s)” to which the decrease is related.
The same approach would also be applied to both Category A and Category B remeasurement events. For example, if the ROU asset increases because variable payments become fixed, the increase would be measured at the then-current exchange rate; however, the historical exchange rate would continue to be applied to the previously recognized ROU asset balance.

On the basis of formal discussions with the SEC staff, we understand that either View 1 or View 2 is acceptable. Entities should elect one of the two approaches as an accounting policy and apply it consistently to all leases. In addition, entities should disclose the accounting policy elected, if material. However, we understand that these views should not be applied by analogy to revenue transactions within the scope of ASC 606.

8.8.3 Accounting for Leasehold Improvements

8.8.3.1 Amortization of Leasehold Improvements

Amounts attributable to leasehold improvements (i.e., improvements to leased property, such as additions, alterations, remodeling, or renovations) are recognized separately from the underlying ROU asset that is the subject of a lease. A lessee is generally required to amortize leasehold improvements over the shorter of the useful life of those improvements or the lease term. The useful life of an asset is the period over which an asset is expected to contribute directly or indirectly to the owner’s future cash flows.

If the ownership of the underlying asset that is the subject of the lease agreement is transferred to the lessee at the end of the lease term or if the lease agreement includes a purchase option whose exercise by the lessee is reasonably certain, the leasehold improvements would be amortized over their useful life. In this case, the lessee is not constrained by the lease term since it will be able to benefit from the leasehold improvements beyond the lease term (provided that the useful life is greater than the lease term).

Q&A 8-17 Leasehold Improvements: Depreciation Period and the Consideration of Residual Value

Question

Over what period and to what amount should a lessee amortize its leasehold improvements?

Answer

Leasehold improvements normally should be amortized over the shorter of the lease term or the asset’s useful life (the period over which an asset is expected to contribute directly or indirectly to future cash flows). Note that the lease term is the same term used to determine lease classification.
If the lease arrangement automatically transfers title of the leased asset to the lessee at the end of the lease term, or the lessee has a purchase option such that purchase of the leased asset is reasonably certain, an amortization period greater than the lease term, if shorter than the economic life of the leasehold improvements, may be appropriate.

In addition, if the lessee determines that leasehold improvements can be relocated or sold upon lease expiration without significant diminution in fair value (including removal costs, such as relocation costs), it may be appropriate to amortize the leasehold improvements over the lease term to expected fair value. In such cases, all facts and circumstances should be considered and companies should establish an accounting policy that should be applied consistently to similar transactions.

**Connecting the Dots — Amortization of Leasehold Improvements Under ASC 842 Is Consistent With That Under ASC 840**

The amortization of leasehold improvements under ASC 842 is generally consistent with that under ASC 840. As a result, entities may not be significantly affected by the guidance on leasehold improvements in ASC 842. However, see Q&A 16-2C for considerations related to transition for leasehold improvements with an amortization period greater than the remaining lease term.

As a reminder, leasehold improvements, as well as other long-lived assets in an asset group (e.g., ROU assets arising from a lease), are subject to impairment testing under ASC 360. See Section 8.4.4 for additional information about the application of the impairment guidance in ASC 360 to a lessee’s ROU assets.

**Connecting the Dots — Importance of Determining Which Party Owns the Property Improvements**

Determining which party in the arrangement owns the improvements that are made to a property subject to a lease is important and affects the related accounting. For example, if a lessee (or the lessor on behalf of the lessee) is making improvements to a rented space for the purpose of building out the space to be consistent with the lessee’s branding and owns such improvements, any costs that are paid by the lessor with respect to the buildout would generally be considered a lease incentive. In contrast, if the overall lease agreement was for a fully built-out space (e.g., a fully functioning office space with interior walls, plumbing, and lighting) and the lessor owns the improvements, any costs that are paid would generally be considered as part of the overall asset subject to the lease.

Factors for an entity to consider when evaluating whether the lessee or lessor owns the improvements include, but are not limited to:

- Whether the terms of the lease agreement obligate the tenant to construct or install specifically identified assets (i.e., the leasehold improvements) as a condition of the lease.
- Whether the tenant’s failure to make specified improvements is an event of default under which the landlord can require the lessee to make those improvements or otherwise enforce the landlord’s rights to those assets (or a monetary equivalent).
- Whether the tenant is permitted to alter or remove the leasehold improvements without the consent of the landlord or without compensating the landlord for any lost utility or diminution in fair value.
- Whether the tenant is required to provide the landlord with evidence supporting the cost of tenant improvements before the landlord pays the tenant for the tenant improvements.
• Whether the landlord is obligated to fund cost overruns for the construction of leasehold improvements.
• Whether the leasehold improvements are unique to the tenant or could reasonably be used by the lessor to lease to other parties.
• Whether the economic life of the leasehold improvements is such that a significant residual value of the assets is expected to accrue to the benefit of the landlord at the end of the lease term.

All factors for each lease must be carefully evaluated; no one factor should be considered determinative.

8.8.3.2 Leasehold Improvements Acquired in a Business Combination

ASC 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.

ASC 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.

In a manner similar to the guidance on a lessee's accounting for leasehold improvements, an acquiree is required to amortize any of the leasehold improvements acquired in a business combination “over the shorter of the useful life” of those improvements or the lease term unless “the lease transfers ownership of the underlying asset to the lessee” or it is reasonably certain that the lessee will exercise the “option to purchase the underlying asset.” Therefore, when the lease transfers ownership of the underlying asset to the lessee or if the lessee's exercise of an option to purchase the underlying asset is reasonably certain, it would be appropriate for the lessee to amortize the leasehold improvements over their estimated useful life.

8.8.4 Lessee's Accounting for Maintenance Deposits

ASC 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.
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.

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).

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.

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.

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.

Leases of certain types of equipment (e.g., an aircraft lease) may dictate that the lessee is legally or contractually required to perform all of the repair and maintenance of the underlying asset throughout the lease term. These leases often include a requirement that a lessee make deposits to the lessor to financially protect the lessor in the event that the lessee does not perform the required repair and maintenance activities. In these cases, the lessor must refund the deposits (often referred to as maintenance reserves or supplemental rent) to the lessee upon the completion of the contractually required repairs and maintenance activities.

The maintenance deposits under these types of arrangements are generally determined on the basis of a usage performance measure (e.g., hours of flight in the case of an aircraft). In accordance with the contract terms and to the extent the amount is on deposit, the lessor must reimburse the lessee any amounts paid for the required repairs and maintenance of the underlying asset once the maintenance activities have been completed.

8.8.4.1 Accounting for Maintenance Deposits During the Lease Term

The accounting for maintenance deposits, from the lessee's perspective, is directly linked to whether, at the end of the lease term, the lessor must refund any excess portion of the maintenance deposit not expended by the lessee for maintenance activities.
Refundable Maintenance Deposit

If a lessee is entitled to a refund of any maintenance deposit excess at the end of the lease term (a refundable maintenance deposit), all lease payment amounts attributable to repair and maintenance activities will be recognized as a deposit asset by the lessee. Therefore, as the lessee makes a payment that is attributable to the refundable maintenance deposit, it will recognize the following journal entries:

- Deposit asset XXX
- Cash XXX

As the lessee performs the required repair and maintenance activities, it will be reimbursed by the lessor for these costs by using the amounts on deposit. At the end of the lease term, any remaining amounts returned to the lessee will offset the deposit asset. Therefore, the lessee would recognize the following entries during the term of the agreement and at the end of the lease term (in this example, we have assumed that the lessee's policy is to expense the maintenance costs as incurred):

### Repair and maintenance activities (during term)

- Repair and maintenance expense XXX
- Cash XXX
- To reflect the maintenance event.

- Cash XXX
- Deposit asset XXX
- To reflect the reimbursement from lessor.

### Residual balance returned (end of the lease term)

- Cash XXX
- Deposit asset XXX

In addition, to the extent that the arrangement provides for interest on the deposit, any interest earned on the refundable maintenance deposit that the lessee forgoes (i.e., that the lessor is entitled to retain) should be considered a variable lease payment and would be recognized in the following manner:

- Variable lease cost XXX
- Interest income XXX

Nonrefundable Maintenance Deposit

If a lessee is not entitled to a refund of the maintenance deposit excess at the end of the lease term, at lease commencement, the lessee must evaluate whether it is less than probable that the total amount of payments will ultimately be reimbursed over the lease term through the repair and maintenance activity requests.
Any amounts paid to the lessor for repair and maintenance activities whose return is not deemed probable should be accounted for in a manner similar to variable lease expense (i.e., recognized in profit and loss in the period in which the obligation for those payments is incurred). Any amounts paid to the lessor for repair and maintenance activities whose return is deemed probable should be recognized as a deposit asset that will be used to reimburse the lessee as such activities are performed. Therefore, as the lessee makes a payment that is attributable to the nonrefundable maintenance deposit, it records the following journal entries (in this example, we have assumed that the lessee’s policy is to expense the maintenance costs as incurred):

**Nonrefundable deposit recognition**

- Deposit asset (return is probable) XXXX
- Variable lease cost (return is not probable) XXXX
- Cash XXXX
- Repair and maintenance expense. XXXX
- Cash XXXX
- To reflect the maintenance event
- Cash XXXX
- Deposit asset XXXX
- To reflect the reimbursement from lessor.

The concept of probability should continually be reassessed over the lease term and if no longer deemed probable, the deposit asset should be reduced by recognizing variable lease expense.

Irrespective of whether the maintenance deposit is refundable or nonrefundable, as the actual repair and maintenance activities are performed, the lessee would capitalize or expense these costs in accordance with its maintenance capitalization policy.

### Connecting the Dots — Maintenance Deposits Versus Other Deposits

**Considerations Related to Refundable Deposits**

Refundable maintenance deposits are deferred and recognized as a deposit asset until the actual repairs and maintenance activities are performed during the lease term. Other refundable deposits retained by the lessor (e.g., for other reasons such as excess wear and tear on the underlying asset) would generally be considered a variable lease payment. As with other variable payment requirements, lessees should consider the implementation guidance in ASC 842-20-55-1 and 55-2 when evaluating whether a lessee should recognize costs from variable payments before the achievement of a specified target (see Q&A 8-10 for further details).

**Considerations Related to Nonrefundable Deposits**

Nonrefundable maintenance deposits are accounted for in the following manner: (1) amounts whose use is probable are deferred and recognized as a deposit asset until the actual repairs and maintenance activities are performed during the lease term and (2) amounts whose return is less than probable are recognized as a variable lease cost when return is no longer deemed probable. In contrast, other types of nonrefundable deposits are considered lease payments and included in the determination of the lease liability.

See Section 6.1 for additional discussion of other refundable and nonrefundable deposits.
8.9 Codification Examples

<table>
<thead>
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<tbody>
<tr>
<td><strong>55-21</strong> Example 3 illustrates how a lessee would initially and subsequently measure right-of-use assets and lease liabilities and how a lessee would account for a change in the lease term.</td>
</tr>
<tr>
<td><strong>55-40</strong> Example 4 illustrates how a lessee would recognize lease cost in an operating lease and initially and subsequently measure right-of-use assets and lease liabilities for that lease.</td>
</tr>
</tbody>
</table>

The examples below from ASC 842-20-55-21 through 55-46 and ASC 842-10-55-211 through 55-224 reflect various aspects of the lessee accounting model. Rather than carving up each example and reproducing different pieces throughout this chapter, we have decided to keep them intact in their entirety since we find that approach to be more useful.

8.9.1 Lease Recognition, Initial and Subsequent Measurement, and Reassessment of Lease Term

The examples below from ASC 842-20-55-21 through 55-46 reflect implementation considerations related to the guidance in ASC 842-20-25-1 through 35-15 on a lessee’s recognition and initial and subsequent measurement of its leases as well as the reassessment of the lease term under the new lease accounting requirements.

Example 3 illustrates a lessee’s recognition and initial and subsequent measurement of its leases as well as the reassessment of lease term in the context of both a finance lease and an operating lease. Example 4 comprehensively illustrates the recognition and initial and subsequent measurement of an operating lease by a lessee.

8.9.1.1 Example 3 — Initial and Subsequent Measurement by a Lessee and Accounting for a Change in the Lease Term

<table>
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<tr>
<td><strong>Example 3 — Initial and Subsequent Measurement by a Lessee and Accounting for a Change in the Lease Term</strong></td>
</tr>
<tr>
<td><strong>Case A — Initial and Subsequent Measurement of the Right-of-Use Asset and the Lease Liability</strong></td>
</tr>
<tr>
<td><strong>55-22</strong> 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.</td>
</tr>
<tr>
<td><strong>55-23</strong> 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.</td>
</tr>
<tr>
<td><strong>55-24</strong> 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.</td>
</tr>
<tr>
<td><strong>55-25</strong> 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).</td>
</tr>
</tbody>
</table>
ASC 842-20 (continued)

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

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).

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

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).

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

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.

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).

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.
Chapter 8 — Lessee Accounting

ASC 842-20 (continued)

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).

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.

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

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

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.

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).

8.9.1.2 Example 4 — Recognition and Initial and Subsequent Measurement by a Lessee in an Operating Lease

ASC 842-20

Example 4 — Recognition and Initial and Subsequent Measurement by a Lessee in an Operating Lease

55-41 Lessee enters into a 10-year lease for 5,000 square feet of office space. The annual lease payment is $10,000, 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 classifies the lease as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3. Lessee incurs initial direct costs of $5,000.

55-42 At the commencement date, Lessee receives a $10,000 cash payment from Lessor that Lessee accounts for as a lease incentive. Lessee measures the lease liability at the present value of the 10 remaining lease payments ($10,000 in Year 1, increasing by 5 percent each year thereafter), discounted at the rate of 6 percent, which is $90,434. Lessee also measures a right-of-use asset of $85,434 (the initial measurement of the lease liability + the initial direct costs of $5,000 – the lease incentive of $10,000)
55-43 During the first year of the lease, Lessee determines the remaining cost of the lease as the sum of the following:

a. The total lease payments of $115,779 (the sum of the 10 escalating payments to Lessor during the lease term of $125,779 – the lease incentive paid to Lessee at the commencement date of $10,000)

b. The total initial direct costs attributable to the lease of $5,000.

The amount of the remaining lease cost is therefore $120,779 ($115,779 + $5,000). Consequently, Lessee determines that the single lease cost to be recognized every year throughout the lease term is $12,078 ($120,779 ÷ 10 years). This assumes that there are no remeasurements of the lease liability or modifications to the lease throughout the lease term.

55-44 At the end of Year 1, the carrying amount of the lease liability is $85,860 (9 remaining lease payments, discounted at the rate of 6 percent), and the carrying amount of the right-of-use asset is the amount of the liability, adjusted for the following:

a. Accrued lease payments of $2,578 (the amount of payments to Lessor to be recognized as part of the single lease cost each year during the lease of $12,578 [total payments to Lessor of $125,779 ÷ 10 years] – the first year’s lease payment of $10,000)

b. Unamortized initial direct costs of $4,500 (gross initial direct costs of $5,000 – amounts recognized previously as part of the single lease cost of $500 [total initial direct costs of $5,000 ÷ 10 years])

c. The remaining balance of the lease incentive of $9,000 (gross lease incentive of $10,000 – amounts recognized previously as part of the single lease cost of $1,000 [total lease incentives of $10,000 ÷ 10 years]).

Therefore, at the end of Year 1, Lessee measures the right-of-use asset at the amount of $78,782 ($85,860 – $2,578 + $4,500 – $9,000).

55-45 At the beginning of Year 2, Lessee determines the remaining cost of the lease to be $108,701 (the total lease payments of $115,779 + the total initial direct costs of $5,000 – the single lease cost recognized in Year 1 of $12,078). The single lease cost to be recognized in Year 2 is still $12,078 ($108,701 ÷ 9 years). For the purposes of the Example, only the first two years’ determination of the single lease cost are shown. However, the single lease cost will be determined in the same way as in Years 1 and 2 for the remainder of the lease and, in this Example, will continue to equal $12,078 every period for the remainder of the lease term assuming that there are no remeasurements of the lease liability or modifications to the lease.

55-46 At the end of Year 2, the carrying amount of the lease liability is $80,511, and the carrying amount of the right-of-use asset is $71,855 (the carrying amount of the lease liability of $80,511 – the accrued lease payments of $4,656 + the unamortized initial direct costs of $4,000 – the remaining balance of the lease incentive received of $8,000). For the purposes of the Example, the subsequent measurement of the lease liability and the subsequent measurement of the right-of-use asset are shown only for the first two years. However, Lessee will continue to measure the lease liability and the right-of-use asset for this lease in the same manner throughout the remainder of the lease term.

8.9.2 Accounting for Purchase Options

The examples below from ASC 842-10-55-211 through 55-224 reflect implementation considerations related to a lessee’s accounting for purchase options, as discussed in ASC 842-10-30-3 (see Section 5.3 for additional information).
Examples 23 and 24 illustrate a lessee's initial and subsequent measurement of a finance lease as a result of the determination, at lease commencement, that the exercise of the purchase option in the contract was deemed reasonably certain. The examples also illustrate the accounting impact of the lessee's exercise of the purchase option at the end of year 5 and the subsequent settlement of the lease liability and reclassification of the ROU asset to PP&E on the date of the option's exercise.

8.9.2.1 Example 23 — Lessee Purchase Option

ASC 842-10

Example 23 — Lessee Purchase Option

55-211 Lessee enters into a 5-year lease of equipment with annual lease payments of $59,000, payable at the end of each year. There are no initial direct costs incurred by Lessee or lease incentives. At the end of Year 5, Lessee has an option to purchase the equipment for $5,000. The expected residual value of the equipment at the end of the lease is $75,000. Because the exercise price of the purchase option is significantly discounted from the expected fair value of the equipment at the time the purchase option becomes exercisable, Lessee concludes that it is reasonably certain to exercise the purchase option. The fair value of the equipment at the commencement date is $250,000, and its economic life is 7 years. The discount rate for the lease, which is Lessee's incremental borrowing rate because the rate implicit in the lease is not available, is 6.5 percent.

55-212 Because the lease grants Lessee an option to purchase the underlying asset that it is reasonably certain to exercise, Lessee classifies the lease as a finance lease.

55-213 Lessee recognizes the lease liability at the commencement date at $248,834 (the present value of 5 payments of $59,000 + the present value of the $5,000 payment for the purchase option, discounted at 6.5%). Because there are no initial direct costs, lease incentives, or other payments made to Lessor at or before the commencement date, Lessee recognizes the right-of-use asset at the same amount as the lease liability.

55-214 Lessee amortizes the right-of-use asset over the seven-year expected useful life of the equipment, rather than over the lease term of five years, because Lessee is reasonably certain to exercise the option to purchase the equipment. Lessee depreciates its owned assets on a straight-line basis. Therefore, the right-of-use asset is amortized on a straight-line basis.

55-215 During the first year of the lease, Lessee recognizes interest expense on the lease liability of $16,174 (6.5% × $248,834) and amortization of the right-of-use asset of $35,548 ($248,834 ÷ 7).

55-216 At the end of Year 1, the right-of-use asset is $213,286 ($248,834 – $35,548), and the lease liability is $206,008 ($248,834 + $16,174 – $59,000).

55-217 At the end of Year 5, the carrying amount of the right-of-use asset is $71,094 ($248,834 – [$35,548 × 5]), and the remaining lease liability is $5,000, which is the exercise price of the purchase option. Lessee exercises the purchase option and settles the remaining lease liability. If the right-of-use asset was not previously presented together with property, plant, and equipment, Lessee reclassifies the right-of-use asset to property, plant, and equipment and applies Topic 360 to the asset beginning on the date the purchase option is exercised.
8.9.2.2 Example 24 — Lessee Purchase Option

ASC 842-10

Example 24 — Lessee Purchase Option

55-218 Lessee enters into a 5-year lease of specialized equipment with annual lease payments of $65,000, payable in arrears. There are no initial direct costs or lease incentives. At the end of Year 5, Lessee has an option to purchase the equipment for $90,000, which is the expected fair value of the equipment at that date. Lessor constructed the equipment specifically for the needs of Lessee. Furthermore, the specialized equipment is vital to Lessee's business; without this asset, Lessee would be required to halt operations while a new asset was built or customized. As such, Lessee concludes that it is reasonably certain to exercise the purchase option because the specialized nature, specifications of the asset, and its role in Lessee's operations create a significant economic incentive for Lessee to do so. The fair value of the equipment at the commencement date is $440,000, and its economic life is 10 years. Lessee's incremental borrowing rate is 6.5 percent, which reflects the fixed rate at which Lessee could borrow an amount similar to that of the lease payments ($65,000 × 5 lease payments) + the $90,000 purchase option exercise price = $415,000 in the same currency, for the same term, and with similar collateral as in the lease at the commencement date.

55-219 The lease grants Lessee an option to purchase the underlying asset that it is reasonably certain to exercise. In addition, the underlying asset is of such a specialized nature that it is expected to have no alternative use to Lessor at the end of the lease term. As such, Lessee classifies the lease as a finance lease.

55-220 Lessee recognizes the lease liability at the commencement date at $335,808 (the present value of 5 payments of $65,000 + the present value of the $90,000 payment for the purchase option to be made at the end of Year 5, discounted at 6.5%). Because there are no initial direct costs, lease incentives, or other payments made to Lessor at or before the commencement date, Lessee recognizes the right-of-use asset at the same amount as the lease liability.

55-221 Lessee amortizes the right-of-use asset over the 10-year expected useful life of the equipment rather than over the lease term of 5 years, because Lessee is reasonably certain to exercise the option to purchase the equipment. Lessee depreciates its owned assets on a straight-line basis. Therefore, the right-of-use asset is amortized on a straight-line basis.

55-222 During the first year of the lease, Lessee recognizes interest expense on the lease liability of $21,828 (6.5% × $335,808) and amortization of the right-of-use asset of $33,581 ($335,808 ÷ 10).

55-223 At the end of Year 1, the right-of-use asset is $302,227 ($335,808 – $33,581), and the lease liability is $292,636 ($335,808 + $21,828 – $65,000).

55-224 At the end of Year 5, the carrying amount of the right-of-use asset is $167,903 ($335,808 – $33,581 × 5), and the remaining lease liability is $90,000, which is the amount of the purchase option. Lessee exercises the option to purchase the equipment and settles the remaining lease liability. If the right-of-use asset was not previously presented together with property, plant, and equipment, Lessee reclassifies the right-of-use asset to property, plant, and equipment and will apply Topic 360 to the equipment beginning on the date the purchase option is exercised.
Chapter 9 — Lessor Accounting

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9.1 Overview

This chapter discusses the different steps in a lessor's accounting for leases. Specifically, Section 9.2 discusses classification of the various lease types and Section 9.3 addresses recognition and measurement considerations related to each of these classifications. Section 9.4 covers other lessor reporting issues. Section 9.5 covers leveraged leases.

As discussed in Chapter 1, the primary objective of the Board's leasing project was to require presentation of the lessee's off-balance-sheet liabilities. However, a common misconception is that lessor accounting has not changed much under the new leasing guidance. While it is true that the lessor's classification and resulting accounting are largely unchanged, there are key differences between ASC 842 and ASC 840 that companies should focus on during their implementation of ASU 2016-02. Specific improvements the Board made to lessor accounting include those to align ASC 842 with (1) enhancements made to its revenue standard, ASU 2014-09 (codified as ASC 606), and (2) updates to key terms related to lessee accounting.

Regarding the alignment with the revenue standard, because lessors will be adopting ASC 842 on the heels of ASC 606, preparers will need to establish the timing of changes and how such changes should be reflected. (See Chapter 16 for guidance on how to adopt by using the transition provisions of ASC 842.) Further, both the revenue and lease models now underscore the principle of control transfer rather than the transfer of risks and rewards, the latter of which was the principle under ASC 605 and ASC 840.

Although lease classification is similar for lessees and lessors under ASC 842, it is not fully symmetrical. For instance, there are two classes of leases for a lessee and three for a lessor.

We recommend supplementing a review of this section of the Roadmap with a review of the following chapters:

- Chapter 2, which discusses how to identify whether an arrangement is within the scope of the leasing standard.
- Chapter 3, which discusses whether an arrangement is, or contains, a lease.
- Chapter 4, which discusses how to identify the separate lease components and nonlease components within a contract and how the consideration is allocated to components.
- Chapter 5, which discusses the term over which a lessor recognizes consideration related to the lease component.
- Chapter 6, which discusses the initial and subsequent measurement of consideration that must be allocated to the components identified.
The changes addressed in Chapter 4 are particularly significant for lessors, since they may find the guidance discussed therein challenging to apply and inconsistent with ASC 840. For example, while lessors now have a practical expedient under ASU 2018-11 (see below) to elect not to separate lease and nonlease components, lessors must meet certain conditions to apply such an expedient. Lessors that do not elect the practical expedient must allocate consideration in the contract to the separate lease and nonlease components on a relative stand-alone selling price basis in a manner consistent with ASC 606. This chapter of the Roadmap (Chapter 9) focuses on the accounting for the lease component and presumes that the lessor has already applied the provisions discussed in Chapter 4.

As noted above, in July 2018, the FASB issued ASU 2018-11, which contains a new practical expedient under which lessors can elect, by class of underlying asset, not to separate lease and nonlease components, provided that the associated nonlease component(s) otherwise would be accounted for under the revenue guidance in ASC 606 and both of the following conditions are met:

- **Criterion A** — The timing and pattern of transfer for the lease component are the same as those for the nonlease components associated with that lease component.
- **Criterion B** — The lease component, if accounted for separately, would be classified as an operating lease.

The ASU also clarifies that the presence of a nonlease component that is ineligible for the practical expedient does not preclude a lessor from electing the expedient for the lease component and nonlease component(s) that meet the criteria. Rather, the lessor would account for the nonlease component (or components) that does not qualify for the practical expedient separately from the combined lease and nonlease component (or components) that does qualify.

See Section 4.3.3.2 for further details about the practical expedient related to a lessor’s separation of lease and nonlease components. In addition, see Section 15.3.2.4 for the disclosure requirements, and Section 16.4.6 for the transition requirements, related to ASU 2018-11.

**Connecting the Dots — Variable Consideration**

While there are conceptual consistencies between ASC 606 and ASC 842, principally with respect to their reliance on control transfer, the two standards sometimes differ in their recognition and measurement principles. For example, under ASC 606, variable payments are estimated and included in the transaction price subject to a constraint; under ASC 842, however, variable lease payments not linked to an index or rate are generally excluded from the determination of a lessor’s lease receivable. Variable consideration may be allocated in a contract to a lease component (recognition governed by ASC 842) and a nonlease component (recognition most likely governed by ASC 606 — see below). In paragraph BC163 of ASU 2016-02, the FASB addresses its decisions regarding the differences between accounting for variable payments under ASC 842 and accounting for variable consideration under ASC 606:

The Board decided that providing guidance on consideration in the contract was necessary to ensure consistent application of the allocation guidance in Topic 842, particularly for lessors because of the differences between how the Board decided a lessor should account for variable lease payments and how an entity accounts for variable consideration in Topic 606. The Board concluded that accounting for a variable payment that relates partially to a lease component (for example, a performance bonus that relates to the leased asset and the lessor’s operation of that asset) in the same manner as a variable lease payment (that is, with respect to recognition and measurement) will be less costly and complex than accounting for that variable payment in accordance with the variable consideration guidance in Topic 606.
Because an entity may be permitted to recognize revenues under ASC 606 earlier than revenues generated from lease components, it is critical to determine the allocation of the consideration to the appropriate component. See Q&A 4-11 for more information.

### 9.2 Lease Classification

The five criteria that a lessor uses to determine whether a lease is a sales-type lease are the same as those that a lessee uses to establish whether a lease is a finance lease. If none of those criteria are met, the lessor evaluates whether the lease is a direct financing lease; two criteria must be met for the lease to be considered a direct financing lease. If neither the sales-type lease criteria nor the direct financing lease criteria are met, the lease is an operating lease. A lessor performs its lease classification assessment at lease commencement (i.e., when the lessee obtains the right to use the asset).

The decision tree below illustrates the lessor's classification assessment as well as the criteria that must be met for each type of lease.
Chapter 9 — Lessor Accounting

1 If a lease component is at or near the end of its economic life, it is not subject to the economic life test. See Section 9.2.1.3.1 for more information.
Changing Lanes — Classification Date
Unlike ASC 842, ASC 840 requires entities to classify leases on the basis of the facts and circumstances present at lease inception (i.e., the date of the lease agreement or commitment, if earlier) instead of at lease commencement (the date on which the lessor makes an underlying asset available to the lessee). For many entities, this is not a significant change, since there typically is not a significant lag between lease inception and lease commencement; however, in certain circumstances, the two dates significantly differ. In such cases, a lessor could theoretically arrive at different conclusions if facts and circumstances change between the dates (e.g., the fair value of the underlying asset or the rate implicit in the lease). The diagram below illustrates the difference between lease inception and lease commencement.

Lease inception: “The date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.”

Lease commencement: “The date on which a lessor makes an underlying asset available for use by a lessee.”

Changing Lanes — Leveraged Leases
ASC 840 addressed a fourth type of lease, a leveraged lease. Leveraged lease accounting was a special type of accounting that a lessor employed for certain direct financing leases. Special accounting was required for a leveraged lease because of the unique economic effect on the lessor. This unique economic effect stemmed from a combination of nonrecourse financing and a cash flow pattern that typically enabled the lessor to recover its investment in the early years of the lease (as a result of tax benefits generated by depreciation, interest, and investment tax credit deductions) and subsequently afforded it the temporary use of funds from which additional income could be derived.

The FASB did not include leveraged leases in the guidance in ASC 842 on lease classification. In the Background Information and Basis for Conclusions of ASU 2016-02, the FASB addresses why it decided not to retain leveraged leases in the new leasing model, indicating that some Board members objected to the net presentation related to leveraged leases and others believed that the accounting for such leases was too complex. However, the Board decided to grandfather in existing leveraged leases given that “there would be significant complexities relating to unwinding existing leveraged leases” during transition. Therefore, a lessor must continue to apply the accounting in ASC 840 for such a lease (as carried forward in ASC 842) and classify the lease as a leveraged lease provided that it enters into the lease before the effective date of ASC 842. See Chapter 16 for a discussion of the effective date and Section 9.5 for more information about how to account for grandfathered leveraged leases.
Bridging the GAAP — IFRS 16 Does Not Distinguish Between Sales-Type and Direct Financing Leases

IFRS 16 does not differentiate sales-type leases from direct financing leases. Rather, lessors will account for leases as either operating or finance leases, as is required under IAS 17. Although ASC 842 requires a lessor to classify a finance lease as either a sales-type or a direct financing lease, we do not believe that there will be any differences besides the differences between ASC 840 and IAS 17 in this area. See Appendix B for a summary of the differences between ASC 842 and IFRS 16.

9.2.1 Sales-Type Lease

In a sales-type lease, the lessor transfers control of the underlying asset to the lessee. In paragraph BC93 of ASU 2016-02, the FASB acknowledges that “[e]ven though a sales-type lease is not necessarily identical to a sale, the transactions are economically similar (for example, 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 under a sales-type lease).” Paragraph BC93 of ASU 2016-02 further points out that the hallmark of a sales-type lease is the recognition of “selling profit at lease commencement” and that such recognition “is consistent with the principle of a sale in [ASC] 606 and [ASC] 610.”

Changing Lanes — Sales-Type Leases Affected by Shift From Risks-and-Rewards Model to Control Model

A sales-type lease results in the recognition of profit (or loss). Therefore, to be consistent with ASC 606, the FASB decided to align the transfer-of-control notion, as it applies to the evaluation of whether a lease qualifies as a sales-type lease, with that in ASC 606. In paragraph BC121 of ASU 2014-09, the Board observes:

[T]he assessment of when control has transferred could be applied from the perspective of either the entity selling the good or service or the customer purchasing the good or service. Consequently, revenue could be recognized when the seller surrenders control of a good or service or when the customer obtains control of that good or service. Although in many cases both perspectives lead to the same result, the Boards decided that control should be assessed primarily from the perspective of the customer. That perspective minimizes the risk of an entity recognizing revenue from undertaking activities that do not coincide with the transfer of goods or services to the customer.

The evaluation of whether a lease qualifies as a sales-type lease therefore focuses on whether the lessee effectively obtains control of the entire underlying asset (i.e., and not just the right to use it) rather than whether the lessor has relinquished control. Accordingly, an arrangement that a lessor historically classified as a sales-type lease because it transferred a portion of the risks and rewards of the underlying asset to the lessee and a portion to a third party through a residual value guarantee (e.g., residual value insurance) may no longer qualify as a sales-type lease.
25-2 [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.

25-7 See paragraphs 842-10-55-2 through 55-15 for implementation guidance on lease classification.

The criteria in ASC 842-10-25-2 for a lessor’s sales-type lease classification are identical to the criteria lessees use to identify a finance lease. (See Section 8.1 for a discussion of the lessee’s classification.)

Changing Lanes — Sales-Type Leases for Real Estate

When performing the ASC 840 lease classification test, a lessor may have determined that a lease met the criteria used by a lessee to identify a capital lease. However, the lessor only used those criteria as gating criteria to further identify the classification. If any of those criteria were met, the lessor was then required to assess whether the underlying asset was real estate or non–real estate. If the underlying asset was considered real estate within the scope of ASC 360, a lease could not have been a sales-type lease unless the lease transferred the title of the property to the lessee by the end of the lease.

Because a lease may qualify as a sales-type lease without a title transfer under ASC 842, more leases will qualify for sales-type classification. ASC 842 does not distinguish between the accounting for real estate and that for non–real estate. In paragraph BC99 of ASU 2016-02, the FASB states, in part:

Previous GAAP included different lessor requirements for leases of real estate (for example, a lease of real estate could only be a sales-type lease if it transferred title to the real estate to the lessee by the end of the lease term) because the revenue requirements in previous GAAP for the sale of real estate differed from the revenue requirements in previous GAAP applicable to the sale of other assets. The creation of Topic 606 eliminated those different revenue accounting requirements; therefore, there is no longer a reason for the accounting for leases of real estate to differ from the accounting for leases of other assets.

Connecting the Dots — Real Estate Lessors Must Perform Classification Test

As discussed above, under ASC 840, real estate lessors did not spend considerable time evaluating sales-type lease classification because title transfer was required for a real estate lease to qualify as a sales-type lease. However, because ASC 842 does not distinguish between real estate leases and non–real-estate leases and does not require that title transfer occur before a sales-type lease is recognized, real estate lessors will need to evaluate whether leases meet the criteria for classification as a sales-type lease.
Changing Lanes — Collectibility Does Not Affect Classification as Sales-Type Lease

Under ASC 840, collectibility of minimum lease payments had to be reasonably predictable for a lease to qualify as a sales-type lease. While collectibility affects recognition related to sales-type leases under ASC 842 (discussed in Section 9.3.7.2), ASC 842 does not address collectibility with respect to the classification of such leases. Therefore, because the classification criteria in this regard are less strict, more leases will qualify as sales-type leases.

9.2.1.1 Transfer of Ownership at the End of the Lease Term

ASC 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.

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.

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).

If the lease transfers ownership, such as through the transfer of title at or shortly after the end of the lease term, the above criterion in ASC 842-10-25-2(a) would be met. In substance, such a transaction is akin to a financed purchase (i.e., the asset was purchased and financed through lease payments). Historically, such a finance lease has been accounted for as a sale/purchase. For example, ASC 840-10-10-1 states that “a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as . . . a sale or financing by the lessor.” While the model has evolved from a risks-and-rewards model (i.e., benefits and risks) to a control-based model, the principle is the same. If the lessee is required to pay a nominal fee for title transfer, the lease would meet the criterion in ASC 842-10-25-2(a). If paying the fee (even in circumstances in which the fee is nominal) is optional, the lease would not meet this criterion, although the lease should be evaluated under the “reasonably certain purchase option” criterion in ASC 842-10-25-2(b); see further discussion in Section 9.2.1.2 below.

9.2.1.2 Purchase Option Reasonably Certain to Be Exercised

As indicated in ASC 842-10-25-2(b), when a “lease grants the lessee an option to purchase the underlying asset,” it must be reasonably certain that the lessee will exercise that option, at which point the lessor is required to classify the lease as a sales-type lease. “Reasonably certain” is a high threshold. A purchase option's exercise may be reasonably certain for many reasons (e.g., an economic compulsion or incentive for the lessee to exercise its option). See Section 5.2.2 for a discussion of the notion of “reasonably certain.”

ASC 842-10-55-26 includes a list of economic factors (not all-inclusive) for an entity to consider when evaluating whether the exercise of an option is reasonably certain. Such an evaluation must include an assessment of whether an economic compulsion exists.
The examples below demonstrate scenarios in which the lessee’s exercise of its purchase option would be reasonably certain.

**Example 9-1**

Entity P leases a tractor that it may purchase for $10,000 at the end of the lease term. The fair value of the tractor is expected to be $20,000 when the lease term ends. Further, P has provided the lessor with a residual value guarantee of $25,000 in the event that P does not exercise the purchase option.

**Example 9-2**

Entity U leases an airplane in which it installs luxury seating and a gold-plated cocktail bar, both of which add significant value to the airplane. At the end of the lease term in three years, U may purchase the airplane for an amount that is commonly paid for an airplane that does not have luxury seating and a cocktail bar. The remaining useful life of the seating and bar assets extends 20 years after the noncancelable lease term.

### 9.2.1.3 Major Part of the Remaining Economic Life

The ASC master glossary defines economic life as “[e]ither 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.” As noted above, if the “lease term is for the major part of the remaining economic life of the underlying asset,” the lease is a sales-type lease; however, if the lease term begins “at or near the end of the economic life of the underlying asset,” the lessor should not use this criterion in its evaluation. (For further discussion, see Section 9.2.1.3.1.)

**Q&A 9-1 Use of ASC 840’s Bright-Line Thresholds for Lease Classification**

ASC 840 requires an entity to classify a lease on the basis of an evaluation of, among other things, certain quantitative bright-line thresholds. That is, under ASC 840, a lease would be classified as a capital lease if the lease term is 75 percent or more of the remaining economic life of an underlying asset or if the sum of the present value of the lease payments and the present value of any residual value guarantees amounts to 90 percent or more of the fair value of the underlying asset. However, when developing the lease classification guidance in ASC 842-10-25-2, the Board decided not to require the use of bright lines.

**Question**

Although entities are no longer required to assess certain quantitative bright-line thresholds when classifying a lease, are they permitted to use quantitative thresholds when classifying a lease under ASC 842?
**Answer**

Yes. The implementation guidance in ASC 842-10-55 states that a reasonable approach to applying the lease classification criteria in ASC 842 is to use the same bright-line thresholds as those in ASC 840. ASC 842-10-55-2 states the following:

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.

On the basis of this implementation guidance, we would not object if an entity were to apply ASC 840’s bright-line thresholds when classifying a lease under ASC 842. We would expect that under such an approach, an entity would classify a lease in accordance with the quantitative result. That is, if an entity applies ASC 840’s bright-line thresholds and determines that a lease term is equal to 76 percent of an asset’s useful life, the entity should classify the lease as a sales-type lease. The entity should not attempt to overcome the assessment with qualitative evidence to the contrary. Likewise, if the same entity determines that a lease term is equal to 74 percent of an asset’s useful life, the entity should classify the lease as an operating lease (provided that other lease classification criteria are not met). We would expect that if an entity decides to apply the bright-line thresholds in ASC 840 when classifying a lease, the entity would apply those thresholds consistently to all of its leases.

**Q&A 9-2 Estimated Economic Life Versus Depreciable Life**

**Question**

Can an asset’s depreciable life differ from its estimated economic life?

**Answer**

It depends. Generally, we would expect the economic life of an asset to correspond to its depreciable life used for financial reporting. In accordance with ASC 360, depreciable life is calculated on the basis of the asset’s useful life, which is similar but not identical to the economic life an entity uses in performing the lease classification test.

The ASC master glossary defines useful life as the “period over which an asset is expected to contribute directly or indirectly to future cash flows” and economic life as “[e]ither 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.”

The objective of determining either the useful life or economic life of an asset is to identify the period over which the asset will provide benefit. The asset’s useful life represents the period over which the reporting entity will benefit from use of the asset. In contrast, the economic life represents the period over which “one or more users” will benefit from use of the asset. Therefore, the asset’s estimated depreciable life pertains to the intended use by the current owner, whereas the estimated economic life may encompass both the current and future owners of the asset.
This difference between the two definitions is not relevant in many cases since a single entity (the current owner) is often expected to use an asset for its entire life. However, depending on the facts and circumstances, it may sometimes be appropriate for an entity to use an estimated economic life for lease classification purposes that is longer than the asset's estimated depreciable life.

**Example**

Company X, an automobile lessor, routinely purchases automobiles that are economically usable for seven years. Company X leases the automobiles to lessees for three years and sells the automobiles after the end of the three-year lease term. Company X may have a supportable basis for using a three-year depreciable life (with a correspondingly higher salvage value) for financial reporting purposes but a seven-year economic life for lease classification purposes.

**Q&A 9-3  Lease Classification — Estimated Economic Life Test**

**Question**

Should the estimated economic life test be applied to a lease that only involves land?

**Answer**

No. Land has an infinite economic life and therefore could never meet the criterion in ASC 842-10-25-2(c).

**Q&A 9-4  Impact of Lessor’s Intent to Sell Leased Property at the End of the Lease Term on Determination of the Estimated Economic Life of Leased Property**

As described in ASC 842-10-25-2(c), the third criterion for classifying a lease as a sales-type lease is that the “lease term is for the major part of the remaining economic life of the underlying asset.” However, an entity should not use this criterion to classify the lease “if the commencement date falls at or near the end of the economic life of the underlying asset.”

**Question**

If the lessor intends to sell leased property immediately after the end of the lease term, can the leased property’s estimated economic life extend beyond its expected sale date?

**Answer**

Yes. The lessor’s intention to sell the asset immediately after the end of the lease term should not influence its estimated economic life if the asset can still be used for its intended purpose by other users.

Generally, decisions concerning economic lives for leased property will be similar to those for owned assets. Thus, the estimated economic life of a leased asset generally will be the same as the depreciable life of a similar asset for financial reporting purposes (except as discussed in Q&A 9-2).
Changing Lanes — 25 Percent Fair Value Test for Land Is Removed

Under ASC 840, in classifying a lease involving both land and a building, an entity is required to assess the land separately from the building when (1) the lease meets either the transfer-of-ownership or the bargain-purchase-price classification criterion or (2) the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception. Under ASC 842, an entity would no longer consider this “25 percent fair value” criterion in assessing classification and therefore may identify separate units for classification purposes (i.e., a land component and a separate building component). See Chapter 4 for more information on how to identify lease components.

Q&A 9-5  Lease Agreement Covering a Group of Assets That Have Different Economic Lives

A lease contract often includes a package of equipment. For example, an equipment lease may include virtually all pieces of equipment necessary to operate a store (e.g., refrigeration cases, air conditioning units, alarm and phone systems, cash registers, and store furniture).

Question

When pieces of equipment that have different useful economic lives are leased in the aggregate, how should an entity determine the estimated economic life of the leased assets for lease classification purposes under ASC 842-10-25-2(c)?

Answer

When pieces of equipment that have different useful economic lives are leased in the aggregate, an entity should consider the guidance in ASC 842-10-15-28, which states that a right to use an asset would be considered a separate lease component when it meets the following two criteria:

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.

To the extent that the above guidance does not require separation, an entity should then consider the provisions of ASC 842-10-25-5, which indicates that “[i]f 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).” Regarding the assessment of the predominant asset in a lease component, paragraph BC74 of ASU 2016-02 states, in part:

The Board noted that assessing the predominant asset in a lease component that includes multiple underlying assets will be straightforward in most cases. That is, the assessment is a qualitative one that requires entities to conclude on what is the most important element of the lease, which should be relatively clear in most cases. The Board also noted that if an entity is unable to identify the predominant asset, it may indicate that there is more than one separate lease component in the contract.

Chapter 4 discusses, in detail, the guidance in ASC 842-10-15-28 on separating lease components.
9.2.1.3.1 At or Near the End of the Remaining Economic Life

If a lease component is at or near the end of its economic life, it is not subject to the economic-life test. In its 2013 leasing ED, the FASB contemplated not including this exception. Paragraph BC71 of ASU 2016-02 addresses the Board’s reasons for ultimately including the exception in the leases guidance and states, in part:

The exception to considering this criterion when the lease commences at or near the end of the economic life of the underlying asset is contrary to the lease classification principle because a lessee can direct the use of and obtain substantially all the remaining benefits from a significantly used asset just the same as it can a new or slightly used asset. However, the Board determined that an exception is appropriate because it would be inconsistent to require that a lease covering the last few years of an underlying asset’s economic life be recorded as a finance lease by a lessee (or sales-type lease by a lessor) when a similar lease of that asset earlier in its economic life would have been classified as an operating lease. The Board concluded that this would not appropriately reflect the economics of those leases.

9.2.1.4 Substantially All of the Fair Value of the Underlying Asset

As indicated in ASC 842-10-25-2(d), if 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 . . . equals or exceeds substantially all of the fair value of the underlying asset,” the lease is classified as a sales-type lease. The present value is calculated by using a discounted cash flow approach. (See Chapter 6 for details on the amounts included in this calculation.) While a lessee will generally use its incremental borrowing rate (if the rate implicit in the lease is not readily determinable) to calculate the present value
of its lease payments, as discussed in Section 7.2, a lessor must use the rate implicit in the lease. The ASC master glossary defines the rate implicit in the lease as follows:

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. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used.

Q&A 9-6  Solving for the Rate Implicit in the Lease as Part of the “Substantially All of the Fair Value” Test for Sales-Type Lease Classification

Question
How does an entity determine the rate implicit in the lease for a sales-type lease?

Answer
An entity may solve for the rate implicit in the lease by using the internal-rate-of-return calculation function through either a spreadsheet database (as shown below) or another calculator mechanism.

Example
A lessor leases a yacht with a fair value of $256,300 to an actor for three years for an annual payment made in arrears of $75,000. When the actor returns the yacht, the fair value of the asset is expected to be $90,000. Using an internal-rate-of-return functionality, the lessor determines that its rate implicit in the lease is 9.57 percent.

<table>
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<tr>
<th>Date</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
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<td>1/1/2019</td>
<td>(256,300)</td>
<td>Fair value of underlying asset</td>
</tr>
<tr>
<td>1/1/2020</td>
<td>75,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>1/1/2021</td>
<td>75,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>1/1/2022</td>
<td>165,000</td>
<td>Lease payment + unguaranteed residual value</td>
</tr>
<tr>
<td></td>
<td>9.57%</td>
<td>Implicit rate in the lease</td>
</tr>
</tbody>
</table>

Note that, in this example, no investment tax credits were received and no initial direct costs were incurred.
Connecting the Dots — Evaluating “Substantially All”

One of the most notable aspects of ASC 842 is the exclusion of “bright lines” (e.g., the 90 percent previously used in the fair value test) from the lease classification tests. However, ASC 842-10-55-2 acknowledges that 90 percent may be an appropriate threshold for the “substantially all” criterion. See Q&A 9-1 for more information.

Changing Lanes — At or Near the End of Its Economic Life and “Substantially All”

Under ASC 840, an entity was not allowed to use the 90 percent fair value test when classifying a lease if the beginning of the lease term fell within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use. However, the FASB chose to no longer include that prohibition under ASC 842. As a result, an entity will need to evaluate the “substantially all” criterion when classifying a lease under ASC 842, regardless of when the lease term begins.

Changing Lanes — Evaluating 89.9 Percent Lease Payments

Under ASC 840, there were many opportunities to create highly structured leases. Specifically, many leases were designed so that the present value of lease payments would be 89.9 percent of the fair value. Because the FASB has taken a more principles-based approach to classification in ASC 842, we do not believe that an 89.9 percent present value would necessarily result in a non-sales-type lease. However, this would depend on the entity’s accounting policies (see Q&A 9-1), which should be consistently applied.

Changing Lanes — Consideration of Nonperformance-Related Default Provisions

Some lease agreements contain nonperformance-related default provisions that may require the lessee to purchase the leased asset or make another payment if the lessee is in default under such provisions. Under ASC 840, these provisions needed to be carefully considered and often directly affected the classification of the lease. The guidance in ASC 840 on nonperformance-related default provisions was not carried over to ASC 842. For more information about this issue and about lessees’ treatment of payments associated with nonperformance-related default provisions under ASC 842, see Section 8.3.3.6. In line with the discussion in that section, lessors should generally treat these payments as variable and should consider the guidance in ASC 842-30. See Section 9.3 for more information about a lessor’s treatment of variable lease payments.

Changing Lanes — Classification of the Land Component Under ASC 840

ASC 842 diverges from ASC 840 in how both lessees and lessors allocate consideration and classify the land component of a lease arrangement when the entity accounts for the right to use land separately from the other components in the contract. For more information about how this guidance differs, see Section 4.2.2.

Q&A 9-7 Lessor Consideration of Initial Direct Costs Related to the Rate Implicit in the Lease

Question

How should a lessor consider initial direct costs when calculating the rate implicit in the lease to (1) determine lease classification and (2) initially recognize and measure a net investment in the lease?
Answer

Lease Classification

A lessor must first determine whether the lease meets any of the criteria in ASC 842-10-25-2 for classification as a sales-type lease. If none of those criteria are met, the lessor is next required to determine whether the lease must be classified as a direct financing lease in accordance with ASC 842-10-25-3(b); if not, the lease would be classified as an operating lease.

ASC 842-10-25-2(d), which contains one of the criteria for sales-type lease classification, states:

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.

To determine the “present value of the sum of the lease payments and any residual value guaranteed by the lessee,” the lessor must determine the “rate implicit in the lease.” The ASC master glossary defines the rate implicit in the lease as follows:

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. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used.

ASC 842-10-25-4 clarifies that "[f]or 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.”

As a result, when determining whether a lease is a sales-type lease under ASC 842-10-25-2(d) (quoted above), the lessor does not include initial direct costs in its determination of the rate implicit in the lease if the underlying asset’s fair value differs from its carrying value.

In all other cases (i.e., when the underlying asset’s fair value equals its carrying value in the determination of whether a lease is a sales-type lease under ASC 842-10-25-2(d) or whether a lease is a direct financing lease under ASC 842-10-25-3(b)), the lessor would include initial direct costs in its determination of the rate implicit in the lease.

Initial Recognition and Measurement

For sales-type and direct financing leases, a lessor is required to recognize (at commencement) a net investment in the lease. The net investment in the lease comprises the sum of the lease receivable and any unguaranteed residual value, both of which are measured at present value by using the same rate implicit in the lease that was used for lease classification purposes.

ASC 842-30-25-1(c) requires that initial direct costs be expensed “if, at the commencement date, the fair value of the underlying asset is different from its carrying amount.” In these cases, because the rate implicit in the lease (as determined during lease classification) did not include initial direct costs because they were not eligible for deferral, those costs are automatically excluded from the net investment in the lease (i.e., there is no need to remove them separately).
In all other cases (i.e., when the underlying asset’s fair value equals its carrying value in the determination of whether a lease is a sales-type lease or whether a lease is a direct financing lease under ASC 842-10-25-3(b)), “[i]f the fair value of the underlying asset equals its carrying amount, initial direct costs . . . are deferred at the commencement date and included in the measurement of the net investment in the lease” in accordance with ASC 842-30-25-1(c). Therefore, because the initial direct costs are eligible for deferral and were included in the determination of the rate implicit in the lease for classification purposes, they are automatically included in the rate used to calculate the net investment in the lease.2 This is consistent with ASC 842-30-25-1(c) (sales-type lease recognition) and ASC 842-30-25-8 (direct financing lease recognition), each of which suggests that the rate implicit in the lease is defined in such a way 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.”

Q&A 9-8  Unit of Account for Assessing Lease Classification

The lessor must classify a lease as a sales-type lease if any of the lease classification criteria in ASC 842-10-25-2 are met. This requirement differs from that in ASC 840, under which real estate lessors needed to meet the transfer-of-title condition to qualify for sales-type treatment.

Question

How does a multiunit real estate lessor assess the criterion in ASC 842-10-25-2(d) (i.e., in assessing whether the lease is a sales-type lease)?

Answer

Such a lessor would use the fair value of the unit allocable to the lease component in its present value test. In other words, the lessor would identify the underlying asset at the level associated with the space being leased and not beyond the identified lease component (e.g., at the level of a retail store in a shopping mall, not at the level of the shopping mall itself).

Example

Lessor A leases a retail store at the mall it owns. The fair value of the mall is $10 million, and the fair value of the individual retail store is $500,000. The present value of the lease payments for the retail store is $450,000 (there is no residual value guarantee). To determine the classification of the lease, the lessor should compare the fair value of the portion of the building allocable to the lease component ($500,000) with the present value of the lease payments ($450,000).

9.2.1.4.1  Impracticable to Determine Fair Value

ASC 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).

2 For example, the inclusion of initial direct costs in the determination of the rate implicit in the lease results in a lower rate (see Cases A and C in Example 1, which begins in ASC 842-30-55-19). This lower implicit rate applied to the future lease payments effectively results in a higher net investment in the lease, which inherently includes the initial direct costs.
We believe it would be unlikely that a lessor would not be able to determine the fair value of an underlying asset, including portions of larger assets (as discussed in Q&A 9-8A below). Lessors that consider this paragraph to be applicable to their facts and circumstances should consult their accounting advisers.

Q&A 9-8A Lessor’s Determination of the Fair Value of a Portion of a Larger Asset

In determining whether to classify a lease as a sales-type or direct financing lease, a lessor must determine whether “the present value of the sum of the lease payments . . . equals or exceeds substantially all of the fair value of the underlying asset” in accordance with ASC 842-10-25-2(d) (see Section 9.2.1.4). Accordingly, when classifying the lease (i.e., as a sales-type, direct financing, or operating lease), the lessor must determine the fair value of the underlying asset — for use in the fair value test — at the level associated with the identified lease component (see Q&A 9-8). This level could be a portion of a larger asset, such as a floor of an office building. If it is impracticable for a lessor to determine the fair value of an underlying asset in accordance with ASC 842-10-55-3, the lessor should assess the lease classification without considering the criterion in ASC 842-10-25-2(d) and ASC 842-10-25-3(b)(1). In this context, “practicable” means that fair value can be reasonably estimated without undue cost or effort.

Consider an example in which a lessor leases space on a cell tower (e.g., a hanger) to a lessee. The lessor previously recorded the entire cell tower (i.e., the larger asset) on its books, and the hanger is considered a portion of the larger asset. The lessor has a practice of leasing individual hangars within the cell tower to lessees; thus, the individual hanger would be the unit of account from a leasing perspective. A similar situation may arise when a lessor leases a floor of a building to a lessee. The entire building (i.e., the larger asset) is recorded on the lessor’s books. The lessor commonly leases individual floors in the building to lessees. As stated above, when classifying the lease, the lessor must determine the fair value of the underlying asset for use in the fair value test — which would be at the level of the individual hanger or individual floor in these examples — unless it is impracticable to do so.

Question

How should a lessor determine the fair value of a portion of a larger asset?

Answer

While ASC 842 does not address this issue, we believe that a lessor can use various methods to determine the fair value of a portion of a larger asset, depending on the facts and circumstances. Because a lessor will typically be able to determine the fair value of the entire larger asset (e.g., a cell tower or building, as described in the examples above), it will often be appropriate to use an “allocation approach” to allocate the fair value of the larger asset to the respective portions of the larger asset that are being leased.

For example, the fair value of the larger asset could be proportionately allocated — on the basis of the perceived value of the individual leasable spaces — to the individual portions of the larger asset that the lessor leases. When this method is used, other conditions that may be more representative of the fair value of the leased asset should be considered. In a building, for instance, higher floors are often more desirable, have a higher stand-alone selling price, and are leased at a higher cost to the lessee than lower floors. In such circumstances, use of an appropriate allocation method would result in the allocation of a greater fair value to the higher floors. Such an allocation would better represent the economics of the individual lease arrangements and better reflect the fair value of each respective portion.
Likewise, we believe that an entity that is estimating the fair value of a portion of a larger asset should consider the intended use of the asset. It is also important not to confuse relative fair value with relative construction or replacement costs. In the cell tower example described above, while the percentage of the costs for the individual hangers may not be disproportionately high compared with the cost of the overall structure, it is likely that the hangers in the aggregate account for most of the fair value of the tower since they represent its revenue-producing parts. In other words, we would sometimes expect the fair value of discrete portions of a larger asset to be disproportionate compared with that of the entire asset on a space or square-footage basis when the relative revenue-producing potential of the discrete portions is taken into account.

We generally believe that it would be unusual for a lessor not to be able to determine the fair value of a portion of an underlying asset. Further, we would expect that a lessor that can estimate the fair value of the larger asset (which will generally be the case) would typically be able to reasonably allocate an appropriate percentage of that fair value to the portion being leased without undo cost or effort.

9.2.1.4.2 Residual Value Guarantees Provided for a Portfolio of Assets

**ASC 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.

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).

Although a lessor would consider residual value guarantees on individual leases as part of the lease payments when performing the lease classification test, such guarantees would generally be excluded from the test when they are provided for a portfolio of assets under ASC 842-10-55-10. See Q&A 9-8B below for a potential exception to this rule.

**Q&A 9-8B Impact of Portfolio Residual Value Guarantees on Lessor’s Lease Classification**

Lessors often enter into lease agreements to lease multiple similar assets to lessees. In these circumstances, lessees will often guarantee the residual value for the group of assets being leased (e.g., the portfolio of underlying assets) rather than that for each individual underlying asset. ASC 842-10-55-10 states that a lessor should not consider residual value guarantees of a portfolio of underlying assets when evaluating the lease classification criteria, since “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.”
The guidance in ASC 842 on how lessors should treat residual value guarantees of a portfolio of underlying assets when classifying a lease is similar to historical practice under ASC 840. Specifically, in an inquiry, the SEC was asked to give its views on how a lessor should apply ASC 840-10-25-1(d) and ASC 840-10-25-5 in determining the minimum lease payments for lease classification purposes when the lessee provided a guarantee of the aggregate residual value of a portfolio of leased assets. ASC 840-30-S99-1 states that, in response to this inquiry, the SEC staff indicated the following:

The SEC staff believes 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 and, accordingly, no such amounts should be included in minimum lease payments.

Therefore, the general practice under ASC 840 is for a lessor not to include residual value guarantees for a portfolio of leased assets in the determination of minimum lease payments, since it is not possible to identify the individual residual value guarantee for any individual leased asset within the portfolio. Because the classification analysis under ASC 840 is performed on an individual-asset basis, it is rare for a lessor to include a residual value guarantee of a portfolio of assets in the determination of minimum lease payments. However, in certain circumstances, it is appropriate to do so. Specifically, under ASC 840, if a group of leased assets associated with the PRVG meets the following criteria, the PRVG should be factored into the calculation of minimum lease payments:

- The leases commence and end at the same time.
- The leased assets are physically similar to each other.
- The variability associated with the expected residual values is expected to be highly correlated (i.e., one asset's residual value is expected to be similar to that of the other assets' residual values).

Under ASC 842, a lessor can account for a group of leases at a portfolio level provided that (1) the leases are similar in nature (e.g., have similar underlying assets) and (2) have identical or nearly identical contract provisions (see Section 8.2.2). In addition, paragraph BC120 of ASU 2016-02 states, in part:

The Board decided to explicitly state that lessees and lessors are permitted to apply the leases guidance at a portfolio level. The Board acknowledged that an entity would need to apply judgment in selecting the size and composition of the portfolio in such a way that 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.
Because ASC 842 can be applied at a portfolio level, lessors have questioned whether it is appropriate for them to factor in a residual value guarantee for a group of assets being leased when determining the lease classification of each separate lease. We believe that, when certain facts and circumstances exist, it may be appropriate for a lessor to consider a PRVG for a group of assets being leased. Consider the following example:

**Example**

A lessor enters into an agreement to lease 10 physically similar laptops to a lessee. The leases commence and end on the same day. The agreement has no stated renewal or purchase options. The individual assets have a fair value at commencement of $500 each and an expected residual value at the end of the lease term of $150 each. The variability associated with the expected residual value of each laptop is expected to be highly correlated. The lessee guarantees that the combined residual value of the leased assets will be $1,500. If the PRVG were excluded from the lease classification test, all of the individual leases would be operating leases. However, if the PRVG were included, classification may change depending on the attribution of the PRVG to the individual leases in the portfolio.

**Question**

Could the lessor in the example above take the impact of the PRVG into account when classifying the individual laptop leases?

**Answer**

Yes. We believe that, as described in the example above, there are circumstances in which it may be acceptable for a lessor to include a PRVG in the classification of leased assets that are subject to a residual value guarantee for the group of assets. In such circumstances, we would expect the PRVG to be apportioned equally to each leased asset (e.g., $150 per laptop).

We believe that the lessor may consider a PRVG when classifying the individual leases within a portfolio when an arrangement meets the following criteria that were applied in practice under ASC 840 (outlined in the background above):

- The leases commence and end at the same time.
- The leased assets are physically similar to each other.
- The variability associated with the expected residual values is expected to be highly correlated.

While ASC 842-10-55-10, read literally, suggests that a PRVG should never be considered in the lessor’s determination of lease classification, we believe that the FASB did not intend to change this historical practice under ASC 840. Further, we believe that use of the criteria above will result in a lease classification that is consistent with the underlying economics of the leasing arrangement.

**Changing Lanes — Classification of the Land Component Under ASC 840**

ASC 842 diverges from ASC 840 in how both lessees and lessors allocate consideration and classify the land component of a lease arrangement when the entity accounts for the right to use land separately from the other components in the contract. For more information about how this guidance differs, see Section 4.2.2.
9.2.1.5  Underlying Asset Is Specialized and Has No Alternative Use to the Lessor at the End of the Lease Term

ASC 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.

The criterion in ASC 842-10-25-2(e) states that 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 lease is a sales-type lease. When an underlying asset has no alternative use to the lessor at the end of a lease term, it is presumed that the lessee will consume all (or substantially all) of the benefits of the asset. The substantive lack of alternative use can be identified if there is a contractual restriction or an anticipated significant economic loss related to directing the asset for another use.

Changing Lanes — New Lease Classification Criterion

The new lease classification criterion in ASC 842-10-25-2(e) has not been previously applied in practice by companies that follow U.S. GAAP and is not expected to frequently be met in isolation. We do not believe that this criterion should be interpreted as applying to situations in which the underlying asset is near the end of its economic life and the lessee, by virtue of the lease, therefore has obtained all of the use of the asset so that it has “no alternative use.” Rather, the application of this criterion is intended to identify situations in which the lessee uses all of the asset’s economic benefits because the asset is so specialized for that particular lessee that the lessor would not be expected to generate economic benefit from the asset's use outside of the lease.

Q&A 9-9  Significant Economic Losses to Direct an Underlying Asset for Another Use

ASC 842-10-55-7 states, in part:

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 [economic] loss.

Question

What represents a significant economic loss to the lessor?
**Answer**

Although ASC 842 does not define the term “significant economic loss,” the standard and the Background Information and Basis for Conclusions of ASU 2016-02 discuss the term “significant economic incentive.” When an entity has a significant economic incentive, it may conclude that the exercise of a purchase option or renewal option is reasonably certain in accordance with ASC 842-10-30-1 through 30-3. Because “reasonably certain” is a high threshold in the assessment of renewal (termination) options and purchase options (as discussed in Section 5.2.2), we would expect the threshold for a significant economic loss to also be high.

In addition, an entity can consider ASC 606-10-55-10 when considering situations in which a significant loss exists. ASC 606-10-55-10 states:

> A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. **A significant economic loss could arise because the entity either would incur significant costs to rework the asset or would only be able to sell the asset at a significant loss.** For example, an entity may be practically limited from redirecting assets that either have design specifications that are unique to a customer or are located in remote areas. [Emphasis added]

**Example**

An entity leases a highly specialized underwater vehicle with patented technology to another entity. The asset took three years to produce. The lessee uses the asset to search the deep ocean floor for buried treasure in a remote area of the Arctic Ocean. The cost of transporting the asset to the search site was approximately half the cost of the asset itself, and it is not expected that any other entity is going to want to use that asset in that specific location. The lessor would incur significant losses in transporting the asset to its manufacturing facility in Chicago at the end of the lease term for refurbishment and redeployment. The lessor does not believe that any other entities would be interested in a similar use (searching the Arctic Ocean for buried treasure), and the asset is designed for that particular environment and no other. As a result, the lessor in this example would meet the criterion for classifying the lease as a sales-type lease (i.e., the criterion in ASC 842-10-25-2(e)). We believe that it is likely that other criteria for sales-type classification (e.g., the “substantially all of the fair value” test) would also be met in such situations.

**Connecting the Dots — Meeting the Criterion in ASC 842-10-25-2(e)**

It is unlikely that the criterion in ASC 842-10-25-2(e) would be met in isolation because a lessor economically would not enter into an arrangement in which it would not be compensated to obtain a worthless asset at the end of a lease term. However, if a lease is structured with entirely variable lease payments (and the lease therefore does not meet the criterion in ASC 842-10-25-2(d)), the lease may be more likely to meet criterion (e) in isolation.

**9.2.2 Direct Financing Lease**

If a lease does not meet any of the criteria for classification as a sales-type lease, the lessor must assess whether it has relinquished control of the underlying asset but has not transferred control to the lessee. The lessor would classify a lease that does not meet any of the criteria for a sales-type lease as a direct financing lease if two criteria are met, as described below.
Chapter 9 — Lessor Accounting

Changing Lanes — Fewer Leases Expected to Be Direct Financing Leases

Under ASC 840, selling profit or loss was required for sales-type lease classification; as a result, leases were often classified as direct financing leases. ASC 842 no longer contains this requirement, so we would expect there to be more sales-type leases and fewer direct financing leases under ASC 842. Further, unlike ASC 840, ASC 842 does not limit the classification of leases with selling profit or loss to sales-type leases; direct financing leases also can give rise to selling profit or loss under ASC 842. However, such selling profit or loss will be recognized over the lease term as an adjustment to yield under ASC 842 (as discussed in Section 9.3.8).

Changing Lanes — Direct Financing Lease and 90 Percent of Fair Value Test

To be a direct financing lease under ASC 840, a lease had to meet one of the capital lease criteria in ASC 840-10-25-1. However, if a lease meets any of those criteria under ASC 842, the lease would be a sales-type lease. A key difference between a sales-type lease and a direct financing lease under ASC 842 is that a lessor would include residual value guarantees from third parties in its fair value test for direct financing leases. In fact, the only reason a lessor could classify a lease as a direct financing lease is because it obtains a third-party residual value guarantee.

Bridging the GAAP — Different Treatment of Selling Profit in Direct Financing Leases

Under ASC 842, a lessor in a direct financing lease must defer selling profit at lease commencement and recognize it over the lease term. In contrast, IFRS 16 requires a lessor to recognize profit or loss in a finance lease at lease commencement. While the two standards may significantly differ in this respect, this issue may not arise frequently given the scarcity of leases with third-party residual value guarantees that result in a selling profit.

9.2.2.1 Criteria

<table>
<thead>
<tr>
<th>ASC 842-10</th>
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<tbody>
<tr>
<td><strong>25-3</strong> When none of the criteria in paragraph 842-10-25-2 are met: . . .</td>
</tr>
<tr>
<td>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:</td>
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<tr>
<td>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.</td>
</tr>
<tr>
<td>2. It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.</td>
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</table>
9.2.2.1.1 First Criterion — Present Value of Lease Payments and Any Residual Value Guarantee Equals or Exceeds Substantially All of the Fair Value of the Underlying Asset

The present value of lease payments includes any payments described in ASC 842-10-30-5 (see Chapter 6). However, when determining whether a lease is a sales-type or direct financing lease, a lessor includes different amounts in the lease payments with respect to residual value guarantees. In performing the sales-type lease classification test, lessors only include the residual value guarantee provided by the lessee. The direct financing lease classification test takes it one step further and requires a lessor to include any residual value guaranteed by any third party unrelated to the lessor. When performing the direct financing lease test, an entity would apply the “substantially all” criterion in the same manner as it would when performing the sales-type classification test addressed in ASC 842-10-25-2(d) (e.g., 90 percent of the fair value). See Section 9.2.1.4 for more information.

Residual value guarantees provided for a portfolio of leased assets and not for individual leased assets should not be included in the lessor classification assessment, as described in Section 9.2.1.4.2.

A lease that does not meet the “substantially all” criterion in ASC 842-10-25-3(b)(1) is an operating lease.

Q&A 9-10 Solving for the Rate Implicit in the Lease as Part of the “Substantially All of the Fair Value” Test for Direct Financing Lease Classification

**Question**

How does an entity determine the rate implicit in the lease for a direct financing lease?

**Answer**

An entity may solve for the rate implicit in the lease by using the internal-rate-of-return calculation function through either a spreadsheet database or another calculator mechanism.

**Example**

A lessor leases a luxury tour bus with a fair value of $7,230,589 (which equals the bus's carrying value) to a music group for three years for an annual payment made in arrears of $2,000,000. The lessor incurs $25,000 in initial direct costs. When the music group returns the tour bus, the fair value of the asset is expected to be $4,023,023. Using an internal-rate-of-return functionality, the lessor determines that its rate implicit in the lease is 14.68 percent.

Note that, in this example, no investment tax credits were received. Also, because the fair value of the bus equals its carrying value, the initial direct costs were included in the calculation of the rate implicit in the lease. See Q&A 9-7 for more information about how to consider initial direct costs in the determination of the lease's implicit rate.
Q&A 9-11 Impact of a Lessor’s Subsequent Purchase of Residual Value Insurance on Lease Classification

Under ASC 842-10-25-3(b)(1), when a lessor calculates lease payments to assess whether the lease should be classified as a direct financing lease or operating lease, the lessor must classify a lease as a direct financing lease if 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 . . . and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.” Accordingly, if a lessor purchases residual value insurance at the commencement of the lease, the amount of the residual covered by the insurance would be included in the lessor’s computation as part of the direct-financing lease classification test. In some circumstances, a lessor may purchase residual value insurance for property leased under an operating lease after the commencement of that lease in an amount that would have required the lease to be classified as a direct financing lease had that insurance been purchased at the commencement of the lease.

Question
Would a lessor’s purchase of residual value insurance from a third party (unrelated to the lessor or the lessee) after the commencement of the lease constitute a lease modification and trigger a reevaluation of the lease’s classification in accordance with ASC 842-10-25-8?

Answer
No. A lessor’s acquisition of residual value insurance after the lease commencement date, in the absence of a change in the lease’s provisions that the lessor and lessee mutually agree to, does not represent a change in the lease provisions as contemplated by the definition of a “lease modification” in ASC 842-10-20. Accordingly, the lessor’s purchase of this insurance does not create a modified lease (that is not a separate contract) that must be reclassified in accordance with ASC 842-10-25-1 and ASC 842-10-25-8 through 25-10 (see Section 9.3.4 for more information).

Note that if residual value insurance from a third party was contemplated or entered into at or near the same time of lease commencement, the lessor should consider whether to include this information in its lease classification assessment.

9.2.2.1.2 Second Criterion — It Is Probable That the Lessor Will Collect the Lease Payments

The second criterion for direct financing lease classification in ASC 842-10-25-3(b) indicates that it must be “probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.” In this context, collectibility is only assessed at lease commencement; changes in collectibility will not result in a change in classification.

If the lease does not meet this criterion, the lease is an operating lease.
**Connecting the Dots — Collectibility Issues Related to Concepts in ASC 606**

For a contract to be within the scope of ASC 606, collectibility must be probable (step 1). Similarly, under ASC 842, no lease-related recognition or measurement occurs when collectibility is not probable. Therefore, ASC 606 and ASC 842 are aligned with respect to the deposit liability concept.

When the sales-type lease consideration does not meet the probability threshold, the sale is only recognized when either (1) the contract has been terminated and the lease payments received from the lessee are nonrefundable or (2) the lessor has repossessed the underlying asset, the lessor has no further obligation under the contract to the lessee, and the lease payments received from the lessee are nonrefundable.

The underlying principles in ASC 606 are similar. Specifically, ASC 606-10-25-7 states:

> When a contract with a customer does not meet the criteria in paragraph 606-10-25-1 and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when one or more of the following events have occurred:

a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.

b. The contract has been terminated, and the consideration received from the customer is nonrefundable.

c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

The ongoing evaluation of (or lack thereof) whether the lease payments and any residual value guarantees become probable over the lease term is similar to the ongoing assessment required by ASC 606. However, an important distinction is that a lessor would never reassess the probability threshold once it is met, since the single obligation to deliver the leased asset has already been fulfilled (i.e., there is no future performance, which may occur in a revenue contract as future goods and services are delivered).

### 9.2.3 Operating Lease

If the lease does not meet any of the five criteria for a sales-type lease or the two criteria for a direct financing lease, the lease is an operating lease.

**Connecting the Dots — Operating Lease Classification**

Lessors are required to first evaluate whether a lease is a sales-type lease; if the lease is not a sales-type lease, the lessor must assess whether it is a direct financing lease. A lessor can only conclude that a lease is an operating lease if it does not meet the criteria for either of the other two classifications. There are no separate criteria for classifying an operating lease.
9.3 Recognition and Measurement

The subsections below provide guidance on how a lessor should account for each type of lease in each phase of the lease “life cycle.”

9.3.1 Lease Inception

Lease inception is the date on which the terms of the contract are agreed to and the agreement creates enforceable rights and obligations. In accordance with ASC 842-10-15-2, at contract inception, an entity identifies whether a contract is or contains a lease, as well as the components in the contract (e.g., a service component) and allocates consideration on the basis of stand-alone selling prices. See Chapter 3 for more information on how to identify a lease and Chapter 4 for a discussion on identifying components in a contract.
### 9.3.2 Lease Commencement (Initial Measurement and Recognition)

The table below summarizes the recognition implications associated with lease commencement and initial measurement for each of the three lease classification types and includes cross-references to the sections of this Roadmap that contain additional details.

<table>
<thead>
<tr>
<th>Lease Classification</th>
<th>Balance Sheet Recognition</th>
<th>Income Statement Recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales-type lease — collectibility is probable (see Section 9.3.7.1)</td>
<td>Recognize a net investment in the lease. The net investment in the lease comprises the sum of the lease receivable and the present value of the unguaranteed residual value. Derecognize the carrying value of the underlying asset. If the fair value of the underlying asset equals the carrying value, defer any initial direct costs.</td>
<td>Recognize any selling profit or selling loss immediately. If the fair value of the underlying asset does not equal the carrying value, expense any initial direct costs immediately.</td>
</tr>
<tr>
<td>Sales-type lease — collectibility is not probable (see Section 9.3.7.2)</td>
<td>None, unless the payments are made up front. If the payments are up front, recognize consideration received as a deposit liability.</td>
<td>Recognize any selling loss immediately. If the fair value of the underlying asset does not equal the carrying value, expense any initial direct costs immediately.</td>
</tr>
<tr>
<td>Direct financing lease (see Section 9.3.8.1)</td>
<td>Recognize a net investment in the lease. The net investment in the lease comprises the sum of the lease receivable and the present value of the unguaranteed residual value. Defer the initial direct costs and selling profit within the net investment in the lease. Derecognize the carrying value of the underlying asset.</td>
<td>Recognize any selling loss immediately. Do not recognize any selling profit at commencement.</td>
</tr>
<tr>
<td>Operating lease (see Section 9.3.9.1)</td>
<td>Defer initial direct costs. If lease payments are received up front, recognize consideration received as a deposit liability.</td>
<td>None.</td>
</tr>
</tbody>
</table>

**Connecting the Dots — Treatment of Initial Direct Costs Under ASC 842 Is Similar to Treatment of Contract Costs Under ASC 606**

The recognition of initial direct costs in connection with a sales-type lease is analogous to that related to a product sale under ASC 606. When an entity sells a product in accordance with ASC 606, any costs of obtaining a contract (i.e., initial direct costs) are recognized in connection with that product sale. Similarly, when a sales-type lease is recognized, initial direct costs are expensed immediately when the fair value of the asset differs from its carrying amount.

When initial direct costs associated with an operating lease are recognized, they are deferred and expensed over the lease term. This would be similar to how such costs (e.g., sales commissions paid) would be recognized in an arrangement where services are being delivered over time. In both the operating lease and services arrangement, such costs are recognized over time to align with the delivery of the service.
Q&A 9-11A  Lessor’s Accounting for Lease “Fulfillment” Costs

In addition to the costs of negotiating and arranging the lease, lessors often incur certain costs related to fulfillment of the lease (e.g., costs of mobilizing the asset) after lease inception but before lease commencement. Since these costs are related to fulfilling, rather than obtaining, the lease, they would not meet the definition of initial direct costs. Because the cost accounting guidance in ASC 842 is limited to initial direct costs, questions have arisen about how a lessor should account for the costs of fulfilling the lease before the lease commences.

ASC 842 provides guidance on accounting for initial direct costs, which ASC 842-10-20 defines as “[i]ncremental costs of a lease that would not have been incurred if the lease had not been obtained.” Further, ASC 842-10-30-9 and 30-10 provide the following guidance on the types of costs that are and are not deemed to be initial direct costs:

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.

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.

The definition of initial direct costs in ASC 842 is largely consistent with the definition of “incremental costs to obtain a contract” in ASC 340-40, which applies to costs related to contracts within the scope of the revenue recognition guidance in ASC 606. The FASB discussed the link between “initial direct costs” and “incremental costs to obtain a contract” at its May 2014 meeting. Specifically, the Board rejected an alternative approach related to expanding the definition of initial direct costs and confirmed that these costs should only include the costs of negotiating and arranging the lease.

In addition to guidance on incremental costs of obtaining a contract, ASC 340-40 provides guidance on accounting for certain contract fulfillment costs incurred by a seller in a revenue arrangement. However, unlike ASC 340-40, ASC 842 does not provide lessors with any additional cost guidance beyond the guidance on initial direct costs.

**Question**

How should a lessor account for costs of fulfilling a lease before the lease commences?

**Answer**

As noted above, ASC 842 only provides guidance on how to account for initial direct costs, which do not include the costs of fulfilling a lease before the lease commences. On the basis of a technical inquiry with the FASB staff, we understand that a lessor should first consider whether these types of fulfillment costs are within the scope of other GAAP. If these costs are not within
the scope of other GAAP, a lessor could elect, as an accounting policy, to account for the costs under either of the following approaches:

• **Approach A** — Analogize to the guidance on contract fulfillment costs in ASC 340-40 (for more information, see Chapter 12 of Deloitte’s Revenue Roadmap) and capitalize such costs as appropriate. A lessor that elects this approach would be required to evaluate the criteria in ASC 340-40-25-5 to determine whether such costs should be capitalized. ASC 340-40-25-5 states:

> An entity shall recognize an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).

b. The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.

c. The costs are expected to be recovered.

• **Approach B** — Expense the costs as incurred.

On the basis of the aforementioned technical inquiry, lessors should apply the accounting policy election consistently on an entity-wide basis to all leases and should disclose the accounting policy elected, if material.

The above approaches are consistent with a speech given by Andrew Pidgeon, a professional accounting fellow in the SEC’s Office of the Chief Accountant, at the 2018 AICPA Conference on Current SEC and PCAOB Developments. Mr. Pidgeon stated, in part:

> For example, a lessor may incur costs to transport a leased asset to the lessee. If the specific lessor costs are not within the scope of other GAAP, and to the extent the costs would qualify for deferral if the lease was within the scope of Topic 606, in lieu of recognizing those costs in current period earnings, the staff did not object to a lessor’s analogy to Subtopic 340-40 as an accounting policy election. [Footnote omitted]

If a lessor elects to follow Approach A, its subsequent accounting should be in line with the guidance in ASC 340-40-35-1 that requires any asset recognized from contract fulfillment costs to be “amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates.” Therefore, for operating leases, a lessor applying Approach A would typically amortize (i.e., expense) any capitalized costs over the lease term, which is aligned with a view that the lessor in an operating lease is providing the use of its asset to the lessee over the lease term (i.e., the related goods or services are being provided over time in a manner similar to a service). In contrast, for sales-type leases or direct financing leases, the related good or service is typically delivered at lease commencement with the transfer of the asset to the lessee (in a manner similar to the sale of a good that may include a significant financing component). Therefore, any eligible fulfillment costs in a sales-type or direct financing lease that meet the criteria in ASC 340-40 for capitalization would typically be amortized (i.e., expensed) fully at lease commencement.

In addition, see the Connecting the Dots below for discussion of ASU 2019-01, under which lessors other than manufacturers or dealers should capitalize lease fulfillment costs as part of...
the net investment in the lease for sales-type leases and direct financing leases when certain conditions are met.

**Example**

A shipowner enters into a contract with a charterer (i.e., the customer) to give the charterer exclusive use of its vessel for two years in exchange for fixed consideration of $1,000 per month (i.e., total contractual consideration of $24,000). The contract is structured as a time charter in which the charterer has full discretion over the ports visited, routes taken, vessel speeds (within the limits established in the contract), and number of trips the vessel makes during the contract term. Because of contractual restrictions, the charterer is only permitted to send the vessel to safe ports and the vessel can only carry lawful cargo. The contract explicitly prevents the shipowner from substituting the vessel during the contract term unless the vessel is damaged. The shipowner has concluded that the vessel represents an identified asset and that the charterer has the right to control the use of the vessel during the contract term; therefore, the contract contains a lease of the vessel. In addition, the shipowner (lessor) has evaluated the lease and has determined that it is an operating lease.

Before the lease commences, the shipowner incurs certain lease fulfillment costs (e.g., transporting the vessel to the contractual point of origin). Because such costs are not related to negotiating and arranging a lease, they do not meet the definition of initial direct costs under ASC 842. The shipowner should first evaluate whether these costs are within the scope of any other GAAP. In the absence of directly relevant guidance, the shipowner may elect to do either of the following:

- Analogize to the contract fulfillment guidance in ASC 340-40 to account for such costs. Specifically, the shipowner would evaluate the criteria in ASC 340-40-25-5 (quoted above) to determine whether the costs should be capitalized.
- Expense the costs as incurred.

The shipowner should apply its election consistently to all leases and disclose the accounting policy elected, if material.

**Connecting the Dots — ASU 2019-01 on Acquisition Costs for Lessors That Are Not Manufacturers or Dealers**

In March 2019, the FASB issued ASU 2019-01, which provides guidance on how lessors that are not manufacturers or dealers (qualifying lessors) should determine the fair value of the underlying asset and apply it to lease classification and measurement. Specifically, for qualifying lessors, the fair value of the underlying asset at lease commencement should be its cost, including any acquisition costs, such as sales taxes or delivery charges. Accordingly, many costs related to the fulfillment of sales-type leases and direct financing leases should be capitalized as part of the net investment in the lease for qualifying lessors. However, if a significant lapse of time occurs between the acquisition of the underlying asset and lease commencement, lessors are required to determine fair value in accordance with ASC 820, which does not include such costs. Moreover, since this ASU does not apply to manufacturers and dealers, such lessors are always required to determine fair value in accordance with ASC 820. See Section 17.3.1.7 for more information about ASU 2019-01.
### 9.3.3 Subsequent Measurement

The table below summarizes recognition implications associated with subsequent measurement for each of the three classification types and includes cross-references to the sections of this Roadmap that contain additional details.

<table>
<thead>
<tr>
<th>Lease Classification</th>
<th>Balance Sheet Recognition</th>
<th>Income Statement Recognition</th>
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</thead>
<tbody>
<tr>
<td><strong>Sales-type lease — collectibility is probable</strong> <em>(see Section 9.3.7.1)</em></td>
<td>Reduce the net investment in the lease for consideration received from the lessee. Increase the net investment in the lease for interest income earned. Reduce the carrying value of the net investment in the lease due to any impairment.</td>
<td>Recognize interest income on the basis of the net investment in the lease at the implicit rate in the lease. Recognize any impairments.</td>
</tr>
<tr>
<td><strong>Sales-type lease — collectibility is not probable</strong> <em>(see Sections 9.3.7.2 and 9.3.7.3)</em></td>
<td>If collectibility remains not probable, recognize consideration received as a deposit liability and reduce the carrying value of the underlying asset by any depreciation incurred. If collectibility becomes probable during the lease term, derecognize any deposit liability, derecognize the underlying asset, and recognize a net investment in the lease (taking into account the sum of the lease receivable and the unguaranteed residual value).</td>
<td>If collectibility remains not probable, recognize depreciation expense for the underlying asset and any impairments. If collectibility becomes probable during the lease term, recognize the net of the values recorded on the balance sheet as selling profit or loss. Over the remainder of the lease term, recognize interest income on the basis of the net investment in the lease at the implicit rate in the lease. Recognize any impairments.</td>
</tr>
<tr>
<td><strong>Direct financing lease</strong> <em>(see Section 9.3.8.1)</em></td>
<td>Reduce the net investment in the lease for consideration received from the lessee. Increase the net investment in the lease for interest income earned. Reduce the carrying value of the net investment in the lease due to any impairment.</td>
<td>Recognize interest income on the basis of the net investment in the lease at the implicit rate in the lease. Recognize any impairments.</td>
</tr>
<tr>
<td><strong>Operating lease</strong> <em>(see Section 9.3.9.1)</em></td>
<td>Recognize any deferred rent receivable/deposit liability. Reduce capitalized initial direct costs for amortization.</td>
<td>Recognize lease income on a straight-line basis (or by using another systematic and rational basis, if appropriate). Amortize any initial direct costs.</td>
</tr>
</tbody>
</table>

### 9.3.4 Lease Modification

ASC 842-10-20 defines a lease modification as follows:

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).

**Connecting the Dots — Rent Concessions Provided as a Result of COVID-19**

In response to the COVID-19 pandemic, the FASB provided both lessees and lessors with relief related to accounting for rent concessions resulting from COVID-19. An entity that elects to apply the relief to qualifying concessions may choose to account for the concessions by either (1) applying the modification framework for these concessions in accordance with ASC 840 or ASC 842 as applicable or (2) accounting for the concessions as if they were made under the enforceable rights included in the original agreement and are thus outside of the modification framework. See Section 17.3.4 for more information.
When a lease modification occurs, an entity may or may not be required to reevaluate the lease classification:

**ASC 842-10**

25-1 . . . 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. . . .

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.

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 in accordance with paragraph 842-10-25-1 as of the effective date of the modification.

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.

25-18 See Examples 15 through 22 (paragraphs 842-10-55-159 through 55-209) for illustrations of the requirements on lease modifications.

55-159 Examples 15 through 22 illustrate the accounting for lease modifications.

Whenever there is a substantive change in the terms and conditions of a contract, the lessor should reassess whether the contract is or contains a lease. (See Q&A 8-15AA for additional discussion.) In addition, as noted above, when the terms and conditions of a lease contract are modified, resulting in a change in the scope of or consideration for a lease, the lessor must evaluate whether (1) “an additional right of use not included in the original lease” is being granted as a result of the modification and (2) there is an increase in the lease payments that is “commensurate with the standalone price for the additional right of use.” If the modification does not meet both of these conditions, the lessor must reassess the lease’s classification. See Section 8.3.4 for considerations related to lease classification reassessment. In a manner consistent with the ASC 606 modification framework, any remaining consideration in the contract, including any termination penalty received from or paid to a lessee as part of a partial termination of a lease, should be reallocated to the remaining components in the contract and recognized prospectively. See Q&A 8-15AD for additional discussion.

If both of the conditions are met, the entity would account for a lease modification as a separate contract and would apply the guidance in ASC 842 to the separate contract. See Section 8.6.2 for additional discussion of the accounting for a modification as a separate contract.

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4 Although Section 8.6 is written from the perspective of a lessee, the concepts described in the cited Q&As and sections also apply to lessors.

5 See footnote 4.

6 See footnote 4.
Example 9-3

Modification Resulting in a Separate Contract

A lessor enters into an arrangement to lease 15,000 square feet of retail space in a shopping mall for 20 years. At the beginning of year 10, the lessor agrees to amend the original lease to include an additional 5,000 square feet of space adjacent to the existing space currently being leased when the current tenant vacates the property in 18 months. The increase in lease consideration as a result of the amendment is commensurate with the market rate for the additional 5,000 square feet of space in the shopping mall. The lessor would account for this modification (i.e., the lease of the additional 5,000 square feet) as a separate contract because the modification provides the lessee with a new ROU asset at a price that reflects its stand-alone price.

Example 9-4

Modification Not Resulting in a Separate Contract

A lessor enters into an arrangement to lease 15,000 square feet in a shopping mall for 20 years. At the beginning of year 10, the lessor agrees to amend the original lease by reducing the annual rental payments from $60,000 to $50,000 for the remaining 10 years of the agreement. Because the modification results in a change only to the lease consideration (i.e., the modification does not result in an additional ROU asset), the lessor would not account for this modification as a separate contract.

Changing Lanes — In a Lease Modification, Entities Are No Longer Required to Consider Previous Terms and Conditions in Determining Lease Classification

Under ASC 840, there was a two-step process related to an entity’s determination of whether a change in lease classification was required. Specifically, an entity determined whether the substitution of the modified lease provisions would have resulted in a different lease classification at inception of the lease, as though such terms had been in place since inception. If so, the lease was considered a new agreement to be assessed for classification by using updated assumptions. The guidance in ASC 840 therefore differs from that in ASC 842, which neither requires nor permits a lessor to consider the terms and conditions or facts and circumstances present as of lease inception (or commencement). As the Board suggests in paragraph BC169 of ASU 2016-02, it is making this change to reduce the complexity of the lease modification guidance and make it “more intuitive to apply.”

Connecting the Dots — Contract Modifications Accounted for as a Separate Contract Under ASC 842 Are Similar but Not Identical to Those Under ASC 606

ASC 606-10-25-12 indicates that a contract modification must be accounted for as a separate contract if both of the following conditions are met:

- “The scope of the contract increases because of the addition of promised goods or services that are distinct.”
- “The price of the contract increases by an amount of consideration that reflects the entity’s standalone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract.”

These conditions are similar to those in ASC 842 that apply to the determination of whether a lease modification should be accounted for as a separate contract. The aligned modification guidance should reduce the complexity of accounting for the modification of a contract that includes both (1) lease components and (2) nonlease components within the scope of ASC 606.
However, there is a key distinction between modifications under ASC 842 and those under ASC 606 with respect to the first condition related to accounting for a modification as a separate contract. That is, for the modification to be accounted for as a separate contract under ASC 842-10-25-8(a), it must grant “an additional right of use not included in the original lease”; on the other hand, ASC 606-10-25-12(a) requires that the modification result in “the addition of promised goods or services that are distinct.” On the surface, these two requirements appear similar, since both mandate the addition of something new to the contract. However, ASC 842 requires that this addition be a new right of use “not included in the original lease.” As a result, a modification that extends the right to use the same underlying asset subject to the existing lease does not qualify to be accounted for as a separate contract under ASC 842, even if that extension is priced at its stand-alone price. In contrast, an extension of the same service (e.g., maintenance) subject to an existing revenue arrangement could qualify to be accounted for as a separate contract under ASC 606. If a lessor has not elected the practical expedient not to separate lease and nonlease components and a modification includes an extension of both an existing right of use and an existing service, the modification would not qualify to be accounted for as a separate contract since it would include more than just the addition of promised goods or services that are distinct. This is because the modification guidance is applied at the contract level rather than at the level of the agreement's individual components, even when different Codification topics apply to such components.

### Q&A 9-12  Evaluation of “Terms and Conditions” and “Facts and Circumstances”

ASC 842-10-25-9 requires a lessor to reassess a lease's classification as of the effective date of the modification in accordance with ASC 842-10-25-1. This assessment is made on the basis of the lease's “modified terms and conditions” as well as the “facts and circumstances” as of the effective date.

**Question**

What are “terms and conditions” and “facts and circumstances” in the context of a lease contract?

**Answer**

“Terms and conditions” are legal stipulations in the contract; facts and circumstances are factors outside the contract. Examples of each that may affect lease classification include:

- **Terms and conditions:**
  - Purchase option on underlying asset.
  - Transfer of the title of the underlying asset at the end of the lease term.
  - Change in a contractual right or obligation in the contract (e.g., lease term or lease payment).

- **Facts and circumstances:**
  - Change in the fair value of the asset.
  - Change in the economic life of the asset.
  - No alternative use of the underlying asset for the lessor.
  - Change in the entity’s view on whether there is a significant economic incentive to purchase or renew the lease.
Note that changes in facts and circumstances alone would never constitute a lease modification; an entity would only need to determine whether a lease classification reassessment must be performed when there are actual changes in the terms and conditions of the contract. However, the lease classification assessment should take into account facts and circumstances present as of the modified lease classification date.

**Connecting the Dots — Significant Asset Improvements**

Although changes in facts and circumstances alone would never constitute a lease modification, questions have arisen about whether a change in rights and obligations that results in a change in the scope of or the consideration for a lease could constitute a lease modification without a written amendment to the contract. For example, a lessor may decide to make a significant improvement to an underlying asset during the lease term without making a corresponding change to the lease contract. In these circumstances, we believe that the lessor should consider whether the significant asset improvement has enhanced the scope of the lessee’s right of use and whether the lessee’s enhanced right of use is legally enforceable. If the significant asset improvement has changed the conditions of the lease by providing the lessee with a legally enforceable, enhanced right of use, we believe that it would generally be appropriate for the lessor to conclude that a lease modification has taken place.

Likewise, we believe that a lessor should also consider whether a significant asset improvement has resulted in such a significant change in the nature of the asset that it has effectively substituted the underlying asset with a new asset. See Q&A 3-6 for additional information on how parties to a contract should account for the supplier’s exercise of a nonsubstantive substitution right.

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7 Although written from the perspective of a lessor, the concepts described in this Connecting the Dots also apply to lessees.

8 Since a change in the conditions of the contract has taken place that results in a change in the scope of the lease, we believe that the conclusion that a lease modification has taken place is appropriate regardless of whether a corresponding change in the contract consideration has occurred.
The decision tree below illustrates the lessor’s evaluation of a change in terms and conditions of a contract that is, or contains, a lease component.

There has been a change in the terms and conditions of a contract that is or contains a lease component.

Is there a change to the terms and conditions of the contract, including, but not limited to, one that adds or terminates the right to use one or more underlying assets or extends or shortens the lease term?

No lease accounting impact.

Yes

Does the modification grant the lessee an additional ROU not included in the original lease?

No

Yes

Are the lease payments commensurate with the stand-alone price for the additional ROU, adjusted for circumstances of the particular contract?

No

Reassess the lease classification as of the effective date of the modification on the basis of its modified terms and conditions and the facts and circumstances as of that date.

Yes

Account for the modification as a separate contract.
The diagram below illustrates the different types of potential lease modifications. The Roadmap sections cross-referenced in the diagram discuss each of the modification types in detail.

Q&A 9-12A  Circumstances in Which a Lessor Is Required to Update Stand-Alone Selling Prices

Lessors are required to allocate the consideration in the contract to the separate lease and nonlease components in accordance with step 4 of the revenue recognition model in ASC 606-10-32-28 through 32-41. That is, lessors will generally allocate the consideration in the contract on the basis of the relative stand-alone selling price. The stand-alone selling price, in accordance with ASC 606-10-32-32, is “the price at which an entity would sell a promised good or service separately to a customer.” See Section 4.4.2.2 for further discussion of allocating consideration in the contract.
Generally, a lessor does not remeasure its net investment in a lease (sales-type lease or direct financing lease) or its assets and liabilities associated with an operating lease. However, if a lease modification is not accounted for as a separate contract in accordance with ASC 842-10-25-8 (as discussed above), the lease balance may need to change. Specifically, ASC 842-10-35-6 states that 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.” See Section 6.10 for more information about subsequent measurement of lease payments.

Under ASC 842-10-15-41, if a lease modification is not accounted for as a separate contract (as discussed in Section 4.4.2.3), 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.”

While the guidance explicitly specifies that a lessor should reallocate consideration in the contract when there is a contract modification that is not accounted for as a separate contract, it is not clear on whether the lessor would need to reevaluate stand-alone selling prices as of the modification date or whether it would be appropriate to retain the original inception-date relative stand-alone selling prices and thus to carry forward the original allocation percentages determined in accordance with ASC 606.

**Question**

Is a lessor required to reevaluate stand-alone selling prices and update the relative stand-alone selling price allocation percentages when a contract modification occurs that is not accounted for as a separate contract?

**Answer**

Yes. A lessor should update its estimates of stand-alone selling prices and the resulting relative stand-alone selling price allocation percentages for the separate contract components when a contract modification occurs that is not accounted for as a separate contract.

The guidance in ASC 842 is intentionally aligned with several concepts in ASC 606, including guidance on contract modifications. Therefore, a lessor’s contract modification is similar to a revenue contract modification in accordance with ASC 606-10-25-12 and 25-13, under which an entity must account for a contract modification as if it were a termination of the existing contract, and the creation of a new contract, when certain conditions are met (as explained in the Connecting the Dots above). As a result, an entity would need to evaluate updated stand-alone selling prices for the newly created contract.

Therefore, when a lease contract is modified and is not accounted for as a separate contract, the allocation to the remaining lease and nonlease components is performed on the basis of the facts and circumstances (and the modified terms and conditions, if applicable) that exist as of the date of the modification (see Q&A 9-12). Given that the lessee and lessor have agreed to the modified terms and conditions as of the modification date, the economic split between the lease and nonlease components should also be revised.
We believe that it would be counterintuitive not to revise the relative stand-alone selling prices and related allocation percentages since there could be additional (or fewer) components in the contract after the modification. For example, if the lessor modifies the contract, the modification does not result in a separate contract, and the modification results in the addition (or elimination) of the right to use one or more underlying assets, it would not make sense to retain the allocation percentages that were determined at lease inception. The reason such retention would not make sense in such circumstances is that either (1) any new components in the contract would not have been included in the initial determination (when new components are added) or (2) any eliminated components would have been included in the initial determination and would no longer be subject to allocation (when there are partial terminations — see Section 9.3.5).

In addition, a lessor would apply the revenue contract modification guidance to the nonlease (revenue) components that are accounted for in accordance with ASC 606. For those components, an entity would be required to evaluate the updated stand-alone selling prices at the time of modification in accordance with ASC 606-10-25-12 and 25-13. (For more information, see Sections 9.2.1 and 9.2.2 of Deloitte’s Revenue Roadmap.) Therefore, the allocation of consideration among the nonlease components would change. This guidance further supports the view that a lessor should apply the same method to the lease components. The entire arrangement, including both lease and nonlease components, would be subject to an evaluation of the updated stand-alone selling prices at the time of modification.

### 9.3.5 Lease Termination

The table below summarizes recognition implications associated with a lease termination for each of the three classification types and includes cross-references to the sections of this Roadmap that contain additional details.

<table>
<thead>
<tr>
<th>Lease Classification</th>
<th>Balance Sheet Recognition</th>
<th>Income Statement Recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales-type lease — collectibility is probable (see Section 9.3.7.8)</td>
<td>Derecognize the net investment in the lease and measure the carrying value of the asset recognized on the basis of the net investment in the lease, less any impairments.</td>
<td>Recognize any ASC 310 or ASC 326 impairments.</td>
</tr>
<tr>
<td>Sales-type lease — collectibility is not probable (see Section 9.3.7.8)</td>
<td>Derecognize the deposit liability if the balance is nonrefundable to the lessee and either (1) the lease is terminated or (2) the lessor has repossessed the underlying asset and has no further obligation under the contract.</td>
<td>If the lessor can derecognize any deposit liability, recognize the amounts as selling profit.</td>
</tr>
<tr>
<td>Direct financing lease (see Section 9.3.8.6)</td>
<td>Derecognize the net investment in the lease and measure the carrying value of the asset recognized on the basis of the net investment in the lease, less any impairments.</td>
<td>Recognize any ASC 310 or ASC 326 impairments.</td>
</tr>
<tr>
<td>Operating lease (see Section 9.3.9.5)</td>
<td>Write off any deferred rent receivables (or prepaid lease liability if amounts are nonrefundable to the lessee) or initial direct costs.</td>
<td>Recognize any impact of the write-offs.</td>
</tr>
</tbody>
</table>
Any termination penalty received from or paid to a lessee as part of a full termination of a lease should be included in the determination of any gain or loss upon termination. However, any termination penalty received from or paid to a lessee as part of a partial termination of a lease should be reallocated to the remaining components in the contract and recognized prospectively. See Q&A 8-15AD for additional discussion.\(^9\)

### 9.3.6 End of Lease

The table below summarizes recognition implications associated with lease expiration for each of the three classification types and includes cross-references to the sections of this Roadmap that contain additional details.

<table>
<thead>
<tr>
<th>Lease Classification</th>
<th>Balance Sheet Recognition</th>
<th>Income Statement Recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales-type lease — collectibility is probable (see Section 9.3.7.9)</td>
<td>Derecognize the net investment in the lease and measure the carrying value of the asset recognized on the basis of the net investment in the lease, less any impairments.</td>
<td>Recognize any ASC 310 or ASC 326 impairments.</td>
</tr>
<tr>
<td>Sales-type lease — collectibility is not probable (see Section 9.3.7.9)</td>
<td>Derecognize the deposit liability if the balance is nonrefundable to the lessee and either (1) the lease is terminated or (2) the lessor has repossessed the underlying asset and has no further obligation under the contract.</td>
<td>If the lessor can derecognize any deposit liability, recognize the amounts as selling profit.</td>
</tr>
<tr>
<td>Direct financing lease (see Section 9.3.8.6)</td>
<td>Derecognize the net investment in the lease and measure the carrying value of the asset recognized on the basis of the net investment in the lease, less any impairments.</td>
<td>Recognize any ASC 310 or ASC 326 impairments.</td>
</tr>
<tr>
<td>Operating lease (see Section 9.3.9.5)</td>
<td>No impact.</td>
<td>No impact.</td>
</tr>
</tbody>
</table>

### 9.3.7 Sales-Type Lease

In a sales-type lease, the lessee gains control of the underlying asset and the lessor therefore relinquishes control to the lessee. Accordingly, the lessor derecognizes the underlying asset and in its place recognizes its new asset, the net investment in the lease (which consists of the sum of the lease receivable and the present value of the unguaranteed residual asset). Any selling profit or loss created as a result of the difference between those two amounts (net investment in the lease less carrying amount of asset) would be recognized at lease commencement. Initial direct costs would be recognized as an expense at lease commencement unless there is no selling profit or loss. If there is no selling profit or loss, the initial direct costs would be deferred and recognized over the lease term. In addition, the lessor would recognize interest income from the lease receivable over the lease term to reflect its new position with respect to the asset as a creditor of the “loan” provided to the customer (lessee).

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\(^9\) A partial termination occurs when the parties in an existing lease agree to terminate the lessee's right to use (1) some of the assets under the lease (e.g., discrete pieces of equipment) or (2) a portion of an asset (e.g., one of several leased floors in an office building).

\(^10\) See footnote 4.
Connecting the Dots — Sales-Type Leases When Fair Value Equals Carrying Value of the Underlying Asset

When the fair value of the asset subject to a sales-type lease is equal to its carrying value, the subsequent measurement is similar to the accounting for a direct financing lease because there is no gain (or loss) to immediately recognize. Therefore, all of the “income” associated with the lease is interest income (with no selling profit incorporated into the activity). Further, the initial direct costs are deferred (included in the net investment in the lease) and recognized over the term of the lease. This approach is the same as that used for direct financing leases.

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

9.3.7.1 Recognition, Initial Measurement, and Subsequent Measurement

9.3.7.1.1 Recognition and Initial Measurement

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>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:</td>
</tr>
<tr>
<td>a. A net investment in the lease, measured in accordance with paragraph 842-30-30-1</td>
</tr>
<tr>
<td>b. Selling profit or selling loss arising from the lease</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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).</td>
</tr>
</tbody>
</table>

If collectibility for the sales-type lease is probable at lease commencement, the underlying asset is derecognized on the commencement date and a “net investment in the lease” is recognized. The difference between the net investment in the lease, or sales price, and the carrying value of the underlying asset must be recognized as selling profit or selling loss. See Section 9.3.7.2 for information on how to account for a sales-type lease when collectibility is not probable at lease commencement.

While ASC 842 indicates that selling loss could be recognized on the commencement date, lessors should ensure the completeness of their ASC 360 impairment analysis if they determine that a selling loss exists.

11 The definition of probable in this context is that “the future event or events are likely to occur” and is aligned with the definition in ASC 450 (formerly FASB Statement 5).
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.

See Chapter 6 for more information on amounts included in and excluded from lease payments.

**Connecting the Dots — Estimated Residual Value of Land**

Under ASC 840, the estimated residual value of land in a sales-type or direct financing lease is limited to the land’s fair value determined at lease inception. While ASC 842 is silent on this issue, we believe that the same principle applies under ASC 842. That is, a lessor’s estimate of a land’s residual value in a sales-type or direct financing lease should be limited to the land’s fair value as of lease commencement. As a result, the land’s estimated residual value will never exceed the land’s fair value at lease commencement.

Any initial direct costs are recognized as an expense if, on the commencement date, the fair value of the underlying asset differs from the lessor’s carrying amount. If the fair value of the underlying asset equals the carrying amount, initial direct costs are deferred on the commencement date and are included in the measurement of the net investment in the lease. See Section 6.11 for more information on what amounts constitute initial direct costs.
Changing Lanes — Narrower Definition of Initial Direct Costs

ASC 842 narrows the definition of initial direct costs. Previously, many lessors capitalized amounts related to overhead from their leasing departments (e.g., employees’ salaries in that department). Because such costs would be incurred regardless of whether a lease was executed, lessors will be prohibited from capitalizing them as a result of this narrower definition.

9.3.7.1.2 Subsequent Measurement

ASC 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 . . .

While selling profit is recognized in a sales-type lease at lease commencement, it is also necessary to recognize interest income for the financing provided by the lessor (i.e., to reflect that, through the contract, the lessor has effectively converted the leased asset into a financial asset).

ASC 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.

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.

Interest income should generally be recognized during all reporting periods, regardless of payment timing. Any interest income not yet paid would be included as an increase in the basis of the net investment in the lease. The rate the lessor uses should be a constant periodic discount rate with respect to the remaining balance of the net investment in the lease (i.e., the lessor should subsequently measure the net investment in the lease by using the effective interest method and the rate implicit in the lease).

Because variable lease payments are not included in the net investment in the lease, any amounts receivable or received (allocated to the lease component) must be recognized as income in the period in which the changes in facts and circumstances on which the variable lease payments are based occur. See Chapter 6 for more information on how to identify whether a lease payment is variable and Q&A 4-11 for a discussion about recognizing variable payments for which a portion is attributable to a nonlease component.
The following scenario, reprinted from Example 1 in ASC 842-30-55, illustrates a lessor’s accounting for a sales-type lease:

**ASC 842-30**

30-3 See Example 1 (paragraphs 842-30-55-18 through 55-43) for an illustration of the requirements for sales-type . . . leases.

**Illustration of Lessor Accounting**

55-18 Example 1 illustrates how a lessor would account for sales-type leases and direct financing leases.

**Example 1 — Lessor Accounting Example**

**Case A — Lessor Accounting — Sales-Type Lease**

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.

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. In accordance with paragraph 842-10-25-4, the discount rate used to determine the present value of the lease payments and the present value of the residual value guaranteed by Lessee (5.4839 percent) for purposes of assessing whether the lease is a sales-type lease under the criterion in paragraph 842-10-25-2(d) assumes that no initial direct costs will be capitalized because the fair value of the equipment is different from its carrying amount.

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).
ASC 842-30 (continued)

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.

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%).

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.

Below is a summary of the steps the lessor in the above scenario would perform as well as the journal entries it would record.

Step 1: Gather the Facts

- Lease term: 6 years.
- Lease payments: $9,500/year beginning at the end of year 1.
- Residual value guarantee provided by lessee: $13,000.
- Collectibility of the lease payments and residual value guarantee as of commencement is probable.
- Economic life of equipment: 9 years.
- Carrying amount: $54,000.
- Fair value: $62,000.
- Expected residual value at end of term: $20,000.
- No transfer of ownership and no purchase options.
- Lessor incurs $2,000 in initial direct costs.
Step 2: Determine the Rate Implicit in the Lease

The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate so that the sum equals the fair value of the asset. Because the fair value of the asset differs from the carrying value, the initial direct costs are not included in the calculation of the rate implicit in the lease (since such amounts are immediately expensed).

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>(62,000)</td>
<td>Fair value of underlying asset</td>
</tr>
<tr>
<td>1</td>
<td>9,500</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>9,500</td>
<td>Lease payment</td>
</tr>
<tr>
<td>3</td>
<td>9,500</td>
<td>Lease payment</td>
</tr>
<tr>
<td>4</td>
<td>9,500</td>
<td>Lease payment</td>
</tr>
<tr>
<td>5</td>
<td>9,500</td>
<td>Lease payment</td>
</tr>
<tr>
<td>6</td>
<td>29,500</td>
<td>Lease payment + unguaranteed residual value and guaranteed residual value</td>
</tr>
</tbody>
</table>

5.4839% Implicit rate in the lease

Step 3: Determine the Lease Classification

The lessor would apply the criteria in ASC 842-10-25-2 to determine whether the lease should be classified as a sales-type lease:

| ASC 842-10-25-2(a) — Does the lease transfer ownership of the equipment to the lessee by the end of the lease term? | No. |
| ASC 842-10-25-2(b) — Does the lease contain a purchase option that the lessee is reasonably certain to exercise? | No. |
| ASC 842-10-25-2(c) — Does the lease term represent a major part of the remaining economic life of the underlying asset? | No. The remaining economic life of the equipment is nine years, and the lease term is six years. Management concludes that this does not constitute a major part of the economic life of the asset. |
| ASC 842-10-25-2(d) — Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset? | Yes. The present value of the lease payments is $47,482. As it is required to do in performing the sales-type lease classification test, a lessor must include the present value of the entire residual value guarantee provided by the lessee. The present value of $13,000 is $9,437. The sum of $47,482 and $9,437 is $56,919. Therefore, management concludes that the lease payments constitute substantially all of the fair value of the asset ($62,000). |
| ASC 842-10-25-2(e) — Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease? | No, the underlying asset is not specialized. |

Because the lease meets the criterion in ASC 842-10-25-2(d), the lessor determines that the lease is a sales-type lease.
Step 4: Record the Commencement-Date Journal Entries

Because control of the asset was lost, the lessor must derecognize the asset and record the net investment in the lease.

The net investment in the lease is measured as the present value of the sum of the (1) lease payments not yet received by the lessor, (2) residual value guaranteed by the lessee or a third party unrelated to the lessor, and (3) residual value that is not guaranteed by the lessee or a third party unrelated to the lessor. The lessor determines the present value of the lease payments not yet received as $47,482, and the present value of the residual asset that is guaranteed and unguaranteed that the lessor expects to receive is $14,518 ($9,437 and $5,081, respectively). The net investment in the lease is therefore $62,000 (or the fair value of the underlying asset), as reflected in the following journal entry:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net investment in the lease</td>
<td>62,000</td>
</tr>
<tr>
<td>Carrying value of the underlying asset</td>
<td>54,000</td>
</tr>
<tr>
<td>Selling profit</td>
<td>8,000</td>
</tr>
</tbody>
</table>

The difference between the net investment in the lease and the carrying value of the underlying asset is recognized as selling profit at lease commencement. Because the fair value of the underlying asset differs from the carrying amount of the underlying asset as of the commencement date, initial direct costs are not eligible for deferral:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial direct cost expense</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash</td>
<td>2,000</td>
</tr>
</tbody>
</table>

Step 5: Record the Activities Related to the Sales-Type Lease

In year 1, the lessee pays the lessor $9,500. A portion of the payment is allocable to interest income, since the lessor is effectively financing the lessee’s purchase. The interest income is recognized as $3,400 ($62,000 × 5.4839%). Note that this income should be recognized over the reporting period and is not governed by when the amount is paid by the lessee. The other portion of the lessee’s payment results in a reduction in the lessor’s net investment in the lease (which represents the receivable from the lessee). Embedded within the interest income (and related increase in the net investment in the lease) is the accretion of the unguaranteed residual value of the asset.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>9,500</td>
</tr>
<tr>
<td>Interest income</td>
<td>3,400</td>
</tr>
<tr>
<td>Net investment in the lease</td>
<td>6,100</td>
</tr>
</tbody>
</table>
The remainder of the cash payments received over the life of the lease should be recognized as follows through year 6:

<table>
<thead>
<tr>
<th>Year</th>
<th>Payment</th>
<th>Beginning Net Investment in the Lease</th>
<th>Interest Income</th>
<th>Decrease in Net Investment in the Lease</th>
<th>Ending Net Investment in the Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$9,500</td>
<td>$55,900</td>
<td>$3,066</td>
<td>$6,434</td>
<td>$49,466</td>
</tr>
<tr>
<td>3</td>
<td>$9,500</td>
<td>$49,466</td>
<td>$2,713</td>
<td>$6,787</td>
<td>$42,678</td>
</tr>
<tr>
<td>4</td>
<td>$9,500</td>
<td>$42,678</td>
<td>$2,340</td>
<td>$7,160</td>
<td>$35,519</td>
</tr>
<tr>
<td>5</td>
<td>$9,500</td>
<td>$35,519</td>
<td>$1,948</td>
<td>$7,552</td>
<td>$27,966</td>
</tr>
<tr>
<td>6</td>
<td>$9,500</td>
<td>$27,966</td>
<td>$1,534</td>
<td>$7,966</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

**Step 6: Record the Return of the Underlying Asset to the Lessor**

The ending net investment in the lease represents the estimated value the lessor will receive from the lessee when the lessor regains control over the underlying asset. The balance of the net investment in the lease will equal the expected value of the residual asset estimated at commencement (less any impairments). Note no increases in the expected underlying value of the asset should be recognized during the lease term. The lessor would record the following journal entry to reflect the return of the underlying asset at the residual value expected at the end of the lease term:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>20,000</td>
</tr>
<tr>
<td>Net investment in the lease</td>
<td>20,000</td>
</tr>
</tbody>
</table>

**Q&A 9-13 Commencement Loss Resulting From a Significant Variable Payment in a Sales-Type or Direct Financing Lease**

While the FASB's goal was to align lessor accounting with the revenue guidance in ASC 606, an important distinction between the two may affect lessors in a number of industries. Under ASC 606, variable payments are estimated and included in the transaction price subject to a constraint. By contrast, under ASC 842, variable lease payments not linked to an index or rate are generally excluded from the determination of a lessor's lease receivable.

Accordingly, sales-type or direct financing leases that have a significant variable lease payment component may result in an entity’s recognition of a loss at commencement because the measurement of the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset. This could occur, for example, if lease payments are based entirely on the number of units produced by the leased asset (i.e., payments are 100 percent variable) or when a portion of the expected cash flows from the lease is variable (e.g., 50 percent of the total expected cash flows are variable). However, these transactions typically do not represent an economic loss for the lessor.

**Question**

Should a lessor recognize a loss at lease commencement when its initial measurement of the net investment in a sales-type or direct financing lease is less than the carrying value of the underlying asset?
Answer

Yes. At the FASB’s November 30, 2016, meeting, the Board acknowledged that a lessor’s initial measurement of a sales-type or direct financing lease that includes a significant variable-lease payment component may result in a loss at lease commencement if the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset being leased. The Board discussed whether a loss at commencement would be appropriate in these situations or whether other possible approaches would be acceptable, such as (1) incorporating variable lease payments subject to a constraint (by reference to ASC 606) or (2) using a negative discount rate to avoid the loss at commencement. The Board expressed its belief that while stakeholders may disagree with the outcome of recognizing a loss at commencement, ASC 842 is clear on how the initial measurement guidance should be applied to sales-type and direct financing leases.

In discussions with the FASB staff, we observed that in situations similar to those outlined in Examples 1 and 2 below, the outcome of the calculation of the “rate implicit in the lease,” which is based on how that term is defined in ASC 842-30-20, may result in a negative discount rate. However, at the FASB’s November 30, 2016, meeting, the Board acknowledged that using a negative discount rate to determine the rate implicit in the lease (as defined in ASC 842-10-20) is inappropriate.12 ASU 2018-10 clarifies that lessors should use a 0 percent discount rate when measuring the net investment in a lease if the rate implicit in the lease is negative.

Example 1

A lessee and manufacturer lessor enter into a five-year sales-type lease of the lessor’s R2-series equipment. Before lease commencement, the lessor customizes the R2-series equipment specifically for the lessee.13 The asset has a carrying value of $100, a fair value at commencement of $120, and an estimated unguaranteed residual value of $50 at the end of the lease term. Payments are based entirely on the lessee’s usage of the R2-series equipment. The lessor has significant insight into the lessee’s equipment needs over the five-year term, and although the payments are 100 percent variable, the lessor has priced the lease with the expectation that it will receive an annual payment of $20. The lessor thus charges the lessee a rate of 6.4 percent.14

The tables below illustrate the terms of the sales-type lease and the lessor’s accounting for the lease under ASC 842.

<table>
<thead>
<tr>
<th>Terms</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease term</td>
<td>5 years</td>
</tr>
<tr>
<td>Fair value</td>
<td>$ 120</td>
</tr>
<tr>
<td>Carrying amount</td>
<td>$ 100</td>
</tr>
<tr>
<td>Annual fixed lease payments</td>
<td>—</td>
</tr>
<tr>
<td>Required discount rate*</td>
<td>0%</td>
</tr>
<tr>
<td>Estimated residual value at the end of the lease term</td>
<td>$ 50</td>
</tr>
</tbody>
</table>

12 This is consistent with the amendments that ASU 2018-10 made to the definition of the term “rate implicit in the lease” in the glossary of ASC 842. See Section 17.3.1.3 for further discussion of the ASU.
13 Accordingly, the lease would meet the criterion in ASC 842-10-25-2(e) for classification as a sales-type lease.
14 The lessor determined the rate it used to price the lease by discounting expected annual cash inflows of $20, plus a terminal cash inflow of $50 for the expected residual value of the asset, to the asset’s fair value of $120.
Example 1 (continued)

**Sales-Type Lease — 100% Variable**

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Investment in Lease</th>
<th>Interest Income</th>
<th>Variable Lease Revenue</th>
<th>Profit and Loss (P&amp;L)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$50**</td>
<td>—</td>
<td>—</td>
<td>$(50)</td>
</tr>
<tr>
<td>1</td>
<td>50</td>
<td>—</td>
<td>$20</td>
<td>20</td>
</tr>
<tr>
<td>2</td>
<td>50</td>
<td>—</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>3</td>
<td>50</td>
<td>—</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>4</td>
<td>50</td>
<td>—</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>5</td>
<td>50</td>
<td>—</td>
<td>20</td>
<td>20</td>
</tr>
</tbody>
</table>

Subtotals $100

Total P&L on lease $50

* In this example, instead of using the rate it used to price the lease as the discount rate when measuring its net investment in the lease (i.e., the true rate of 6.4 percent), the lessor uses a 0 percent discount rate.

** The net investment in the lease is initially measured as the sum of (1) the lease payments ($0), discounted at a rate of 0 percent, and (2) the amount the lessor expects to derive from the asset after the lease term ($50), discounted at a rate of 0 percent. Expected cash flows of $100 are not included in the measurement of the net investment in the lease because those payments are variable.

Example 2

Assume the same facts as in Example 1. The lessor still charges the lessee a rate of 6.4 percent based on expected annual cash flows of $20. However, the lessor prices the lease with 50 percent of the cash flows fixed and 50 percent of the cash flows variable based on the lessee’s usage of the R2-series equipment.

The tables below illustrate the terms of the sales-type lease and the lessor’s accounting for the lease under ASC 842.

**Terms**

<table>
<thead>
<tr>
<th></th>
<th>5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease term</td>
<td></td>
</tr>
<tr>
<td>Fair value</td>
<td>$120</td>
</tr>
<tr>
<td>Carrying amount</td>
<td>$100</td>
</tr>
<tr>
<td>Annual fixed lease payments</td>
<td>$10</td>
</tr>
<tr>
<td>Required discount rate*</td>
<td>0.0%</td>
</tr>
<tr>
<td>Estimated residual value at the end of the lease term</td>
<td>$50</td>
</tr>
</tbody>
</table>

---

15 See footnote 14.
Example 2 (continued)

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Investment in Lease</th>
<th>Interest Income</th>
<th>Variable Lease Revenue</th>
<th>P&amp;L</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$100**</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>1</td>
<td>90</td>
<td>—</td>
<td>$10</td>
<td>$10</td>
</tr>
<tr>
<td>2</td>
<td>80</td>
<td>—</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>3</td>
<td>70</td>
<td>—</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>4</td>
<td>60</td>
<td>—</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>5</td>
<td>50</td>
<td>—</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Subtotals</td>
<td></td>
<td></td>
<td>$50</td>
<td>$50</td>
</tr>
<tr>
<td>Total P&amp;L on lease</td>
<td></td>
<td></td>
<td>$50</td>
<td>$50</td>
</tr>
</tbody>
</table>

* In this example, instead of using the rate it used to price the lease as the discount rate when measuring its net investment in the lease (i.e., the true rate of 6.4 percent), the lessor uses a 0 percent discount rate.

** The net investment in the lease is initially measured as the sum of (1) the lease payments ($50), discounted at a rate of 0 percent, and (2) the amount the lessor expects to derive from the asset after the lease term ($50), discounted at a rate of 0 percent. Expected cash flows of $50 that represent variable payments are not included in the measurement of the net investment in the lease.

Connecting the Dots — Arrangements With Significant Variable Lease Payments

It is common for lease arrangements in a number of industries to include significant or wholly variable lease payments. It is not uncommon for such arrangements to result in sales-type or direct financing lease classification.

Arrangements in the energy sector are frequently accounted for as leases with wholly variable payment streams. For example, PPAs related to renewable energy (i.e., from solar or wind generation facilities) (1) are commonly long term and for the major part of the economic life of the generation facility, (2) provide for payments at a fixed price per unit of electricity output (e.g., $50 per megawatt hour (MWh)), and (3) require the lessee to take all of the output produced by the facility but do not specify a minimum level of production (i.e., the volume of output is wholly variable). Although the output quantity is weather-dependent, the lessor expects the arrangement to be profitable on the basis of historical weather data.

We are also aware of arrangements in the oil and gas industry in which a company builds a gathering and processing system and leases it to a single user under a variable payment structure. For example, an exploration company with rights to multiple oil wells on dedicated acreage may contract with a midstream company to construct and lease the infrastructure necessary to gather and process the oil extracted from the wells. The arrangement may be long term and for a major part of the economic life of the infrastructure, and the payment for the use of the infrastructure may be 100 percent variable (e.g., a fixed price per unit multiplied by the number of units gathered or processed) without a minimum volume requirement. The midstream company would be willing to accept variable consideration in the arrangement if reserve data related to the wells suggest that a sufficient volume of oil will be extracted over the term of the contract to make the arrangement profitable.
In the real estate sector, a commercial real estate lease arrangement (e.g., a lease of retail space) may be priced in such a way that a significant amount of the expected payments are contingent on the lessee's sales (e.g., payments that are a fixed percentage of the retail store's sales for a month). The lessor would account for the arrangement as a sale-type lease if the lease (1) is for a major part of the economic life of the retail location or (2) contains a purchase option that the lessee is reasonably certain to exercise. Arrangements of this type allow the property owner to participate in the upside of the retail store's business and are expected to be profitable.

Finally, in the health care industry, it is not uncommon for a hospital to contract with a medical device owner for the use of specific medical equipment for a major part of the economic life of the equipment. This type of arrangement is often priced in such a way that the consideration is based entirely on the hospital's ongoing purchase of “consumables,” which allow the equipment to function as designed, and may have no minimum volume requirement. The medical device owner is willing to accept variable consideration in the arrangement because demand for the associated health care services suggests that a sufficient volume of consumables will be purchased by the hospital over the term of the contract to make the arrangement profitable.

**9.3.7.2 Accounting for Lack of Collectibility**

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
</table>
| 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.

As indicated above, the lessor would not derecognize the underlying asset if collectibility is not probable as of the commencement date; instead, in such circumstances, any proceeds would be recognized as a deposit liability. See Section 9.3.7.3 for information on accounting for changes in collectibility.

**Changing Lanes — Lack of Collectibility Results in More Restrictive Recognition**

If the collection of lease payments is not reasonably predictable under ASC 840, the lease may not be classified as a sales-type lease. Nonetheless, the lease payments may be recognized in profit or loss under the operating lease model. In an identical scenario in which a lease meets all of the ASC 842 sales-type criteria, a lessor would be required to record any payments received as a deposit liability and income recognition would be delayed. Because ASC 842 would still require the lease to be classified as a sales-type lease (and not be classified as an operating lease, as would have been required under ASC 840) despite the collectibility concerns, a lessor would not be able to recognize lease payments in profit or loss as quickly as under ASC 840.
9.3.7.3 When Collectibility Becomes Probable

ASC 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.

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.

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 credit loss guidance applicable to the net investment in the lease in paragraph 842-30-35-3.

Changes in collectibility after lease commencement do not affect the lease's classification but do affect subsequent measurement. If collectibility is not probable at lease commencement, no sale is recognized. However, if collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, does become probable during the lease term, the lessor may recognize the sale at such time. Further, at such time, the lessor must derecognize the carrying amount of the underlying asset, as well as any deposit liability, and must recognize a net investment in the lease. The lessor should measure the net investment in the lease as the present value of the remaining lease payments, discounting the payments by using the rate implicit in the lease. The difference between these amounts is recorded as selling profit or loss.

The scenario below, reprinted from Example 1 in ASC 842-30-55, illustrates the lessor’s accounting for a sales-type lease when collectibility of the lease payments is not probable. Certain facts in this scenario are the same as those in Case A of Example 1, which is reproduced in Section 9.3.7.1.
Case B — Lessor Accounting — Sales-Type Lease — Collectibility of the Lease Payments Is Not Probable

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.

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.

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).

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.

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).

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.
Below is a summary of the steps the lessor in the above scenario would perform as well as the journal entries it would record.

**Step 1: Gather the Facts**

- Lease term: 6 years.
- Lease payments: $9,500/year beginning at the end of year 1.
- Residual value guarantee provided by lessee: $13,000.
- Collection of the lease payments and residual value guarantee as of commencement is not probable but becomes probable at the end of year 4.
- Economic life of equipment: 7 years.\(^{16}\)
- Carrying amount: $54,000.
- Fair value: $62,000.
- Expected residual value at end of term: $20,000.
- No transfer of ownership and no purchase options.
- Lessor incurs $2,000 in initial direct costs.

**Step 2: Solve for the Rate Implicit in the Lease**

All else being equal, the rate implicit in the lease would be unchanged by the collectibility assessment, although the rate of return would be expected to be higher in situations in which collectibility is in doubt than in arrangements in which collectibility is probable. As in Case A above (see Section 9.3.7.1), the implicit rate in the lease in this scenario is 5.4839 percent.

**Step 3: Determine the Lease Classification**

None of the lease classification criteria for a sales-type lease require a lessor to consider collectibility. Therefore, the change in fact (i.e., it is not probable at commencement that the lease payments are collectible) has no impact on the sales-type lease classification.

**Step 4: Record the Commencement-Date Journal Entries**

Because of the collectibility concerns, a sale has not occurred and the only entry that the lessor records at lease commencement is to recognize the initial direct costs. The fair value of the underlying asset differs from the carrying amount of the underlying asset as of the commencement date; thus, initial direct costs are not eligible for deferral. The following entry would be recorded:

\[
\text{Initial direct cost expense} \quad 2,000 \\
\text{Cash} \quad 2,000
\]

\(^{16}\) Although the beginning of Example B in ASC 842-30-55-25 states that the reader should “[a]ssume the same facts and circumstances as in Case A,” the FASB staff indicated to us that the economic life in Case B should be seven years and not nine years as stipulated in Case A.
Step 5: Record the Activities Related to the Sales-Type Lease

In year 1, the lessee must pay the lessor $9,500. The lessor determines that collectibility is not yet probable. The lease contract has not been terminated, and the lessor has not repossessed the underlying asset. Consequently, the lessor accounts for the $9,500 payment as a deposit liability:

\[
\begin{align*}
\text{Cash} & \quad 9,500 \\
\text{Deposit liability} & \quad 9,500
\end{align*}
\]

Moreover, since the underlying asset was not derecognized because sale accounting was not achieved, the lessor should recognize depreciation expense on the basis of the remaining useful life (7 years) and the carrying value of the underlying asset, $54,000:

\[
\begin{align*}
\text{Depreciation expense} & \quad 7,714 \\
\text{Accumulated depreciation} & \quad 7,714
\end{align*}
\]

In years 2 and 3, (1) the lessor maintains its assessment that collectibility is not yet probable, (2) the lease contract has not been terminated, and (3) the lessor has not repossessed the underlying asset. Balances and activities are recognized as shown below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Deposit Liability Balance</th>
<th>Payment</th>
<th>Ending Deposit Liability Balance</th>
<th>Depreciation Expense</th>
<th>Beginning Accumulated Depreciation</th>
<th>Ending Accumulated Depreciation</th>
<th>Net Carrying Value of Underlying Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$ 9,500</td>
<td>$ 9,500</td>
<td>$ 19,000</td>
<td>$ 7,714</td>
<td>$ 7,714</td>
<td>$ 15,429</td>
<td>$ 38,571</td>
</tr>
<tr>
<td>3</td>
<td>19,000</td>
<td>9,500</td>
<td>28,500</td>
<td>7,714</td>
<td>15,429</td>
<td>23,143</td>
<td>30,857</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.

At the end of year 4, the lessee completes its fourth $9,500 payment; thus, the deposit liability is $38,000 ($28,500 + $9,500). Contemporaneously, the lessor concludes that collectibility of the payments and any amount necessary to satisfy the residual value guarantee provided by the lessee is now probable. Classification is not revisited.
Because a sale has occurred, the lessor must derecognize the asset and record the net investment in the lease. In calculating the “net investment in the lease,” the lessor determines that the present value of the lease payments not yet received is $17,544. The present value of the residual asset that is guaranteed and unguaranteed that the lessor expects to receive is $17,975. The net investment in the lease is therefore $35,519.

<table>
<thead>
<tr>
<th>Year</th>
<th>Payment</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>$ 9,500</td>
<td>$ 9,006</td>
</tr>
<tr>
<td>6</td>
<td>9,500</td>
<td>8,538</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$ 17,544</td>
</tr>
</tbody>
</table>

Amount lessor expects to derive from the underlying asset at the end of the lease term:

<table>
<thead>
<tr>
<th>Payment</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 20,000</td>
<td>$ 17,975</td>
</tr>
<tr>
<td></td>
<td>$ 35,519</td>
</tr>
</tbody>
</table>

The lessor would recognize, as selling profit, the difference between (1) the net investment in the lease, the deposit liability, and the cash received for the fourth payment and (2) the carrying value of the underlying asset. The selling profit is recognized as of the date collectibility becomes probable.

| Net investment in the lease | 35,519 |
| Deposit liability           | 28,500 |
| Cash                        | 9,500  |
| Carrying value of the underlying asset | 23,143 |
| Selling profit              | 50,376 |

As shown below, the lease receivable is subsequently measured as it was in Case A.

<table>
<thead>
<tr>
<th>Year</th>
<th>Payment</th>
<th>Beginning Net Investment in the Lease</th>
<th>Interest Income</th>
<th>Decrease in Net Investment in the Lease</th>
<th>Ending Net Investment in the Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>9,500</td>
<td>35,519</td>
<td>1,948</td>
<td>7,552</td>
<td>27,966</td>
</tr>
<tr>
<td>6</td>
<td>9,500</td>
<td>27,966</td>
<td>1,534</td>
<td>7,966</td>
<td>20,000</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.

**Step 6: Record the Return of the Underlying Asset to the Lessor**

The ending net investment in the lease represents the amount the lessor will receive from the lessee when the lessor regains control over the underlying asset. The entry to reflect the return of the underlying asset at the residual value expected at the end of the lease term is depicted below.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Net investment in the lease</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20,000</td>
</tr>
</tbody>
</table>
9.3.7.4 Collectibility Is Probable at Commencement — Subsequent Changes in Credit Risk

**ASC 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 credit loss guidance applicable to the net investment in the lease in paragraph 842-30-35-3.

Changes in the lessee's credit risk after lease commencement are accounted for in accordance with the impairment guidance discussed in Section 9.3.7.5 below.

9.3.7.5 Impairment

**ASC 842-30**

**25-2** After the commencement date, a lessor shall recognize all of the following: . . .

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

**35-3** A lessor shall determine the loss allowance related to the net investment in the lease and shall record any loss allowance 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 receive (or derive) from the lease receivable and the unguaranteed residual asset during and following the end of the remaining lease term.

The net investment in the lease must be monitored for impairment in accordance with ASC 310 (or ASC 326, when the lessor adopts ASU 2016-13).

**Changing Lanes — ASC 842 Introduces Single Asset Impairment Model**

Under ASC 840, a lessor is required to assess the net investment in the lease for impairments by assessing (1) the lease receivable in accordance with ASC 310 and (2) the unguaranteed residual asset in accordance with ASC 360. However, the FASB did not carry forward the dual model for assessing impairment of the net investment in the lease. In paragraphs BC310 and BC311 of ASU 2016-02, the FASB indicates that including two impairment models is overly complex and would result in financial statement information whose benefits would not justify its costs. Moreover, the Board notes that the net investment in a lease primarily comprises a financial lease receivable (i.e., the unguaranteed residual asset is often insignificant) and therefore should be accounted for as a financial asset under ASC 310.
Changing Lanes — Issuance of ASU 2016-13

In June 2016, the FASB issued ASU 2016-13, which will supersede ASC 310 and therefore will change how lessors measure impairment in the net investment in the lease. Under ASU 2016-13, lessors with net investments in leases will be required to recognize an allowance for credit losses. For PBEs that meet the definition of an SEC filer, the guidance in the ASU will be effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning after January 1, 2020), and interim periods therein. For all other entities, the guidance will be effective for annual periods beginning after December 15, 2022 (i.e., calendar periods beginning after January 1, 2023), and interim periods therein. Early adoption is permitted for all entities as of fiscal years beginning after December 15, 2018, and interim periods therein.

Q&A 9-14 Determining Impairment of the Net Investment in the Lease

Question

Should a lessor include the cash flows that the lessor would expect to derive from the underlying asset at the end of the lease term when evaluating impairment of the net investment in a lease?

Answer

Yes. The unit of account used when the impairment model is applied from the lessor’s perspective is meant to encompass amounts related to the entire net investment in the lease, which would include the residual asset. Therefore, when evaluating the net investment in a sales-type or direct financing lease for impairment, a lessor should apply the guidance in ASC 842-30-35-3, which indicates that a lessor should use the cash flows it expects to derive from the “lease receivable and the unguaranteed residual asset during and following the end of the remaining lease term.” Such cash flows would include those that the lessor expects to derive from the underlying asset at the end of the lease term. When determining the cash flows to be derived from the underlying asset at the end of the lease term, a lessor should consider amounts it would receive for re-leasing or selling the underlying asset to a third party but should not consider the expected credit risk of the potential lessee or buyer of the underlying asset (i.e., it would not be appropriate for the lessor to include a credit risk assumption in its analysis since it does not know the identity of the theoretical buyer).

Impairment of the net investment in the lease is recognized in accordance with ASC 310 (or ASC 326, if applicable). By this measure, any deterioration in the credit quality of the lessee must be reflected in the impairment recognized. Note that after lease commencement, changes in collectibility do not affect the classification of the lease. When measuring the impairment of the net investment in the lease, the lessor should consider the collateral (underlying asset) to be a cash flow that it would expect to derive from the underlying asset. This would include the cash flows that the lessor expects to derive from the underlying asset after the end of the lease term. In other words, amounts expected to be earned from re-leasing the asset would be considered. When using a discounted cash flow approach to measure impairment related to the net investment in leases, the lessor should employ the rate implicit in the lease.
9.3.7.6 Sale of Lease Receivable

ASC 842-30

35-4 If a lessor sells substantially all of 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.

If a lessor sells a lease receivable, an entity should consider the guidance in ASC 860 to determine whether the transfer of a financial asset (i.e., the lease receivable) has occurred and may be derecognized. However, such guidance does not address how the lessor should account for the sale of a sales-type lease receivable when it retains an interest in the unguaranteed residual asset. If the lessor retains an interest in the unguaranteed residual asset, this asset would no longer be accreted to its estimated value over the lease term. Instead, the lessor would keep the asset at its carrying value, less any necessary impairments determined in accordance with ASC 360.

ASC 842-40

Determining Whether the Transfer of the Asset Is a Sale

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.

To gain liquidity, a lessor may enter into a transaction to sell its interest in lease receivables. In addition to the receivable itself, the lessor may sell its interest in the unguaranteed residual asset; from an accounting perspective, the lessor would have already derecognized the underlying asset as part of its leasing transaction. ASC 842 does not indicate how to account for the sale of an unguaranteed residual asset in a sales-type lease. An entity should consider ASC 842-40-25-1 in evaluating whether the sale and derecognition of the unguaranteed residual value of the asset are appropriate. For more information, see Deloitte's Revenue Roadmap.

9.3.7.7 Lease Modification

9.3.7.7.1 Modified Lease Is a Sales-Type or Direct Financing Lease

ASC 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) . . . .

25-16 . . .

a. [T]he 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. . . .
Upon concluding that a lease modification has occurred and that the modification is not accounted for as a separate contract (see Section 9.3.4), the lessor should adjust the discount rate so that the present value of the lease payments equals the carrying value of the net investment in the lease as of the effective date. In performing this calculation, the lessor should remeasure the lease payments as necessary. For example, if the lease payments included an amount that was a variable payment based on an index or rate, the lessor would reset the amount that it previously used in its calculation. Effectively, no additional selling profit would be recognized as a result of the modification; however, the amount of interest income that is recognized prospectively could change (because of the change in the discount rate). Note that a negative discount rate cannot be used and that a lessor should consider whether its net investment in the lease is impaired.

**Connecting the Dots — Modification From Fixed Lease Payments to Variable Lease Payments**

Because variable payments that are not based on an index or rate are not included in the measurement of the net investment in the lease, an impairment of the net investment in the lease could occur if the lease payments are modified so that they become variable (from being previously fixed). This is irrespective of whether a lessor reasonably believes that it would collect the receivable through variable payments.

**9.3.7.7.2 Modified Lease Is an Operating Lease**

As noted in ASC 842-10-25-16, if a sales-type lease is modified in such a way that the 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.” The subsequent measurement of the underlying asset should be accounted for in accordance with ASC 360, and the balance should be classified in the appropriate category of assets.
9.3.7.8 Lease Termination

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.

If a sales-type lease is terminated before the end of the lease term, the net investment in the lease must be tested for impairment and reclassified in the manner described above. The underlying asset must then be subsequently measured in accordance with ASC 360.

9.3.7.9 End of Lease Term

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 commencement, the net investment in the lease is recognized, including the expected residual value of the asset (on either a guaranteed or an unguaranteed basis), at the net investment's then present value. At the end of the lease, the net investment in the lease should have been accreted to its estimated fair value as determined at lease commencement (i.e., no gains will be recognized as a result of the increase in the asset's fair value); when this balance is removed, the asset recorded should reflect the balance of the net investment in the lease at the end of the lease.
Q&A 9-15  Definition of the “Carrying Amount”

Question
In the determination of the value at which a lessor should record a previously leased asset upon the completion or termination of a sales-type lease, does the “carrying amount” of the asset represent the lessor’s net investment in the lease at the time of the termination or the depreciated cost of the asset that would have been recorded on the lessee’s books?

Answer
The “carrying amount” of the asset is the carrying value of the lessor’s net investment in the lease at the time of termination, including impairments, even though that amount may exceed the depreciated cost of the asset that would have been recorded by the lessee.

9.3.8  Direct Financing Lease
In a direct financing lease, the lessee does not individually obtain control of the asset but the lessor does relinquish control. This would occur, for example, if (1) the present value of the lease payments and any residual value guarantee (which could be provided entirely by a third party or consist of a lessee guarantee coupled with a third-party guarantee) represents substantially all of the fair value of the underlying asset and (2) it is probable that the lessor will collect the lease payments and any amounts related to the residual value guarantee(s). In a direct financing lease (in a manner consistent with a sales-type lease), the lessor derecognizes the underlying asset and recognizes a net investment in the lease (which consists of the lease receivable and unguaranteed residual asset). However, unlike the lessor in a sales-type lease, the lessor in a direct financing lease defers profit and amortizes it as interest income over the lease term. As a result, in a direct financing lease, there is no gain recognition in the income statement upon lease commencement.

9.3.8.1  Recognition, Initial Measurement, and Subsequent Measurement

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>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:</td>
</tr>
<tr>
<td>a. A net investment in the lease, measured in accordance with paragraph 842-30-30-2</td>
</tr>
<tr>
<td>b. Selling loss arising from the lease, if applicable.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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).</td>
</tr>
</tbody>
</table>

As noted in Section 9.2.2.1.2, for the classification criteria to be met for a direct financing lease, collection of the lease payments and any residual value guarantee must be probable. In a sales-type lease, however, collectibility is considered when the sale is evaluated for recognition, not during classification.

In a direct financing lease, the underlying asset is derecognized, and the net investment in the lease is recognized, as of the commencement date. If the net investment in the lease is less than the carrying value of the underlying asset, a selling loss should be immediately recognized. If the net investment
in the lease is greater than the carrying value, the difference (i.e., the selling profit) should be offset against the net investment in the lease and there would therefore be no recognition in profit and loss. In paragraph BC97 of ASU 2016-02, the FASB addresses why it would be inconsistent with the principle of direct financing leases (i.e., financings) to recognize selling profit at commencement:

If a direct financing lease gives rise to selling profit (which the Board understands to be infrequent), a lessor does not recognize the selling profit at lease commencement, reducing the lessor’s net investment in the lease. A lessor then recognizes the profit over the lease term in such a manner so as to produce, when combined with the interest income on the remainder of the net investment (that is, the lease receivable and the unguaranteed residual asset), a constant periodic rate of return on the lease. A direct financing lessor recognizes selling profit in this manner over the lease term because that accounting reflects that the lessor generally prices the lease to achieve a reasonable return on its investment in the underlying asset and would not position itself to incur a loss on disposition of the residual asset after the end of the lease.

ASC 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.

30-1 At the commencement date . . . 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.

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.
See Chapter 6 for more information on amounts included in and excluded from lease payments.

In a direct financing lease, any initial direct costs are included in the net investment in the lease (and therefore are deferred). Note that there is no need to add these amounts separately, since they are included in the rate implicit in the lease. In other words, when calculating the implicit rate in the lease, the lessor includes the outflow of initial direct costs in the initial cash outflow. Therefore, when the lessor recognizes the interest income over the term of the lease, the rate incorporates the recognition of initial direct costs.

**ASC 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 . . . .

In a direct financing lease, interest income is earned over the lease term and is recognized during all reporting periods, regardless of whether the payment is received at such times. Any profit (an excess of the net investment in the lease over the carrying value of the underlying asset) is recognized through interest income, since the lessor is not “selling” the asset (according to the classification tests) but is providing financing to the lessee for its lease investment.

**ASC 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.

The commencement-date measurement considerations in ASC 842-30-35-1 that apply to sales-type leases also apply to direct financing leases. See Section 9.3.7.1 for more information.

The scenario below, reprinted from Example 1 in ASC 842-30-55, illustrates the accounting for a direct financing lease.

**ASC 842-30**

Case C — Lessor Accounting — Direct Financing Lease

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.
55-32 None of the criteria in paragraph 842-10-25-2 to be classified as a sales-type lease are met. In accordance with paragraph 842-10-25-4, the discount rate used to determine the present value of the lease payments (5.4839 percent) for purposes of assessing whether the lease is a sales-type lease under the criterion in paragraph 842-10-25-2(d) assumes that no initial direct costs will be capitalized because the fair value of the equipment is different from its carrying amount.

55-32A Rather, 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, and it is probable that Lessor will collect the lease payments plus any amount necessary to satisfy the third-party residual value guarantee. The discount rate used to determine the present value of the lease payments and the present value of the third-party residual value guarantee for purposes of assessing whether the lease meets the criterion in paragraph 842-10-25-3(b)(1) to be classified as a direct financing lease is the rate implicit in the lease of 4.646 percent, which includes the initial direct costs of $2,000 that Lessor incurred.

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.

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).

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.

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]).

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.
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]).

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.

Below is a summary of the steps the lessor in the above scenario would perform as well as the journal entries it would record.

**Step 1: Gather the Facts**

- Lease term: 6 years.
- Lease payments: $9,500/year beginning at the end of year 1.
- Residual value guarantee provided by a third party: $13,000.
- Collection of the lease payments and residual value guarantee as of commencement is probable.
- Economic life of equipment: 9 years.
- Carrying amount: $54,000.
- Fair value: $62,000.
- Expected residual value at end of term: $20,000.
- No transfer of ownership and no purchase options.
- Lessor incurred $2,000 in initial direct costs.
Step 2: Solve for the Rate Implicit in the Lease

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>(62,000)</td>
<td>Fair value of underlying asset</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>9,500</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>9,500</td>
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<tr>
<td>5</td>
<td>9,500</td>
<td>Lease payment</td>
</tr>
<tr>
<td>6</td>
<td>29,500</td>
<td>Lease payment + unguaranteed residual value and guaranteed residual value</td>
</tr>
<tr>
<td>5.4839%</td>
<td>Implicit rate in the lease</td>
<td></td>
</tr>
</tbody>
</table>

The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate in such a way that the sum equals the fair value of the asset. Because the lessor must first assess sales-type lease classification and the fair value of the underlying asset differs from its carrying amount, the lessor initially does not include the initial direct costs in its calculation of the rate implicit in the lease.

Step 3: Determine the Lease Classification

The lessor would apply the criteria in ASC 842-10-25-2 to determine whether the lease should be classified as a sales-type lease:

| ASC 842-10-25-2(a) — Does the lease transfer ownership of the equipment to the lessee by the end of the lease term? | No. |
| ASC 842-10-25-2(b) — Does the lease contain a purchase option that the lessee is reasonably certain to exercise? | No. |
| ASC 842-10-25-2(c) — Does the lease term represent a major part of the remaining economic life of the underlying asset? | No. The remaining economic life of the equipment is nine years, and the lease term is six years. Management concludes that this does not constitute a major part of the economic life of the asset. |
| ASC 842-10-25-2(d) — Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset? | No. The present value of the lease payments is $47,482. As it is required to do in performing the sales-type lease classification test, a lessor must include the present value of the entire residual value guarantee provided by the lessee. Because no residual value guarantees were provided by the lessee, the total present value is $47,482. Management concludes that the lease payments do not constitute substantially all of the fair value of the asset ($62,000). |
| ASC 842-10-25-2(e) — Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease? | No, the underlying asset is not specialized. |
Because none of the above criteria are met, the lease is not a sales-type lease. The lessor would then use the criteria in ASC 842-10-25-3 to determine whether the lease is a direct financing lease:

**ASC 842-10-25-3(b)(1) — Does the present value of the sum of the lease payments and a residual value guaranteed by a third party equal or exceed substantially all of the fair value of the underlying asset?**

Yes. The present value of the sum of the lease payments is $48,770, and the lessee has not provided any residual value guarantees that are not already reflected in the lease payments. The residual value guarantee provided by the **third party** is $13,000, and its present value is $9,899. The sum of $48,770 and $9,899 is $58,669.

Management concludes that the lease payments and the residual value guarantee provided by the third party constitute substantially all of the fair value of the asset ($62,000).

Note that the discount rate used to determine the present value of the lease payments and the residual values is 4.646 percent because, when determining whether the lease is a direct financing lease, the lessor includes initial direct costs in its determination of the rate implicit in the lease.

**ASC 842-10-25-3(b)(2) — Is it probable that the lessor will collect the lease payments plus amounts necessary to satisfy a residual value guarantee?**

Yes.

Because both of these criteria are met, the lease is a direct financing lease.

**Step 4: Record the Commencement-Date Journal Entries**

At lease commencement, the lessor must derecognize the asset and record the net investment in the lease. The discount rate to be applied should cause the unguaranteed residual asset and lease payments (which include the guaranteed residual asset) to equal the fair value of the asset plus any initial direct costs. In calculating the net investment in the lease, the lessor determines that the present value of the lease payments not yet received is $48,770. The present value of the unguaranteed and guaranteed residual assets the lessor expects to receive is $15,230. The fair value of the underlying asset ($62,000) is $8,000 greater than the carrying value ($54,000); therefore, the net investment in the lease should be reduced by $8,000, since no selling profit is immediately recognizable for a direct financing lease. The basis in the net investment in the lease includes the initial direct costs paid. In other words, in the calculation of the implicit rate in the lease, the outflow payment includes the $2,000 in initial direct costs.
Chapter 9 — Lessor Accounting

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Payment</th>
<th>Present Value*</th>
</tr>
</thead>
<tbody>
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<td>$9,078</td>
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<tr>
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<tr>
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<td>9,500</td>
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<tr>
<td></td>
<td>48,770</td>
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<td>6</td>
<td>Guaranteed residual value 13,000</td>
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<tr>
<td>6</td>
<td>Unguaranteed residual value 7,000</td>
<td>5,331</td>
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<td>$64,000</td>
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</tr>
<tr>
<td>Fair value of underlying asset</td>
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</tr>
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<td>Initial direct costs</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$64,000</td>
<td></td>
</tr>
</tbody>
</table>

* Calculated by using discount rate of 4.646 percent.

Using the amounts calculated above, the lessor would record the following journal entry at lease commencement:

Net investment in the lease — receivable (lease payments) 48,770
Net investment in the lease — receivable (guaranteed residual asset) 9,899
Net investment in the lease — unguaranteed residual asset 5,331
Carrying value of the underlying asset 54,000
Net investment in the lease — deferred selling profit 8,000
Cash — Initial direct costs 2,000

Step 5: Record the Activities Related to the Direct Financing Lease

In year 1, the lessee must pay the lessor $9,500. The payment is related to the accretion on the residual asset, the recognition of a portion of the deferred profit, interest income, and a payment toward the receivable balance. The interest is the net investment in the lease multiplied by the rate, 8.258 percent, that would have caused the sum of the lease receivable and the unguaranteed residual asset to equal $56,000.

Cash 9,500

Interest income 2,266
Interest income — guaranteed residual asset 460
Interest Income — unguaranteed residual asset 248
Interest Income — deferred profit 1,651
Net investment in the lease 4,875
The cash payments should be recorded as follows through year 6:

<table>
<thead>
<tr>
<th>Year</th>
<th>Payment</th>
<th>NIL – Receivable</th>
<th>NIL Guaranteed Residual Asset</th>
<th>NIL Unguaranteed Residual Asset</th>
<th>Deferred Profit</th>
<th>Total Net Investment in Lease</th>
<th>Interest Income – NIL Receivable</th>
<th>Interest Income – NIL GRA</th>
<th>Interest Income – URA</th>
<th>Deferred Profit – NIL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>9,500</td>
<td>48,770</td>
<td>9,899</td>
<td>5,331</td>
<td>(8,000)</td>
<td>56,000</td>
<td>2,266</td>
<td>460</td>
<td>248</td>
<td>(1,651)</td>
</tr>
<tr>
<td>2</td>
<td>9,500</td>
<td>41,536</td>
<td>10,359</td>
<td>5,578</td>
<td>(6,349)</td>
<td>51,124</td>
<td>1,930</td>
<td>481</td>
<td>259</td>
<td>(1,552)</td>
</tr>
<tr>
<td>3</td>
<td>9,500</td>
<td>33,966</td>
<td>10,840</td>
<td>5,837</td>
<td>(4,797)</td>
<td>45,846</td>
<td>1,578</td>
<td>504</td>
<td>271</td>
<td>(1,433)</td>
</tr>
<tr>
<td>4</td>
<td>9,500</td>
<td>26,044</td>
<td>11,344</td>
<td>6,109</td>
<td>(3,364)</td>
<td>40,132</td>
<td>1,210</td>
<td>527</td>
<td>284</td>
<td>(1,293)</td>
</tr>
<tr>
<td>5</td>
<td>9,500</td>
<td>17,754</td>
<td>11,871</td>
<td>6,392</td>
<td>(2,071)</td>
<td>33,946</td>
<td>825</td>
<td>552</td>
<td>297</td>
<td>(1,130)</td>
</tr>
<tr>
<td>6</td>
<td>9,500</td>
<td>9,078</td>
<td>12,422</td>
<td>6,689</td>
<td>(941)</td>
<td>27,249</td>
<td>422</td>
<td>577</td>
<td>311</td>
<td>(941)</td>
</tr>
<tr>
<td></td>
<td>0</td>
<td>13,000</td>
<td>7,000</td>
<td>0</td>
<td>20,000</td>
<td>0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In the table above, NIL is net investment in the lease, GRA is guaranteed residual asset, and URA is unguaranteed residual asset. Note that certain amounts in the table are subject to rounding differences.

**Step 6: Record the Return of the Underlying Asset to the Lessor**

The ending net investment in the lease represents the expected value of the underlying asset when it is returned by the lessee. The entry to reflect the return of the underlying asset is depicted below.

```
Asset
Net investment in the lease 20,000
```

**9.3.8.2 Impairment**

When it is not probable that the lease payments will be collected at commencement, it is not possible to classify a lease as a direct financing lease and, provided that the lease is not a sales-type lease, it will be considered an operating lease (see Section 9.2.2.1). In other words, the underlying asset would not be derecognized and would be subject to an impairment analysis under ASC 360.

Other impairment considerations related to direct financing leases are similar to those for sales-type leases. See Section 9.3.7.5 for more information.

**9.3.8.3 Sale of Lease Receivable**

The guidance on sales of lease receivables for direct financing leases is the same as that for sales-type leases. See Section 9.3.7.6 for further details.
9.3.8.4 Lease Modification

The following example from the implementation guidance in ASC 842-10-55-201 through 55-203 illustrates the modification of a direct financing lease and applies to Cases A–C, which are discussed in the sections below:

**ASC 842-10**

Example 22 — Modification of a Direct Financing Lease

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.

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.

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).

9.3.8.4.1 Modified Lease Is a Sales-Type Lease

**ASC 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: . . .

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. . . .

Upon concluding that a lease modification has occurred and that the modification is not accounted for as a separate contract (see Section 9.3.4), the lessor should apply the guidance applicable to a sales-type lease if the terms and conditions and facts and circumstances present as of the modification effective date indicate the lease is a sales-type lease. The commencement date of the sales-type lease is the effective date of the modification. The selling profit recognized is the difference between the fair value as of the modification date and the carrying value of the net investment in the original lease immediately before the effective date of the modification.
The following scenario, reprinted from Example 22 in ASC 842-10-55, illustrates the modification from a direct financing lease to a sales-type lease:

**ASC 842-10**

**Case B — Direct Financing Lease to Sales-Type Lease**

**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.

**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.

Below is a summary of the steps the lessor in the above scenario would perform as well as the journal entries it would record. To account for the original lease before modification, see steps 1–5. To account for the lease after modification, see steps 6–9.

**Step 1: Gather the Facts**

- Lease term: 6 years.
- Lease payments: $11,000/year beginning at the end of year 1.
- Residual value guarantee provided by third party: $15,000.
- Collection of the lease payments and residual value guarantee as of commencement is probable.
- Remaining economic life of equipment: 9 years.
- Carrying amount: $65,240.
- Fair value: $65,240.
- Expected residual value at end of term: $21,000.
- No transfer of ownership and no purchase options; the economic-life criterion is not met.
- Lessor incurred no initial direct costs.
Step 2: Solve for the Rate Implicit in the Lease

The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate in such a way that the sum equals the fair value of the asset.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(65,240)</td>
<td>Fair value of underlying asset</td>
</tr>
<tr>
<td>1</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>3</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>4</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>5</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>6</td>
<td>32,000</td>
<td>Lease payment + unguaranteed and guaranteed residual value</td>
</tr>
<tr>
<td></td>
<td>7.50%</td>
<td>Implicit rate in the lease</td>
</tr>
</tbody>
</table>

Step 3: Determine the Lease Classification

The lessor would apply the criteria in ASC 842-10-25-2 to determine whether the lease should be classified as a sales-type lease:

<table>
<thead>
<tr>
<th>ASC 842-10-25-2(a)</th>
<th>Does the lease transfer ownership of the equipment to the lessee by the end of the lease term?</th>
<th>No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 842-10-25-2(b)</td>
<td>Does the lease contain a purchase option that the lessee is reasonably certain to exercise?</td>
<td>No.</td>
</tr>
<tr>
<td>ASC 842-10-25-2(c)</td>
<td>Does the lease term represent a major part of the remaining economic life of the underlying asset?</td>
<td>No. Management concludes that the lease term does not constitute a major part of the economic life of the asset.</td>
</tr>
<tr>
<td>ASC 842-10-25-2(d)</td>
<td>Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset?</td>
<td>No. The present value of the lease payments is $51,632. As it is required to do in performing the sales-type lease classification test, a lessor must only include the present value of the entire residual value guarantee provided by the lessee. The lessee does not provide any residual value guarantees. Management concludes that the lease payments do not constitute substantially all of the fair value of the asset ($65,240).</td>
</tr>
<tr>
<td>ASC 842-10-25-2(e)</td>
<td>Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease?</td>
<td>No, the underlying asset is not specialized.</td>
</tr>
</tbody>
</table>
Because none of the above criteria are met, the lease is not a sales-type lease. The lessor would then apply the criteria in ASC 842-10-25-3 to determine whether the lease is a direct financing lease:

<table>
<thead>
<tr>
<th>ASC 842-10-25-3(b)(1) — Does the present value of the sum of the lease payments and a residual value guaranteed by a third party equal or exceed substantially all of the fair value of the underlying asset?</th>
<th>Yes. The present value of the sum of the lease payments is $51,632; the lessee has not provided any residual value guarantees that are not already reflected in the lease payments. The residual value guarantee provided by the third party is $15,000, and its present value is $9,719. The sum of $51,632 and $9,719 is $61,351. Management concludes that the lease payments and the residual value guarantee provided by the third party constitute substantially all of the fair value of the asset ($65,240).</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 842-10-25-3(b)(2) — Is it probable that the lessor will collect the lease payments plus amounts necessary to satisfy a residual value guarantee?</td>
<td>Yes.</td>
</tr>
</tbody>
</table>

Because both of these criteria are met, the lease is a direct financing lease.

**Step 4: Record the Commencement-Date Journal Entries**

At lease commencement, the lessor must derecognize the asset and record the net investment in the lease. The discount rate to be applied should cause the unguaranteed residual asset and lease payments (which include the guaranteed residual asset) to equal the fair value of the asset plus any initial direct costs. In calculating the net investment in the lease, the lessor identifies the present value of the lease payments not yet received as $51,632. The present value of the unguaranteed and guaranteed residual assets the lessor expects to receive is $13,608. The fair value of the underlying asset ($65,240) is equal to the carrying value ($65,240); therefore, the net investment in the lease does not need to be reduced by any amount since there is no implied selling profit to be deferred. The basis in the net investment in the lease should include the initial direct costs paid, but no amounts were paid in this example.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Payment</th>
<th>Present Value*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$11,000</td>
<td>$10,233</td>
</tr>
<tr>
<td>2</td>
<td>11,000</td>
<td>9,519</td>
</tr>
<tr>
<td>3</td>
<td>11,000</td>
<td>8,855</td>
</tr>
<tr>
<td>4</td>
<td>11,000</td>
<td>8,237</td>
</tr>
<tr>
<td>5</td>
<td>11,000</td>
<td>7,662</td>
</tr>
<tr>
<td>6</td>
<td>11,000</td>
<td>7,126</td>
</tr>
<tr>
<td></td>
<td></td>
<td>51,632</td>
</tr>
<tr>
<td>6</td>
<td>Unguaranteed residual value</td>
<td>6,000</td>
</tr>
<tr>
<td>6</td>
<td>Guaranteed residual value</td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td>Fair value of underlying asset</td>
<td></td>
</tr>
</tbody>
</table>

*Calculated by using discount rate of 7.50 percent.*
Using the amounts calculated above, the lessor would record the following journal entry at lease commencement:

- Net investment in the lease — receivable (lease payments): 51,632
- Net investment in the lease — unguaranteed residual asset: 3,889
- Net investment in the lease — receivable (guaranteed residual asset): 9,719
- Carrying value of the underlying asset: 65,240

**Step 5: Record the Pre-Modification Activities Related to the Direct Financing Lease**

In year 1, the lessee must pay the lessor $11,000. The payment is related to the accretion on the residual asset, interest income, and a payment toward the receivable balance. The interest is the net investment in the lease multiplied by the rate (7.5 percent) that would cause the sum of the lease receivable and the unguaranteed residual asset to equal $65,240. The following journal entry would be recorded:

- Cash: 11,000
- Interest income: 3,872
- Interest income — guaranteed residual asset: 729
- Interest income — unguaranteed residual asset: 292
- Net investment in the lease: 6,107

This results in a $59,133 balance in the net investment in the lease at the end of year 1.

**Step 6: Gather the Facts Related to the Modification**

- Lease term is extended for 2 years (total remaining lease term after modification is 7 years).
- Lease payments are the same, $11,000/year.
- Estimated residual value is $6,500, no guarantees provided.
- Remaining economic life of the equipment is 8 years.
- Fair value of the equipment is $62,000.
Step 7: Solve for the Rate Implicit in the Lease

The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate so that the sum equals the fair value of the asset.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(62,000)</td>
<td>Fair value of underlying asset</td>
</tr>
<tr>
<td>1</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>3</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>4</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>5</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>6</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>7</td>
<td>17,500</td>
<td>Lease payment + unguaranteed residual value</td>
</tr>
<tr>
<td></td>
<td>7.58%</td>
<td>Implicit rate in the lease</td>
</tr>
</tbody>
</table>

Step 8: Determine the Lease Classification

The lessor reevaluates the lease in accordance with the criteria in ASC 842-10-25-2:

<table>
<thead>
<tr>
<th>ASC 842-10-25-2(a)</th>
<th>No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the lease transfer ownership of the equipment to the lessee by the end of the lease term?</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 842-10-25-2(b)</th>
<th>No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the lease contain a purchase option that the lessee is reasonably certain to exercise?</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 842-10-25-2(c)</th>
<th>Yes. Management concludes that the lease term constitutes a major part of the economic life of the asset.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the lease term represent a major part of the remaining economic life of the underlying asset?</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 842-10-25-2(d)</th>
<th>Not assessed because the criterion in ASC 842-10-25-2(c) is already met.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset?</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 842-10-25-2(e)</th>
<th>No, the underlying asset is not specialized.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease?</td>
<td></td>
</tr>
</tbody>
</table>

Because the criterion in ASC 842-10-25-2(c) is now met, the lease is a sales-type lease.
Step 9: Record Journal Entries Related to the Modification

As of the effective date of the modification, the lessor must derecognize the existing net investment in the lease of $59,133. The selling profit will be recognized immediately and represents the difference between the fair value of the underlying asset and the carrying value of the net investment in the lease immediately before the modification. The following journal entry would be recorded:

\[
\begin{align*}
\text{Net investment in the lease} & \quad 62,000 \\
\text{Net investment in the lease} & \quad 59,133 \\
\text{Selling profit} & \quad 2,867
\end{align*}
\]

9.3.8.4.2 Modified Lease Is a Direct Financing Lease

**ASC 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. . . .

The following scenario, reprinted from Example 22 in ASC 842-10-55 (see the facts that apply to this scenario in Section 9.3.8.4), illustrates the modification of a direct financing lease to another direct financing lease:

**ASC 842-10**

Case A — Direct Financing Lease to Direct Financing Lease

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.

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.
Below is a summary of the steps the lessor in the above scenario would perform as well as the journal entries it would record. To account for the original lease before modification, see steps 1–5. To account for the lease after modification, see steps 6–9.

**Step 1: Gather the Facts**

- Lease term: 6 years.
- Lease payments: $11,000/year beginning at the end of year 1.
- Residual value guarantee provided by third party: $15,000.
- Collection of the lease payments and residual value guarantee as of commencement is probable.
- Carrying amount: $65,240.
- Remaining economic life of equipment: 9 years.
- Fair value: $65,240.
- Expected residual value at end of term: $21,000.
- No transfer of ownership and no purchase options; the economic-life criterion is not met.
- Lessor incurred no initial direct costs.

**Step 2: Solve for the Rate Implicit in the Lease**

The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate so that the sum equals the fair value of the asset.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>(65,240)</td>
<td>Fair value of the underlying asset</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>11,000</td>
<td>Lease payment</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>11,000</td>
<td>Lease payment</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>11,000</td>
<td>Lease payment</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>11,000</td>
<td>Lease payment</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>11,000</td>
<td>Lease payment</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>32,000</td>
<td>Lease payment + unguaranteed and guaranteed residual value</td>
<td></td>
</tr>
<tr>
<td></td>
<td>7.50%</td>
<td>Implicit rate in the lease</td>
<td></td>
</tr>
</tbody>
</table>
Step 3: Determine the Lease Classification

The lessor would apply the criteria in ASC 842-10-25-2 to determine whether the lease should be classified as a sales-type lease:

| ASC 842-10-25-2(a) — Does the lease transfer ownership of the equipment to the lessee by the end of the lease term? | No. |
| ASC 842-10-25-2(b) — Does the lease contain a purchase option that the lessee is reasonably certain to exercise? | No. |
| ASC 842-10-25-2(c) — Does the lease term represent a major part of the remaining economic life of the underlying asset? | No. Management concludes that the lease term does not constitute a major part of the economic life of the asset. |
| ASC 842-10-25-2(d) — Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset? | No. The present value of the lease payments is $51,632. As it is required to do in performing the sales-type lease classification test, a lessor must only include the present value of the entire residual value guarantee provided by the lessee. The lessee does not provide any residual value guarantees. Management concludes that the lease payments do not constitute substantially all of the fair value of the asset ($65,240). |
| ASC 842-10-25-2(e) — Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease? | No, the underlying asset is not specialized. |

Because none of the above criteria are met, the lease is not a sales-type lease. The lessor would then apply the criteria in ASC 842-10-25-3 to determine whether the lease is a direct financing lease:

| ASC 842-10-25-3(b)(1) — Does the present value of the sum of the lease payments and a residual value guaranteed by a third party equal or exceed substantially all of the fair value of the underlying asset? | Yes. The present value of the sum of the lease payments is $51,632 (as shown above), and the lessee does not provide any residual value guarantees that are not already reflected in the lease payments. The residual value guarantee provided by the third party is $15,000, and its present value is $9,719. The sum of $51,632 and $9,719 is $61,351. Management concludes that the lease payments and the residual value guarantee provided by the third party constitute substantially all of the fair value of the asset ($65,240). |
| ASC 842-10-25-3(b)(2) — Is it probable that the lessor will collect the lease payments plus amounts necessary to satisfy a residual value guarantee? | Yes. |

Because both of these criteria are met, the lease is a direct financing lease.
Step 4: Record the Commencement-Date Journal Entries

At lease commencement, the lessor must derecognize the asset and record the net investment in the lease. The discount rate to be applied should cause the unguaranteed residual asset and lease payments (which include the guaranteed residual asset) to equal the fair value of the asset plus any initial direct costs. To calculate the net investment in the lease, the lessor identifies the present value of the lease payments not yet received as $51,632. The present value of the unguaranteed and guaranteed residual assets the lessor expects to receive is $13,608. The fair value of the underlying asset ($65,240) is equal to the carrying value ($65,240) and the net investment in the lease therefore does not need to be reduced by any amount since there is no implied selling profit to be deferred. The basis in the net investment in the lease should include the initial direct costs paid, but no amounts were paid in this example.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Payment</th>
<th>Present Value*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$11,000</td>
<td>$10,233</td>
</tr>
<tr>
<td>2</td>
<td>11,000</td>
<td>9,519</td>
</tr>
<tr>
<td>3</td>
<td>11,000</td>
<td>8,855</td>
</tr>
<tr>
<td>4</td>
<td>11,000</td>
<td>8,237</td>
</tr>
<tr>
<td>5</td>
<td>11,000</td>
<td>7,662</td>
</tr>
<tr>
<td>6</td>
<td>11,000</td>
<td>7,126</td>
</tr>
<tr>
<td></td>
<td></td>
<td>51,632</td>
</tr>
<tr>
<td>6</td>
<td>Unguaranteed residual value</td>
<td>6,000</td>
</tr>
<tr>
<td>6</td>
<td>Guaranteed residual value</td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$65,240</td>
</tr>
</tbody>
</table>

Fair value of underlying asset $65,240

* Calculated by using discount rate of 7.50 percent.

Using the amounts calculated above, the lessor would record the following journal entry at lease commencement:

Net investment in the lease — receivable (lease payments) 51,632
Net investment in the lease — unguaranteed residual asset 3,889
Net investment in the lease — receivable (guaranteed residual asset) 9,719
Carrying value of the underlying asset 65,240
Chapter 9 — Lessor Accounting

Step 5: Record the Pre-Modification Activities Related to the Direct Financing Lease

In year 1, the lessee must pay the lessor $11,000. The payment is related to the accretion on the residual asset, interest income, and a payment toward the receivable balance. The interest is the net investment in the lease multiplied by the rate (7.5 percent) that would have caused the sum of the lease receivable and the unguaranteed residual asset to equal $65,240. The following journal entry would be recorded:

<table>
<thead>
<tr>
<th>Cash</th>
<th>11,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income</td>
<td>3,872</td>
</tr>
<tr>
<td>Interest income — guaranteed residual asset</td>
<td>729</td>
</tr>
<tr>
<td>Interest income — unguaranteed residual asset</td>
<td>292</td>
</tr>
<tr>
<td>Net investment in the lease</td>
<td>6,107</td>
</tr>
</tbody>
</table>

This results in a balance in the net investment in the lease of $59,133 at the end of year 1.

Step 6: Gather the Facts Related to the Modification

- Lease term is reduced by 1 year.
- Remaining lease payments are reduced to $10,000/year.
- Estimated residual value is $33,000, of which $30,000 is guaranteed by an unrelated third party.
- Fair value of the equipment is $56,000.
- Remaining economic life of the equipment is 8 years.

Step 7: Solve for the Rate Implicit in the Lease

The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate in such a way that the sum equals the fair value of the asset.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>10,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>3</td>
<td>10,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>4</td>
<td>43,000</td>
<td>Lease payment + unguaranteed and guaranteed residual value</td>
</tr>
<tr>
<td></td>
<td>8.857%</td>
<td>Implicit rate in the lease</td>
</tr>
</tbody>
</table>
Step 8: Determine the Lease Classification

The lessor reevaluates the lease in accordance with the criteria in ASC 842-10-25-2:

<table>
<thead>
<tr>
<th>ASC 842-10-25-2(a) — Does the lease transfer ownership of the equipment to the lessee by the end of the lease term?</th>
<th>No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 842-10-25-2(b) — Does the lease contain a purchase option that the lessee is reasonably certain to exercise?</td>
<td>No.</td>
</tr>
<tr>
<td>ASC 842-10-25-2(c) — Does the lease term represent a major part of the remaining economic life of the underlying asset?</td>
<td>No. Management concludes that the lease term does not constitute a major part of the economic life of the asset.</td>
</tr>
<tr>
<td>ASC 842-10-25-2(d) — Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset?</td>
<td>No. The present value of the lease payments is $32,499. As it is required to do in performing the sales-type lease classification test, a lessor must only include the present value of the entire residual value guarantee provided by the lessee. The lessee does not provide any residual value guarantees. Management concludes that the lease payments do not constitute substantially all of the fair value of the asset ($56,000).</td>
</tr>
<tr>
<td>ASC 842-10-25-2(e) — Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease?</td>
<td>No, the underlying asset is not specialized.</td>
</tr>
</tbody>
</table>

Because none of the above criteria are met, the lease is not a sales-type lease. The lessor then applies the criteria in ASC 842-10-25-3 to determine whether the lease is a direct financing lease:

| ASC 842-10-25-3(b)(1) — Does the present value of the sum of the lease payments and any residual value guaranteed by a third party equal or exceed substantially all of the fair value of the underlying asset? | Yes. The present value of the sum of the lease payments is $32,499, and the lessee has not provided any residual value guarantees that are not already reflected in the lease payments. The residual value guarantee provided by the third party is $30,000, and its present value is $21,365. The sum of $32,499 and $21,365 is $53,864. Management concludes that the lease payments and the residual value guarantee provided by the third party constitute substantially all of the fair value of the asset ($56,000). |
| ASC 842-10-25-3(b)(2) — Is it probable that the lessor will collect the lease payments plus amounts necessary to satisfy a residual value guarantee? | Yes. |

Because both of these criteria are met, the lease is a direct financing lease.
Step 9: Record Journal Entries Related to the Modification

As of the effective date of the modification, the lessor should 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. Therefore, the lessor will carry forward the balance of the net investment in the lease immediately before the modification, which is $59,133. The discount rate will change from 8.857 percent to 6.95 percent. The 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 term, in a net investment balance of $33,000 that is equal to the estimated residual value of the underlying asset. No journal entries are necessary as of the modification date.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>(59,133)</td>
<td>Net investment in the lease</td>
</tr>
<tr>
<td>1</td>
<td>10,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>10,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>3</td>
<td>10,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>4</td>
<td>43,000</td>
<td>Lease payment + unguaranteed and guaranteed residual value</td>
</tr>
<tr>
<td></td>
<td>6.95%</td>
<td>Implicit rate in the lease</td>
</tr>
</tbody>
</table>

The direct financing lease would be subsequently measured in accordance with the guidance described in Section 9.3.8.

9.3.8.4.3 Modified Lease Is an Operating Lease

**ASC 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: . . .

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.

Upon concluding that a lease modification has occurred and the modification is not accounted for as a separate contract, the lessor should apply the guidance applicable to operating leases if the terms and conditions and facts and circumstances present as of the modification effective date indicate that the lease is an operating lease.
The following scenario, reprinted from Example 22 in ASC 842-10-55 (see the facts that apply to this scenario in Section 9.3.8.4), illustrates the modification of a direct financing lease to an operating lease:

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Case C — Direct Financing Lease to Operating Lease</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

Below is a summary of the steps the lessor in the above scenario would perform as well as the journal entries it would record. To account for the original lease before modification, see steps 1–5. To account for the lease after modification, see steps 6–9.

**Step 1: Gather the Facts**

- Lease term: 6 years.
- Lease payments: $11,000/year beginning at the end of year 1.
- Residual value guarantee provided by third party: $15,000.
- Collection of the lease payments and residual value guarantee as of commencement is probable.
- Carrying amount: $65,240.
- Remaining economic life of equipment: 9 years.
- Fair value: $65,240.
- Expected residual value at end of term: $21,000.
- No transfer of ownership and no purchase options; the economic-life criterion is not met.
- Lessor incurred no initial direct costs.
Step 2: Solve for the Rate Implicit in the Lease

The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate so that the sum equals the fair value of the asset.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>(65,240)</td>
<td>Fair value of underlying asset</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>3</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>4</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>5</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>6</td>
<td>32,000</td>
<td>Lease payment + unguaranteed and guaranteed residual value</td>
</tr>
<tr>
<td>7.50%</td>
<td>Implicit rate in the lease</td>
<td></td>
</tr>
</tbody>
</table>

Step 3: Determine the Lease Classification

The lessor would apply the criteria in ASC 842-10-25-2 to determine whether the lease should be classified as a sales-type lease:

| ASC 842-10-25-2(a) — Does the lease transfer ownership of the equipment to the lessee by the end of the lease term? | No. |
| ASC 842-10-25-2(b) — Does the lease contain a purchase option that the lessee is reasonably certain to exercise? | No. |
| ASC 842-10-25-2(c) — Does the lease term represent a major part of the remaining economic life of the underlying asset? | No. Management concludes that the lease term does not constitute a major part of the economic life of the asset. |
| ASC 842-10-25-2(d) — Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset? | No. The present value of the lease payments is $51,632. As it is required to do in performing the sales-type lease classification test, a lessor must only include the present value of the entire residual value guarantee provided by the lessee. The lessee does not provide any residual value guarantees. Management concludes that the lease payments do not constitute substantially all of the fair value of the asset ($65,240). |
| ASC 842-10-25-2(e) — Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease? | No, the underlying asset is not specialized. |
Because none of the above criteria are met, the lease is not a sales-type lease. The lessor would then apply the criteria in ASC 842-10-25-3 to determine whether the lease is a direct financing lease:

ASC 842-10-25-3(b)(1) — Does the present value of the sum of the lease payments and a residual value guaranteed by a third party equal or exceed substantially all of the fair value of the underlying asset?

Yes. The present value of the sum of the lease payments is $51,632, and the lessee does not provide any residual value guarantees that are not already reflected in the lease payments. The residual value guarantee provided by the third party is $15,000, and its present value is $9,719. The sum of $51,632 and $9,719 is $61,351.

Management concludes that the lease payments and the residual value guarantee provided by the third party constitute substantially all of the fair value of the asset ($65,240).

ASC 842-10-25-3(b)(2) — Is it probable that the lessor will collect the lease payments plus amounts necessary to satisfy a residual value guarantee?

Yes.

Because both of these criteria are met, the lease is a direct financing lease.

Step 4: Record the Commencement-Date Journal Entries

At lease commencement, the lessor must derecognize the asset and record the net investment in the lease. The discount rate to be applied should cause the unguaranteed residual asset and lease payments (which include the guaranteed residual asset) to equal the fair value of the asset plus any initial direct costs. To calculate the net investment in the lease, the lessor identifies the present value of the lease payments not yet received as $51,632. The present value of the unguaranteed and guaranteed residual asset the lessor expects to receive is $13,608. The fair value of the underlying asset ($65,240) is equal to the carrying value ($65,240), and the net investment in the lease therefore does not need to be reduced by any amount since there is no implied selling profit to be deferred. The basis in the net investment in the lease should include the initial direct costs paid, but no amounts were paid in this example.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Payment</th>
<th>Present Value*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$11,000</td>
<td>$10,233</td>
</tr>
<tr>
<td>2</td>
<td>11,000</td>
<td>9,519</td>
</tr>
<tr>
<td>3</td>
<td>11,000</td>
<td>8,855</td>
</tr>
<tr>
<td>4</td>
<td>11,000</td>
<td>8,237</td>
</tr>
<tr>
<td>5</td>
<td>11,000</td>
<td>7,662</td>
</tr>
<tr>
<td>6</td>
<td>11,000</td>
<td>7,126</td>
</tr>
<tr>
<td></td>
<td></td>
<td>51,632</td>
</tr>
<tr>
<td>6</td>
<td>Unguaranteed residual value</td>
<td>6,000</td>
</tr>
<tr>
<td>6</td>
<td>Guaranteed residual value</td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$65,240</td>
</tr>
</tbody>
</table>

Fair value of underlying asset $65,240

* Calculated by using discount rate of 7.50 percent.
Using the amounts calculated above, the lessor would record the following journal entry at lease commencement:

```
Net investment in the lease — receivable (lease payments)            51,632
Net investment in the lease — unguaranteed residual asset         3,889
Net investment in the lease — receivable (guaranteed residual asset) 9,719
CARRYING VALUE OF THE UNDERLYING ASSET                        65,240
```

**Step 5: Record the Pre-Modification Activities Related to the Direct Financing Lease**

In year 1, the lessee must pay the lessor $11,000. The payment is related to the accretion on the residual asset, interest income, and a payment toward the receivable balance. The interest is the net investment in the lease multiplied by the rate (7.5 percent) that would have caused the sum of the lease receivable and the unguaranteed residual asset to equal $65,240. The following journal entry would be recorded:

```
CASH                                                      11,000
Interest income                                           3,872
Interest income — guaranteed residual asset               729
Interest income — unguaranteed residual asset             292
Net investment in the lease                               6,107
```

This results in a balance in the net investment in the lease of $59,133 at the end of year 1.

**Step 6: Gather the Facts Related to the Modification**

At the end of year 1:

- The lease term is reduced by 2 years.
- Lease payments are reduced to $9,000/year for the remaining 3 years.
- The estimated residual value is $33,000, of which $13,000 is guaranteed by an unrelated third party.
- The fair value of the equipment is $56,000.
Step 7: Solve for the Rate Implicit in the Lease

The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate in such a way that the sum equals the fair value of the asset.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>9,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>9,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>3</td>
<td>42,000</td>
<td>Lease payment + unguaranteed and guaranteed residual value</td>
</tr>
<tr>
<td></td>
<td>2.75%</td>
<td>Implicit rate in the lease</td>
</tr>
</tbody>
</table>

Fair value of underlying asset

Step 8: Determine the Lease Classification

The lessor reevaluates the lease in accordance with the criteria in ASC 842-10-25-2:

| ASC 842-10-25-2(a) — Does the lease transfer ownership of the equipment to the lessee by the end of the lease term? | No.                                                                 |
| ASC 842-10-25-2(b) — Does the lease contain a purchase option that the lessee is reasonably certain to exercise? | No.                                                                 |
| ASC 842-10-25-2(c) — Does the lease term represent a major part of the remaining economic life of the underlying asset? | No. Management concludes that the lease term does not constitute a major part of the economic life of the asset. |
| ASC 842-10-25-2(d) — Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset? | No. The present value of the lease payments is $25,580. As it is required to do in performing the sales-type lease classification test, a lessor must only include the present value of the entire residual value guarantee provided by the lessee. The lessee does not provide any residual value guarantees. Management concludes that the lease payments do not constitute substantially all of the fair value of the asset ($56,000). |
| ASC 842-10-25-2(e) — Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease? | No, the underlying asset is not specialized. |
Because none of the above criteria are met, the lease is not a sales-type lease. The lessor then applies the criteria in ASC 842-10-25-3 to determine whether the lease is a direct financing lease:

<table>
<thead>
<tr>
<th>ASC 842-10-25-3(b)(1) — Does the present value of the sum of the lease payments and a residual value guaranteed by a third party equal or exceed substantially all of the fair value of the underlying asset?</th>
<th>No. The present value of the sum of the lease payments is $25,580, and the lessee does not provide any residual value guarantees that are not already reflected in the lease payments. The residual value guarantee provided by the third party is $13,000, and its present value is $11,984. The sum of $25,580 and $11,984 is $37,564. Management concludes that the lease payments and the residual value guarantee provided by the third party do not constitute substantially all of the fair value of the asset ($56,000).</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 842-10-25-3(b)(2) — Is it probable that the lessor will collect the lease payments plus amounts necessary to satisfy a residual value guarantee?</td>
<td>Yes.</td>
</tr>
</tbody>
</table>

Because the lease does not meet both of these criteria, the lease is not a direct financing lease but is an operating lease.

**Step 9: Record Journal Entries Related to the Modification**

As of the effective date of the modification, the lessor should derecognize the net investment in the lease and recognize the carrying value of the equipment at the basis in the net investment in the lease. The following journal entry would be recorded:

```
   Equipment       59,133
   Net investment in the lease 59,133
```

The operating lease would be subsequently accounted for in accordance with the guidance in Section 9.3.9.1; similarly, the asset would be subject to depreciation and impairment under ASC 360.

### 9.3.8.5 Lease Termination

**ASC 842-30**

**40-2** If 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.

**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.

**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.
If a direct financing lease is terminated before the end of the lease term, the net investment in the lease must be tested for impairment in the manner described above and any impairment loss must be recognized. The underlying asset must then be appropriately reclassified and subsequently accounted for in accordance with ASC 360.

**9.3.8.6 End of Lease Term**

The guidance on the end of the lease term is the same for direct financing leases as it is for sales-type leases. See Section 9.3.7.9 for more information.

**9.3.9 Operating Lease**

With operating leases, the underlying asset remains on the lessor’s balance sheet and is depreciated consistently with other owned assets. Income from an operating lease is recognized on a straight-line basis unless another systematic and rational basis is more appropriate. Any initial direct costs (i.e., those that are incremental to the arrangement and that would not have been incurred if the lease had not been obtained) are deferred and expensed over the lease term in a manner consistent with the way lease income is recognized.

**9.3.9.1 Recognition, Initial Measurement, and Subsequent Measurement**

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-10</strong> At the commencement date, a lessor shall defer initial direct costs.</td>
</tr>
<tr>
<td><strong>25-11</strong> After the commencement date, a lessor shall recognize all of the following:</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>c. Initial direct costs as an expense over the lease term on the same basis as lease income (as described in (a)).</td>
</tr>
<tr>
<td><strong>55-17</strong> 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.</td>
</tr>
</tbody>
</table>

As noted above, for operating leases, lessors must recognize “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.”

**Connecting the Dots — Recognizing Rental Revenues on an Other Than Straight-Line Basis**

Upon the issuance of ASC 842, many believed that lessors should consider the recognition pattern for uneven rents in an operating lease and potentially recognize revenue on an other than straight-line basis if the uneven rents were designed to reflect market conditions. That view was based principally on the language in paragraph BC327 of ASU 2016-02, which states 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” (emphasis added). However, on the basis of discussions with the FASB staff, we understand that paragraph BC327 was not intended to require or permit a
lessor to deviate from straight-line recognition, even when uneven rents are designed to reflect market conditions. Accordingly, in a manner similar to their accounting under ASC 840, lessors will continue to recognize rental income from operating leases 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.

Q&A 9-16  Lessor Accounting for Scheduled Rent Increases — Example

Assume that Company A leases a building to Company B for a 10-year period under an operating lease. The first-year lease payment is $1 million, which increases by $100,000 per year for each subsequent year. Assume that all amounts are allocable to the lease component. Collection of the lease payments is probable.

**Question**

How much in lease revenue should A recognize each year?

**Answer**

Company A should recognize lease revenue of $1.45 million per year (total receipts of $14.5 million ÷ 10 years). In years 1–5, A should record the difference between the rental income and rent collected each year as an asset. In years 6–10, the rent payments collected in excess of the rental income recognized each year should be credited to the asset.

The journal entry to record the initial lease payment would be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Accrued rent receivable</td>
<td>450,000</td>
</tr>
<tr>
<td>Lease revenue</td>
<td>1,450,000</td>
</tr>
</tbody>
</table>

Q&A 9-17  Lessor’s Sale or Assignment of Operating Lease Payments Treated as a Borrowing

**Question**

Should the lessor’s sale or assignment of lease payments due under an operating lease be accounted for as a borrowing?

**Answer**

Yes. The lessor’s sale or assignment of lease payments due under an operating lease should be accounted for as a borrowing because a lessor’s economic interest in an operating lease is not a receivable but a right to future revenues under an executory contract. The presumption is that lessors have an obligation to provide services to earn the lease revenues, even when such an obligation involves minimal effort. Therefore, proceeds from such a sale or assignment should be accounted for as a borrowing.
### 9.3.9.2 Collectibility

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-12</strong> 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.</td>
</tr>
<tr>
<td><strong>25-13</strong> 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.</td>
</tr>
<tr>
<td><strong>25-14</strong> See Example 1 (paragraphs 842-30-55-18 through 55-43) for an illustration of the requirements when collectibility is not probable.</td>
</tr>
</tbody>
</table>

The following scenario, reprinted from Example 1, Case D, in ASC 842-30-55, illustrates the lessor’s accounting for an operating lease when collectibility is not probable.

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 1 — Lessor Accounting Example</strong></td>
</tr>
<tr>
<td><strong>Case D — Lessor Accounting — Collectibility Is Not Probable</strong></td>
</tr>
<tr>
<td><strong>55-40</strong> 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.</td>
</tr>
<tr>
<td><strong>55-41</strong> Lessor continues to measure the equipment in accordance with Topic 360 on property, plant, and equipment.</td>
</tr>
<tr>
<td><strong>55-42</strong> 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.</td>
</tr>
<tr>
<td><strong>55-43</strong> 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.</td>
</tr>
</tbody>
</table>
The lessor in the above scenario would perform the following steps and record the following journal entries:

**Step 1: Gather the Facts**
- Lease term: 6 years.
- Lease payments: $7,000 at end of year 1, escalating by $1,000 every year for the remainder of the term.
- Residual value guarantee provided by a third party: $13,000.
- Collection of the lease payments and residual value guarantee as of commencement is not probabil.
- Economic life of equipment: 9 years.
- Carrying amount: $54,000.
- Fair value: $62,000.
- Expected residual value at end of term: $20,000.
- No transfer of ownership and no purchase options.
- Lessor incurred $2,000 in initial direct costs.

**Step 2: Solve for the Rate Implicit in the Lease**
The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate in such a way that the sum equals the fair value of the asset.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>7,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>8,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>3</td>
<td>9,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>4</td>
<td>10,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>5</td>
<td>11,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>6</td>
<td>32,000</td>
<td>Lease payment + unguaranteed and guaranteed residual value</td>
</tr>
<tr>
<td></td>
<td>5.17%</td>
<td>Implicit rate in the lease</td>
</tr>
</tbody>
</table>
Step 3: Determine the Lease Classification

The lessor would apply the criteria in ASC 842-10-25-2 to determine whether the lease should be classified as a sales-type lease:

<table>
<thead>
<tr>
<th>ASC 842-10-25-2(a) — Does the lease transfer ownership of the equipment to the lessee by the end of the lease term?</th>
<th>No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 842-10-25-2(b) — Does the lease contain a purchase option that the lessee is reasonably certain to exercise?</td>
<td>No.</td>
</tr>
<tr>
<td>ASC 842-10-25-2(c) — Does the lease term represent a major part of the remaining economic life of the underlying asset?</td>
<td>No. The remaining economic life of the equipment is nine years and the lease term is six years. Management concludes that this does not constitute a major part of the economic life of the asset.</td>
</tr>
<tr>
<td>ASC 842-10-25-2(d) — Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset?</td>
<td>No. The present value of the lease payments is $47,219. As it is required to do in performing the sales-type lease classification test, the lessor must include the present value of the entire residual value guarantee provided by the lessee. Because the lessee did not provide any residual value guarantees, the total present value is $47,219. Management concludes that the lease payments do not constitute substantially all of the fair value of the asset ($62,000).</td>
</tr>
<tr>
<td>ASC 842-10-25-2(e) — Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease?</td>
<td>No, the underlying asset is not specialized.</td>
</tr>
</tbody>
</table>
Because none of the above criteria are met, the lease is not a sales-type lease. The lessor would then evaluate the criteria in ASC 842-10-25-3(b) to determine whether the lease is a direct financing lease:

ASC 842-10-25-3(b)(1) — Does the present value of the sum of the lease payments and a residual value guaranteed by a third party equal or exceed substantially all of the fair value of the underlying asset?

Yes. The present value of the sum of the lease payments is $48,538, and the lessee has not provided any residual value guarantees that are not already reflected in the lease payments. The residual value guarantee provided by the third party is $13,000 and its present value is $10,050. The sum of $48,538 and $10,050 is $58,588.

Management concludes that the lease payments and the residual value guarantee provided by a third party constitute substantially all of the fair value of the asset ($62,000).

Note that the discount rate used to determine the present value of the lease payments and the residual values is 4.383 percent because, when determining whether the lease is a direct financing lease, the lessor includes initial direct costs in its determination of the rate implicit in the lease.

ASC 842-10-25-3(b)(2) — Is it probable that the lessor will collect the lease payments plus amounts necessary to satisfy a residual value guarantee?

No.

Because collectibility is not probable, the lease is not a direct financing lease and is an operating lease.

Step 4: Commencement-Date Entries
Because no assets are derecognized, there are no entries on the commencement date.

Step 5: Year 1 Entry
Because collectibility is not probable, the lessor recognizes lease income only when the lessee makes the lease payment and in the amount of those lease payments.

Cash 7,000
Rental revenues 7,000

Step 6: Year 2 Entry
At the end of year 2, the 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, the lessor recognizes income of $12,000. The calculation is as follows:

- $57,000 in total lease payments ÷ 6 years = $9,500 per year; $9,500 × 2 = $19,000; recognized to date = $7,000.
- $19,000 – $7,000 = $12,000, recognized in year 2.

Importantly, the lessor is not required or permitted to reassess classification as a result of the change in the collectibility assessment (i.e., for a direct financing lease to exist, collectibility must be probable at commencement).
Step 7: Entries During the Remaining Lease Term

Because collectibility of the payments is probable throughout the remaining lease term, the lessor continues to recognize $9,500 each year.

The lessor in the above scenario would have recorded the following lease income (revenue) and straight-line operating lease receivable over the life of the lease:

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Payment</th>
<th>Lease Income</th>
<th>Receivable Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 7,000</td>
<td>$ 7,000</td>
<td>—*</td>
</tr>
<tr>
<td>2</td>
<td>8,000</td>
<td>12,000**</td>
<td>4,000</td>
</tr>
<tr>
<td>3</td>
<td>9,000</td>
<td>9,500</td>
<td>4,500</td>
</tr>
<tr>
<td>4</td>
<td>10,000</td>
<td>9,500</td>
<td>4,000</td>
</tr>
<tr>
<td>5</td>
<td>11,000</td>
<td>9,500</td>
<td>2,500</td>
</tr>
<tr>
<td>6</td>
<td>12,000</td>
<td>9,500</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$ 57,000</td>
<td>$ 57,000</td>
<td></td>
</tr>
</tbody>
</table>

* The receivable balance at the end of year 1 is zero because the lessor concluded that the collectibility of lease payments was not probable; therefore, the lessor recognized lease income equal only to cash received. If the lessor had concluded that collectibility was probable, it would have recognized $9,500 of lease income and a corresponding $2,500 receivable.

** 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.

On the basis of the above guidance, the operating lease collectibility model in ASC 842-30 indicates that a lessor must assess whether the collectibility of future operating lease payments is probable. This collection assessment is based on the individual lessee's credit risk as opposed to potential disputed charges. When collectibility of lease payments is probable, the lessor will apply an accrual model; for example, it will recognize a straight-line lease receivable to ensure ratable recognition of revenue over the lease term. When collectibility is not probable, the lessor will limit lease income to cash received, as described above in ASC 842-30-25-13.

Connecting the Dots — Collectibility Assessment of Disputed Charges

Questions have been raised regarding "disputed" charges and whether or in what circumstances disputed amounts should be assessed for whether it is probable that the lease payments will be collected. We believe that it would be appropriate for a lessor to evaluate the "enforceable" lease payments first before assessing collectibility; this evaluation should be performed in a manner consistent with ASC 606. That is, first, the lessor evaluates its invoiced amounts to determine whether certain payments may be subject to dispute with its customer (tenant). In circumstances in which it is known or expected that all, or some portion, of an invoiced amount will be subject to a future reduction in the amount expected to be collected for the right to use the lessor’s asset, the lessor should consider any adjustment for these items in a manner similar to the accounting for a price concession within the scope of the new revenue standard (see

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17 Throughout this Roadmap, references to the “collectibility of lease payments” also should be read to include the collectibility of any residual value guarantees in the contract.

18 We believe that the FASB supports this view in paragraph BC102 of ASU 2016-02.
Section 4.2.5 of Deloitte’s Revenue Roadmap for further discussion). Therefore, an evaluation of any future reduction in an invoiced amount should be considered before the assessment in ASC 842-30-25-12 regarding the probability of collection.

The lessor would generally not consider disputed amounts (e.g., a lessee that disputes a variable charge for CAM) in its collectibility assessment under ASC 842 since such disputes would not represent “enforceable” rights in the contract. In a manner consistent with ASC 606-10-25-1(e), the lessor would need to evaluate the disputes before it assesses collectibility. The lessor would then evaluate the customer’s intention and ability to pay promised consideration. As a result, in many cases, disputed amounts may not be recognized as a receivable (i.e., there is no enforceable right to cash); this means there is less revenue (lease income) because of the disputed amount.

Q&A 9-17A  Lessor’s Accounting for an Operating Lease When Collectibility Subsequently Becomes Not Probable

Question

Should a lessor apply the guidance in ASC 842-30-25-12 and 25-13, as illustrated in Example 1, Case D, above, if the lessor determines that collectibility is probable at lease commencement but subsequently is no longer probable (i.e., the assessment of probability changes from favorable to unfavorable)?

Answer

Yes. Although the illustrative example above demonstrates a lessor’s accounting for an operating lease when collectibility is not probable at lease commencement and subsequently becomes probable, the same principle should be followed in accounting for an operating lease for which the lessor determines that collectibility is probable at lease commencement but subsequently is no longer probable. This is supported by the guidance in ASC 842-30-25-13, which states, “[i]f the assessment of collectibility changes after the commencement date” (emphasis added). The lessor must apply this guidance regardless of the direction of its change in conclusion about collectibility (i.e., it goes from probable to not probable or not probable to probable).

To demonstrate this accounting, we have used the same facts and circumstances as in Example 1, Case D, except that collectibility of the lease payments is probable at lease commencement (assume that the lease is still classified as an operating lease). In year 1, the lessor will recognize straight-line lease income of $9,500 (i.e., $57,000 in total lease payments ÷ 6 years = $9,500 per year) and will record the cash lease payment of $7,000 with the remaining amount recorded as an operating lease receivable of $2,500 (i.e., $9,500 of lease income − $7,000 cash received).

The year 1 journal entry is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>7,000</td>
</tr>
<tr>
<td>Operating lease receivable</td>
<td>2,500</td>
</tr>
<tr>
<td>Lease income (revenue)</td>
<td>9,500</td>
</tr>
</tbody>
</table>

19 For simplicity, this example assumes that there are no residual value guarantees in the contract to consider for probability of collection.
If, at the end of year 2, the lessor concludes that collectibility of the remaining lease payments is not probable, the lessor recognizes lease income of $5,500 (i.e., the difference between the $8,000 of cash lease payments received in year 2 and the $2,500 straight-line receivable balance recorded at the end of year 1). As long as the lessor’s assessment of collectibility remains not probable for the entire lease term, the lessor should record lease income equal to only the amount of cash payments received on a cumulative basis from the lessee.

The lessor in this scenario would have recorded the following lease income and straight-line operating lease receivable over the life of the lease:

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Payment</th>
<th>Lease Income</th>
<th>Receivable Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$7,000</td>
<td>$9,500</td>
<td>$2,500</td>
</tr>
<tr>
<td>2</td>
<td>8,000</td>
<td>5,500*</td>
<td>—</td>
</tr>
<tr>
<td>3</td>
<td>9,000</td>
<td>9,000</td>
<td>—</td>
</tr>
<tr>
<td>4</td>
<td>10,000</td>
<td>10,000</td>
<td>—</td>
</tr>
<tr>
<td>5</td>
<td>11,000</td>
<td>11,000</td>
<td>—</td>
</tr>
<tr>
<td>6</td>
<td>12,000</td>
<td>12,000</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$57,000</td>
<td>$57,000</td>
<td>—</td>
</tr>
</tbody>
</table>

* The $5,500 recognized as lease income in year 2 is calculated as cumulative cash received as of the end of year 2 ($15,000 = $7,000 + $8,000) less income already recognized in year 1 ($9,500) = $5,500.

9.3.9.2.1 Assessing Impairment of Operating Lease Receivables

In June 2016, the FASB issued ASU 2016-13, which adds to U.S. GAAP an impairment model — known as the current expected credit loss (CECL) model — that is based on expected losses rather than incurred losses. Once effective, the new guidance will significantly change the accounting for credit impairment under ASC 326.20

In November 2018, the FASB issued ASU 2018-19 to clarify certain aspects of ASU 2016-13, including that operating lease receivables are not within the scope of ASC 326-20. Instead, an entity would need to apply other U.S. GAAP to account for changes in the collectibility assessment for operating leases.

Although ASU 2018-19 amended only ASC 326, which is not effective for calendar-year PBEs until January 1, 2020, we believe that the Board’s clarification that operating lease receivables are within the scope of other guidance, namely ASC 842, rather than ASC 326 may result in a change in how some lessors account for the collectibility of operating lease receivables upon the adoption of ASC 842. We understand that there is currently diversity in practice in how some lessors account for credit losses related to operating lease receivables under ASC 840. Specifically, under current practice, certain lessors account for the collectibility of operating lease receivables in a manner consistent with the way they account for the collectibility of trade receivables (i.e., recognize an allowance for uncollectible accounts and a corresponding bad-debt expense), whereas other lessors account for these credit losses as an adjustment to the related lease income. However, ASC 842 requires all lessors to apply the collectibility guidance discussed above (i.e., no receivable should be recorded when collection of the remaining lease payments is not probable).

20 ASC 326 represents a new Codification topic that includes both legacy impairment guidance moved from other Codification sections and new credit loss guidance introduced by ASU 2016-13. In addition, ASU 2016-13 amended some of the legacy guidance moved to ASC 326 from other Codification sections. See Deloitte’s June 17, 2016, Heads Up for more information about the new guidance in ASU 2016-13.
Chapter 9 — Lessor Accounting

Q&A 9-17B Recognition of a General Allowance for Operating Lease Receivables

Certain lessors recognize a general allowance for credit losses (on a collective or pooled basis) and corresponding bad-debt expense for billed and straight-line operating lease receivables on the basis of the guidance in ASC 450-20 when factors indicate that some or all of the balance is no longer collectible. This guidance was amended by the new CECL impairment model in ASC 326, and most financial assets subject to the guidance in ASC 450-20 will be subject to the guidance in ASC 326. In addition, as discussed above, ASC 842 requires lessors to evaluate the collectibility of individual operating leases in accordance with ASC 842-30.

Therefore, questions have arisen about whether an entity can continue to recognize a general allowance for credit losses (on a collective or pooled basis) and corresponding bad-debt expense for operating lease receivables on the basis of the guidance in ASC 450-20.

Question

Can a lessor continue to recognize a general allowance for operating lease receivables for which the lessor determined that collectibility is probable?

Answer

Two views have emerged regarding whether, after the adoption of ASC 326, a lessor can continue to recognize a general allowance for operating lease receivables for which collectibility is probable. After the adoption of ASC 842, a lessor must apply the guidance in ASC 842-30, as discussed above, for any receivable when collectibility is not probable. That is, any valuation reserve accounting method may be used only after an assessment of whether the collection of future lease payments is deemed probable. Only if the collection of the lease payments over the lease term is deemed probable would the incremental approaches described below be appropriate. If collectibility is not deemed probable, the guidance in ASC 842-30 should be applied and no lease income should be recognized before cash collection.

On the basis of a technical inquiry with the FASB staff, we believe that either of the approaches described below is acceptable as an accounting policy choice. A lessor should apply its accounting policy consistently and disclose its election.

- **View 1: Record an allowance for operating lease receivables** — In the Background Information and Basis for Conclusions of ASU 2018-19, the FASB explains that ASC 326-20 was not intended to change historical lessor accounting for operating leases:

  BC13. The Board noted that the guidance in Topic 842 provides an operational model for determining the collectibility of lease payments that is well understood by lessors. **The Board did not intend to change lessor accounting for operating leases when it issued Update 2016-13.** Therefore, the amendments in this Update clarify that receivables resulting from operating leases accounted for by lessors under Topic 842 are not within the scope of Subtopic 326-20. [Emphasis added]

Therefore, although the amendments in ASU 2018-09 clarify that operating lease receivables are outside the scope of ASC 326-20, it continues to be acceptable for a lessor to apply other U.S. GAAP to ensure that receivables for operating leases for which collectibility of lease payments is probable are not overstated when the lessor does not expect to collect 100 percent of its outstanding receivables.
Under this view, in a manner consistent with the current practice described above, a
lessor would recognize an allowance for credit losses for operating lease receivables in
accordance with ASC 450-20. This would generally be calculated on the total portfolio
of operating lease receivables for which collectibility is probable. The example below
demonstrates the recording of an allowance for operating lease receivables.

**Example**

Lessor X enters into three leases that are each classified as operating leases for which
collectibility of future lease payments\(^{21}\) at commencement is probable. For each lease, the
term is six years, 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. Lessor X will
record the lease payments on a straight-line basis to lease income over the life of the lease
and establish a corresponding straight-line operating lease receivable.

Further, X continues to consider whether the operating lease receivables, at a portfolio
level, are appropriately valued by using principles that are consistent with those applied
under ASC 450-20 (because ASC 326 does not apply) to ensure that its receivables and
its income are not overstated. Lessor X has established a policy (on the basis of historical
evidence and expectations of future collections) that creates an allowance for 10 percent
of all operating lease receivables at the end of each reporting period, recorded as a contra
asset. The offset of the 10 percent allowance is recorded to the income statement. (See
**Q&A 9-17C** for a discussion regarding presentation in the income statement.)

Lessor X would have recorded the following lease income, straight-line operating lease
receivable, allowance for the operating lease receivable, and corresponding income
statement impact\(^{22}\) over the life of the lease (only the first three years of X’s entries are
shown):

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease A Payment</th>
<th>Lease B Payment</th>
<th>Lease C Payment</th>
<th>Total Payment</th>
<th>Lease Income</th>
<th>Receivable Balance</th>
<th>Receivable Allowance</th>
<th>Income Statement*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$7,000</td>
<td>$7,000</td>
<td>$7,000</td>
<td>$21,000</td>
<td>$28,500**</td>
<td>$7,500</td>
<td>$(750)</td>
<td>$750</td>
</tr>
<tr>
<td>2</td>
<td>8,000</td>
<td>8,000</td>
<td>8,000</td>
<td>24,000</td>
<td>28,500</td>
<td>12,000</td>
<td>(1,200)</td>
<td>450</td>
</tr>
<tr>
<td>3</td>
<td>9,000</td>
<td>9,000</td>
<td>9,000</td>
<td>27,000</td>
<td>28,500</td>
<td>13,500</td>
<td>(1,350)</td>
<td>150</td>
</tr>
</tbody>
</table>

* See footnote 18.

** Lease income is calculated as the total lease income ($171,000, or $57,000 for each lease) divided by six years.

- **View 2: No allowance for operating lease receivables** — As stated above, ASU 2018-19 in
  other places suggests that ASC 842 may be the sole guidance to apply when an entity is
  considering the impairment of operating lease receivables after the adoption of ASC 326.
  Under this view, the Codification will no longer provide a basis for evaluating operating
  lease receivables under ASC 450-20.

Therefore, on the basis of this interpretation of the amendments in ASU 2018-19, a
lessor may elect not to record any allowance for operating lease receivables for which
collection is deemed probable. Operating lease receivables should be adjusted, and
will be taken against lease income, only when a lessor specifically identifies a lease for
which collectibility becomes not probable. The lessor will apply the guidance in ASC
842-30-25-12 through 25-14 above to account for changes in collectibility assessments.
Under this view, there is no incremental or supplemental general allowance, and no
corresponding income statement impact (as illustrated in View 1) would be recorded.

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\(^{21}\) See footnote 19.

\(^{22}\) See **Q&A 9-17C** for a discussion of the income statement classification.
Q&A 9-17C  Income Statement Classification of General Allowance for Operating Lease Receivables

**Question**

If an entity establishes an accounting policy of recording a general allowance for operating lease receivables (i.e., as in View 1 in Q&A 9-17B), should the allowance be recorded through reductions to lease income (revenue) or through bad-debt expense?

**Answer**

An entity that records a general allowance for operating lease receivables can record the offset to either lease income or bad-debt expense.

- **Reduction of lease income** — This approach is based on the model established in ASC 842-30 and discussed above. Although the reduction-of-lease-income model in ASC 842-30 is specific to leases for which collectibility is not probable, an entity can apply this same approach and establish an allowance against lease income for expected, but not yet specifically identified, credit issues in the portfolio of leases.

- **Bad-debt expense** — As outlined in View 1 in Q&A 9-17B, in many respects the FASB did not intend to change lessor accounting for operating leases when it issued ASC 326. Under legacy U.S. GAAP, general allowances for operating lease receivables were usually established through bad-debt expense. Therefore, it would be appropriate for an entity to continue using the same approach after the adoption of ASC 842 to be consistent with the FASB's statement that entities should continue current practice when recording the general allowance.

**Connecting the Dots — Disclosure**

On the basis of our discussions with the FASB staff, we understand that the SEC staff is aware of the potential diversity that will exist in practice in this area and has noted that entities should ensure that they apply a consistent policy and provide transparent disclosures regarding this policy. Disclosure of such an accounting policy is consistent with the guidance in ASC 842-30-50-1, which states, “[t]he 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” (emphasis added).

**Connecting the Dots — Complexities With General Allowances**

Although a lessor can establish an accounting policy of recording an allowance for operating lease receivables for leases for which collectibility is probable (i.e., as in View 1 in Q&A 9-17B), the lessor should understand that maintaining a general allowance in addition to specifically identifying and accounting for leases for which collectibility is not probable may involve more effort than would applying a policy to adjust operating lease receivables only when collectibility is not probable (i.e., as in View 2 in Q&A 9-17B).

However, if the lessor applies only the ASC 842 collectibility guidance (i.e., as in View 2 in Q&A 9-17B) or establishes a general allowance through a reduction of lease income as described in Q&A 9-17C, it will create inconsistency with the accounting for revenue receivables that are within the scope of ASC 606 and therefore within the scope of ASC 326. Given this inconsistent treatment, if a lessor's leases include nonlease components that are not combined with the lease component under the lessor practical expedient, the lessor will need to apply two separate subsequent-measurement accounting models for contract receivables that contain lease and nonlease (revenue) components.
Additional questions have arisen regarding how an entity that has established an accounting policy of recording an allowance for operating lease receivables through bad-debt expense should account for changes in a collectibility assessment. Specifically, questions have been asked about what accounting is required when a receivable whose collectibility was originally deemed probable and was therefore included in the general allowance subsequently has a collectibility that is not probable (i.e., accounting for the write-off of the operating lease receivable).

We believe that multiple approaches may be acceptable. When determining the appropriate accounting for changes in collectibility, lessors should consider their policies for establishing the general allowance of operating leases for which collectibility is probable and whether, for such an allowance, they contemplated the future write-off of an operating lease receivable within the portfolio of leases. We encourage lessors to consult with their auditors and accounting advisers on this topic.

**Connecting the Dots — Looking Ahead**

We expect the FASB staff to discuss these collectibility questions at the upcoming Board meeting on July 17, 2019, but it is unclear whether the FASB will address the matter through standard setting. However, that is the only avenue by which operating lease receivables can be brought within the scope of ASC 326, and it remains to be seen whether the FASB will reverse its decision in ASU 2018-19. Our views regarding the inclusion of operating lease receivables within the scope of ASC 326 are expressed in our September 19, 2018, comment letter in response to the FASB’s ED on ASU 2018-19.

### 9.3.9.3 Accounting for the Underlying Asset

<table>
<thead>
<tr>
<th><strong>ASC 842-30</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-4</strong> A lessor shall continue to measure the underlying asset subject to an operating lease in accordance with other Topics.</td>
</tr>
<tr>
<td><strong>35-6</strong> 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.</td>
</tr>
</tbody>
</table>

Because the underlying asset is not derecognized in operating leases, it should be tested for impairment in accordance with ASC 360. The underlying asset should also be subsequently measured under ASC 360 (e.g., depreciation).

### 9.3.9.4 Lease Modification

#### 9.3.9.4.1 Modified Lease Is a Sales-Type Lease

<table>
<thead>
<tr>
<th><strong>ASC 842-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-15</strong> 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: . . .</td>
</tr>
</tbody>
</table>

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.
As indicated above, when “an operating lease is modified and the modification is not accounted for as a separate contract,” the lessor should apply the guidance applicable to sales-type leases if the terms and conditions and facts and circumstances present as of the modification effective date indicate that the lease is a sales-type lease. The commencement date of the sales-type lease is the effective date of the modification.

The following scenario, reprinted from Example 21, Case A, in ASC 842-10-55, illustrates the modification of an operating lease to a sales-type lease:

---

**Example 21 — Modification of an Operating Lease That Changes Lease Classification**

**Case A — Operating Lease to Sales-Type Lease**

**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.

**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.

**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.

**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.

---

Below is a summary of the steps the lessor in the above scenario would perform as well as the journal entries it would record. To account for the original lease before modification, see steps 1–5. To account for the lease after modification, see steps 6–9.
Step 1: Gather the Facts

- Lease term: 4 years.
- Lease payments: $81,000 in first year, increasing by 5 percent each year thereafter.
- Expected residual value of the equipment: $90,000.
- Collection of the lease payments and residual value guarantee as of commencement is probable.
- Remaining economic life of equipment is 7 years.
- Carrying amount: $425,000.
- Fair value: $425,000.
- No transfer of ownership and no purchase options; lease term not for major part of economic life.
- Lessor incurred no initial direct costs.

Step 2: Solve for the Rate Implicit in the Lease

The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate in such a way that the sum equals the fair value of the asset.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(425,000)</td>
<td>Fair value of underlying asset</td>
</tr>
<tr>
<td>1</td>
<td>81,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>85,050</td>
<td>Lease payment</td>
</tr>
<tr>
<td>3</td>
<td>89,303</td>
<td>Lease payment</td>
</tr>
<tr>
<td>4</td>
<td>183,768</td>
<td>Lease payment + unguaranteed and guaranteed residual value</td>
</tr>
<tr>
<td></td>
<td>1.15%</td>
<td>Implicit rate in the lease</td>
</tr>
</tbody>
</table>
**Step 3: Determine the Lease Classification**

The lessor would apply the criteria in ASC 842-10-25-2 to determine whether the lease is a sales-type lease:

<table>
<thead>
<tr>
<th>ASC 842-10-25-2(a) — Does the lease transfer ownership of the equipment to the lessee by the end of the lease term?</th>
<th>No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 842-10-25-2(b) — Does the lease contain a purchase option that the lessee is reasonably certain to exercise?</td>
<td>No.</td>
</tr>
<tr>
<td>ASC 842-10-25-2(c) — Does the lease term represent a major part of the remaining economic life of the underlying asset?</td>
<td>No. The remaining economic life of the equipment is seven years and the lease term is four years. Management concludes that this does not constitute a major part of the economic life of the asset.</td>
</tr>
<tr>
<td>ASC 842-10-25-2(d) — Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset?</td>
<td>No. The present value of the lease payments is $339,038. As it is required to do in performing the sales-type lease classification test, a lessor must include the present value of the entire residual value guarantee provided by the lessee. The lessee does not provide any residual value guarantees. Management concludes that the lease payments do not constitute substantially all of the fair value of the asset ($425,000).</td>
</tr>
<tr>
<td>ASC 842-10-25-2(e) — Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease?</td>
<td>No, the underlying asset is not specialized.</td>
</tr>
</tbody>
</table>

Because none of the above criteria are met, the lease is not a sales-type lease. The lessor would then apply the criteria in ASC 842-10-25-3(b) to determine whether the lease is a direct financing lease:

<table>
<thead>
<tr>
<th>ASC 842-10-25-3(b)(1) — Does the present value of the sum of the lease payments and a residual value guaranteed by a third party equal or exceed substantially all of the fair value of the underlying asset?</th>
<th>No. The present value of the sum of the lease payments is $339,038, and the lessee does not provide any residual value guarantees that are not already reflected in the lease payments. There are no residual value guarantees provided by third parties. Management concludes that the lease payments do not constitute substantially all of the fair value of the asset ($425,000).</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 842-10-25-3(b)(2) — Is it probable that the lessor will collect the lease payments plus amounts necessary to satisfy a residual value guarantee?</td>
<td>Yes.</td>
</tr>
</tbody>
</table>
Because these two criteria are not met, the lease is not a direct financing lease and is an operating lease.

**Step 4: Record the Commencement-Date Journal Entries**
Because no assets are derecognized, there are no entries on the commencement date.

**Step 5: Record Entries for Years 1 and 2**
Because collectibility is probable, the lessor recognizes lease payments on a straight-line basis. The sum of the lease payments (including the 5 percent adjustment) is $349,120. The amount divided by the term of the lease (4 years) is $87,280. The year 1 and year 2 entries are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>Accrued rent receivable</th>
<th>Lease revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>81,000</td>
<td>6,280</td>
<td>87,280</td>
</tr>
<tr>
<td>Year 2</td>
<td>85,050</td>
<td>2,230</td>
<td>87,280</td>
</tr>
</tbody>
</table>

**Step 6: Gather the Facts for the Modification as of the Beginning of Year 3**
- Lease term is extended by 2 years (and lease payments continue to increase by 5 percent each year).
- Fair value of equipment: $346,250.
- Remaining economic life: 5 years.
- Estimated residual value: $35,000.
- Accrued rent receivable balance: $8,510.
- Carrying value of asset is $303,571.

**Step 7: Solve for the Rate Implicit in the Lease**
The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate in such a way that the sum equals the fair value of the asset.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>(346,250)</td>
<td>Fair value of underlying asset</td>
</tr>
<tr>
<td>1</td>
<td>89,303</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>93,768</td>
<td>Lease payment</td>
</tr>
<tr>
<td>3</td>
<td>98,456</td>
<td>Lease payment</td>
</tr>
<tr>
<td>4</td>
<td>138,379</td>
<td>Lease payment + unguaranteed and guaranteed residual value</td>
</tr>
<tr>
<td>7.60%</td>
<td>Implicit rate in the lease</td>
<td></td>
</tr>
</tbody>
</table>
Step 8: Determine the Lease Classification

The lessor would reevaluate the lease to determine whether the criteria in ASC 842-10-25-2 are met:

<table>
<thead>
<tr>
<th>ASC 842-10-25-2(a) — Does the lease transfer ownership of the equipment to the lessee by the end of the lease term?</th>
<th>No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 842-10-25-2(b) — Does the lease contain a purchase option that the lessee is reasonably certain to exercise?</td>
<td>No.</td>
</tr>
<tr>
<td>ASC 842-10-25-2(c) — Does the lease term represent a major part of the remaining economic life of the underlying asset?</td>
<td>Yes. Management concludes that the lease term constitutes a major part of the economic life of the asset.</td>
</tr>
<tr>
<td>ASC 842-10-25-2(d) — Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset?</td>
<td>Yes. The present value of the lease payments is $320,139. As it is required to do in performing the sales-type lease classification test, the lessor must include the present value of the entire residual value guarantee provided by the lessee. The lessee does not provide any residual value guarantees. Management concludes that the lease payments constitute substantially all of the fair value of the asset ($346,250).</td>
</tr>
<tr>
<td>ASC 842-10-25-2(e) — Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease?</td>
<td>No, the underlying asset is not specialized.</td>
</tr>
</tbody>
</table>

Because the criterion in ASC 842-10-25-2(c) or ASC 842-10-25-2(d) is met, the lease is a sales-type lease.

Step 9: Record Journal Entries Related to the Modification

As of the effective date of the modification, the lessor must derecognize the existing net accrued rent receivable. The selling profit will be recognized immediately and represents the difference between the fair value of the underlying asset and the carrying value of the underlying asset immediately before the modification, reduced by the accrued rent receivable balance.

<table>
<thead>
<tr>
<th>Entry</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net investment in the lease — receivable</td>
<td>320,139</td>
</tr>
<tr>
<td>Net investment in the lease — unguaranteed residual asset</td>
<td>26,111</td>
</tr>
<tr>
<td>Carrying value of the asset</td>
<td>303,571</td>
</tr>
<tr>
<td>Selling profit</td>
<td>34,169</td>
</tr>
<tr>
<td>Accrued rent receivable</td>
<td>8,510</td>
</tr>
</tbody>
</table>

23 The calculation of this amount is subject to rounding differences.
9.3.9.4.2 Modified Lease Is a Direct Financing Lease

**ASC 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: . . .

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.

The scenario below, reprinted from Example 21, Case B, in ASC 842-10-55, illustrates the modification of an operating lease to a direct financing lease. Case B assumes the same facts and circumstances as described for Case A in ASC 842-10-55-194 (see Section 9.3.9.4.1).

**ASC 842-10**

*Example 21 — Modification of an Operating Lease That Changes Lease Classification*

**Case B — Operating Lease to Direct Financing Lease**

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.

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.

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.

Below is a summary of the steps the lessor in the above scenario would perform as well as the journal entries it would record. To account for the original lease before modification, see steps 1–5. To account for the lease after modification, see steps 6–9.
Step 1: Gather the Facts

- Lease term: 4 years.
- Lease payments: 81,000 in first year, increasing by 5 percent each year thereafter.
- Expected residual value of the equipment: $90,000.
- Collection of the lease payments and residual value guarantee as of commencement is probable.
- Remaining economic life of equipment: 7 years.
- Carrying amount: $425,000.
- Fair value: $425,000.
- No transfer of ownership and no purchase options, lease term not for major part of economic life.
- Lessor incurred no initial direct costs.

Step 2: Solve for the Rate Implicit in the Lease

The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate such that the sum equals the fair value of the asset.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>(425,000)</td>
<td>Fair value of underlying asset</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>81,000</td>
<td>Lease payment</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>85,050</td>
<td>Lease payment</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>89,303</td>
<td>Lease payment</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>183,768</td>
<td>Lease payment + unguaranteed and guaranteed residual value</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1.15%</td>
<td>Implicit rate in the lease</td>
<td></td>
</tr>
</tbody>
</table>
Step 3: Determine the Lease Classification

The lessor applies the criteria in ASC 842-10-25-2 to determine whether the lease is a sales-type lease:

| ASC 842-10-25-2(a) — Does the lease transfer ownership of the equipment to the lessee by the end of the lease term? | No. |
| ASC 842-10-25-2(b) — Does the lease contain a purchase option that the lessee is reasonably certain to exercise? | No. |
| ASC 842-10-25-2(c) — Does the lease term represent a major part of the remaining economic life of the underlying asset? | No. Management concludes that the lease term does not constitute a major part of the economic life of the asset. |
| ASC 842-10-25-2(d) — Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset? | No. The present value of the lease payments is $339,038. As it is required to do in performing the sales-type lease classification test, the lessor must include the present value of the entire residual value guarantee provided by the lessee. The lessee does not provide any residual value guarantees. Management concludes that the lease payments do not constitute substantially all of the fair value of the asset ($425,000). |
| ASC 842-10-25-2(e) — Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease? | No, the underlying asset is not specialized. |

Because none of the criteria above are met, the lease is not a sales-type lease. The lessor must then apply the criteria in ASC 842-10-25-3(b) to determine whether the lease is a direct financing lease:

| ASC 842-10-25-3(b)(1) — Does the present value of the sum of the lease payments and a residual value guaranteed by a third party equal or exceed substantially all of the fair value of the underlying asset? | No. The present value of the sum of the lease payments is $339,038, and the lessee does not provide any residual value guarantees that are not already reflected in the lease payments. There are no residual value guarantees provided by third parties. Management concludes that the lease payments do not constitute substantially all of the fair value of the asset ($425,000). |
| ASC 842-10-25-3(b)(2) — Is it probable that the lessor will collect the lease payments plus amounts necessary to satisfy a residual value guarantee? | Yes. |

Because these two criteria are not met, the lease is not a direct financing lease and is an operating lease.

Step 4: Record the Commencement-Date Journal Entries

Because no assets are derecognized, there are no entries on the commencement date.
Step 5: Entries for Years 1 and 2

Because collectibility is probable, the lessor recognizes lease payments on a straight-line basis. The sum of the lease payments (including the 5 percent adjustment) is $349,120. The amount divided by the term of the lease (4 years) is $87,280. The entries recorded for years 1 and 2 are as follows:

Cash 81,000
Accrued rent receivable 6,280
Lease revenue 87,280

Cash 85,050
Accrued rent receivable 2,230
Lease revenue 87,280

Step 6: Gather the Facts for the Modification as of the Beginning of Year 3

- Lease term is extended by 1 year.
- New lease payments: $108,000/year.
- Fair value of equipment: $346,250.
- Carrying amount: $303,571.
- Remaining economic life: 5 years.
- Residual value guarantee from third party: $40,000.
- Accrued rent receivable balance: $8,510.
- Estimated residual value: $80,000.

Step 7: Solve for the Rate Implicit in the Lease

The rate implicit in the lease is derived or calculated. The expected cash flows should be discounted by a rate so that the sum equals the fair value of the asset.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow/Values</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>(346,250)</td>
<td>Fair value of underlying asset</td>
</tr>
<tr>
<td>1</td>
<td>108,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>2</td>
<td>108,000</td>
<td>Lease payment</td>
</tr>
<tr>
<td>3</td>
<td>188,000</td>
<td>Lease payment + unguaranteed and guaranteed residual value</td>
</tr>
<tr>
<td></td>
<td>7.36%</td>
<td>Implicit rate in the lease</td>
</tr>
</tbody>
</table>
**Step 8: Determine the Lease Classification**

The lessor would reevaluate the lease to determine whether it is a sales-type lease:

| ASC 842-10-25-2(a) — Does the lease transfer ownership of the equipment to the lessee by the end of the lease term? | No. |
|———|———|
| ASC 842-10-25-2(b) — Does the lease contain a purchase option that the lessee is reasonably certain to exercise? | No. |
| ASC 842-10-25-2(c) — Does the lease term represent a major part of the remaining economic life of the underlying asset? | No. Management concludes that the lease term does not constitute a major part of the economic life of the asset. |
| ASC 842-10-25-2(d) — Does the present value of the sum of the lease payments and any residual value guaranteed by the lessee equal or exceed substantially all of the fair value of the underlying asset? | No. The present value of the lease payments is $281,593. As it is required to do in performing the sales-type lease classification test, the lessor must only include the present value of the entire residual value guarantee provided by the lessee. There are no residual value guarantees provided by the lessee. |
| ASC 842-10-25-2(e) — Is the underlying asset so specialized that it is expected to have no alternative use to the lessor at the end of the lease? | No, the underlying asset is not specialized. |

Because none of the above criteria are met, the lease is not a sales-type lease.

The lessor must then apply the criteria in ASC 842-10-25-3(b) to determine whether the lease is a direct financing lease:

| ASC 842-10-25-3(b)(1) — Does the present value of the sum of the lease payments and a residual value guaranteed by a third party equal or exceed substantially all of the fair value of the underlying asset? | Yes. The present value of the sum of the lease payments is $281,593, and the lessee has not provided any residual value guarantees that are not already reflected in the lease payments. The present value of the residual value guarantee provided by the third party ($40,000) is $32,328. The sum of the present values of the residual value guarantees and the lease payments is $313,922. Management concludes that the lease payments constitute substantially all of the fair value of the asset ($346,250). |
|———|———|
| ASC 842-10-25-3(b)(2) — Is it probable that the lessor will collect the lease payments plus amounts necessary to satisfy a residual value guarantee? | Yes. |

Because both criteria are met, the lease is a direct financing lease.

24 The calculation of this amount is subject to rounding differences.
Step 9: Record Journal Entries Related to the Modification

As of the effective date of the modification, the lessor must derecognize the existing net accrued rent receivable. The lessor must also derecognize the asset and record the net investment in the lease.

The discount rate to be applied should cause the unguaranteed residual asset, guaranteed residual asset, and lease payments to equal the fair value of the asset plus any initial direct costs. In calculating the net investment in the lease, the lessor identifies the present value of the lease payments not yet received as $281,593. The present value of the unguaranteed and guaranteed residual assets the lessor expects to receive is $64,657. The fair value of the underlying asset ($346,250) is $42,679 greater than the carrying value ($303,571); when adjusted for the accrued rent receivable balance ($8,510), the net investment in the lease should be reduced by $34,169 since no selling profit is immediately recognizable for a direct financing lease.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Payment</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 108,000</td>
<td>$ 100,600</td>
</tr>
<tr>
<td>2</td>
<td>108,000</td>
<td>93,707</td>
</tr>
<tr>
<td>3</td>
<td>108,000</td>
<td>87,286</td>
</tr>
<tr>
<td></td>
<td></td>
<td>281,593</td>
</tr>
<tr>
<td>3</td>
<td>Unguaranteed residual value</td>
<td>40,000</td>
</tr>
<tr>
<td>3</td>
<td>Guaranteed residual value</td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$ 346,250</td>
</tr>
</tbody>
</table>

Fair value of the underlying asset $346,250

Note that certain amounts in the table are subject to rounding differences.

Net investment in the lease — receivable (lease payments) 281,593
Net investment in the lease — unguaranteed residual asset 32,328
Net investment in the lease — receivable (guaranteed residual asset) 32,329

Carrying value of the asset 303,571
Accrued rent receivable 8,510
Net investment in the lease — deferred selling profit 34,169

The direct financing lease is subsequently accounted for in accordance with the guidance described in Section 9.3.8.
9.3.9.4.3 Modified Lease Is an Operating Lease

**Example 20 — Modification of an Operating Lease That Does Not Change Lease Classification**

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.

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.

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]).

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.

**Q&A 9-18 Impact of Operating Lease Modifications on Deferred Lease Receivables**

ASC 842-10-25-15(a) states that if an operating lease is modified and the modified lease is 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.”

**Question**

When a lessor has recorded an accrued rent receivable for scheduled rent increases under an operating lease, the lessor subsequently modifies the terms of the lease, and the modification results in an operating lease classification, what is the appropriate accounting for any unamortized accrued rent receivable that exists at the time of modification?
**Answer**

When a lessor has recorded an accrued rent receivable for scheduled rent increases under an operating lease and subsequently renegotiates the terms of the lease, the lessor should continue to amortize the accrued rent receivable over the remaining lease term as a reduction of future rental income.

<table>
<thead>
<tr>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assume that Lessor A leases a building to Lessee B for a 10-year period under an operating lease. The first-year lease payment is $1 million and increases by $100,000 per year for each subsequent year. Assume that the payments are allocable only to a lease component. Because of the escalation in rent, A is recognizing rental income on a straight-line basis and is recording the difference between rental income and the rent collected in years 1–5 as an accrued rent receivable. At the end of year 5, A and B renegotiate the lease by fixing the rent amount at $1.7 million per year and extending the lease term by two years. The modification does not result in a change in lease classification. In this situation, A should continue to amortize the existing accrued rent receivable balance as a reduction of rental income on a straight-line basis over the remaining seven-year term of the new lease.</td>
</tr>
</tbody>
</table>

**9.3.9.5 Lease Termination**

If an operating lease is terminated, a lessor should write off any related balance sheet amounts (e.g., accrued rent receivable, initial direct costs) and evaluate whether the useful lives of certain lessor-owned tenant improvements should be shortened or whether the balances should be written off.

**9.3.10 Subleases**

See Chapter 12 for more information on subleases.

**9.4 Other Lessor Reporting Issues**

**9.4.1 Commitments to Guarantee Performance of Underlying Asset**

For more information about commitments to guarantee performance of underlying assets, see Deloitte’s Revenue Roadmap.
9.4.2 Sales of Equipment With Guaranteed Minimum Resale Amount

ASC 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.

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.

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.

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.

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.

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.

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.

55-8 The equipment should be included in the manufacturer’s balance sheet and depreciated following the manufacturer’s normal depreciation policy.

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.
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.

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.

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).

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.

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.)

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-lessee’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.

In certain arrangements, a supplier may provide a minimum resale value guarantee on equipment sold to a customer. The guarantee may be satisfied if the manufacturer either reacquires the equipment at a guaranteed price or pays the customer an amount representing the difference between the proceeds from selling the equipment and the amount of the guarantee. The supplier may need to consider the guidance in ASC 606 regarding whether the obligation to reacquire the equipment precludes sale accounting and whether, as a result of the guarantee, the arrangement would need to be accounted for as a lease.

For more information about whether a supplier may be required to account for the transaction as a lease because of a right or obligation (i.e., a call option or a forward) to reacquire an asset, see Section 2.3.1.1 or Deloitte’s Revenue Roadmap.
9.4.3 Accounting for Tenant Improvements and Lease Incentives

**ASC 842-10**

<table>
<thead>
<tr>
<th>55-30</th>
<th>Lease incentives include both of the following:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Payments made to or on behalf of the lessee</td>
</tr>
<tr>
<td>b.</td>
<td>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 for use of the assumed underlying asset.</td>
</tr>
</tbody>
</table>

ASC 842 largely does not change the accounting for tenant improvements and lease incentives. Lessor funding of lessee expenditures may be direct or indirect (e.g., cash paid directly to the lessee or cash paid to third parties on behalf of the lessee). The appropriate accounting for the tenant allowance must be determined on the basis of the substance of the arrangement. The determination of whether amounts payable under the lease are a lease incentive should be made on the basis of the contractual rights of the lessee and lessor.

Though superseded, the guidance in FASB Technical Bulletin 88-1 continues to be relevant to lessee/lessor incentives by analogy. Paragraph 7 of Technical Bulletin 88-1 states, in part:

> Payments made to or on behalf of the lessee represent incentives that should be considered reductions of rental expense by the lessee and reductions of rental revenue by the lessor over the term of the new lease. 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 both the lessor and the lessee. Incentives should be recognized on a straight-line basis over the term of the new lease.

Further, in a February 7, 2005, letter to the Center for Public Company Audit Firms, the SEC chief accountant discussed the accounting for lease incentives as follows:

> Landlord/Tenant Incentives — The staff believes that: (a) leasehold improvements made by a lessee that are funded by landlord incentives or allowances under an operating lease should be recorded by the lessee as leasehold improvement assets and amortized over a term consistent with the guidance in item 1 above; (b) the incentives should be recorded as deferred rent and amortized as reductions to lease expense over the lease term in accordance with paragraph 15 of SFAS 13 and the response to Question 2 of FASB Technical Bulletin 88-1 (“FTB 88-1”), Issues Relating to Accounting for Leases, and therefore, the staff believes it is inappropriate to net the deferred rent against the leasehold improvements; and (c) a registrant's statement of cash flows should reflect cash received from the lessor that is accounted for as a lease incentive within operating activities and the acquisition of leasehold improvements for cash within investing activities. The staff recognizes that evaluating when improvements should be recorded as assets of the lessor or assets of the lessee may require significant judgment and factors in making that evaluation are not the subject of this letter.

ASC 842-10-55-30(b) is clear on the accounting for payments made by a landlord to, or on behalf of, a tenant to fund items that would be an expense or obligation of the tenant, such as moving expenses or assumption of the tenant's preexisting lease. However, when a landlord pays a tenant for tenant improvements, the accounting is more complicated. In some situations, such payments may be lease incentives, which the landlord would account for as such and amortize as a reduction of rental income over the lease term. In other situations, the landlord may be acquiring tangible assets (e.g., tenant improvements) to lease to the tenant, which the lessor would account for as its PP&E and depreciate over their useful life.
If, after considering the contractual terms of the arrangement and determining its substance, the landlord concludes that it is acquiring property (e.g., tenant improvements) that is subject to lease, it would be appropriate to account for such payments to the tenant as the acquisition of property. However, notwithstanding the designation of the payment as a tenant improvement allowance in the lease agreement, if it is determined that, in substance, the landlord is not acquiring property, the landlord should account for such payments as lease incentives. Many lease agreements contain general provisions related to payments to fund tenant improvements. Such provisions may include those:

- Stating that the intent of the payment is to fund tenant improvements.
- Indicating that title to all tenant improvements is transferred to the landlord as soon as the improvements are installed.
- Requiring the tenant to provide proof of the release of mechanics liens before the payment is made.
- Requiring the tenant to submit architectural drawings and construction plans to the landlord for approval before construction.

By themselves, these provisions are not necessarily indicative of the arrangement's substance and are not sufficient evidence that the landlord is acquiring property from the tenant. For example, an agreement may specify that the tenant intends to use the allowance to fund leasehold improvements but (1) may not require that the tenant provide the landlord with proof of spending for tenant improvements as called for by the terms of the lease or (2) otherwise provide for a mechanism under which the landlord can monitor the usage of the tenant allowance. In such instances, it generally should be presumed that the payment to the tenant represents a lease incentive and not the acquisition of property.

In other instances, the lease arrangement may require proof of expenditures related to tenant improvements but give the tenant the right to retain or receive any allowance amounts that are greater than actual improvement costs. Ordinarily, it should be presumed that if a lease arrangement permits the tenant to retain this excess allowance as either cash or as a reduction of rent, the substance of the arrangement is that all or a portion of the allowance is a lease incentive and not the acquisition of property. If the tenant has discretion regarding use of the funds received by the landlord (even if it is probable that such funds will be used to construct tenant improvements), this would indicate that the tenant improvements should be considered assets of the tenant for accounting purposes. If it is determined that, in substance, the tenant improvements are assets of the tenant, the landlord should treat the funding provided to the tenant as a lease incentive in accordance with Technical Bulletin 88-1.

It is more difficult and subjective to determine the substance of a lease arrangement that does not (1) allow the tenant to retain the excess of landlord funding over actual improvement costs, (2) give the tenant discretion in how the allowance is spent, or (3) specifically identify the leased property as not including the leasehold improvements.
Generally, the terms of a lease arrangement obligate the landlord to deliver the property subject to the lease. However, the terms associated with the construction of related leasehold improvements typically vary from arrangement to arrangement. In some circumstances, a landlord may appropriately be considered owner of the leasehold improvements and therefore should not account for tenant allowances as a lease incentive. Factors to consider include, but are not limited to, whether the:

- Lease agreement’s terms obligate the tenant to construct or install specifically identified assets (i.e., the leasehold improvements).
- Tenant’s failure to make specified improvements is an event of default under which the landlord can require the lessee to make those improvements or otherwise enforce the landlord’s rights to those assets (or a monetary equivalent).
- Tenant is permitted to alter or remove the leasehold improvements without the landlord’s consent or without compensating the landlord for any lost utility or diminution in fair value.
- Tenant is required to provide the landlord with evidence supporting the cost of tenant improvements before the landlord pays the tenant for the tenant improvements.
- Landlord is obligated to fund cost overruns for the construction of leasehold improvements.
- Leasehold improvements are unique to the tenant or could reasonably be used by the lessor to lease to other parties.
- Economic life of the leasehold improvements is such that a significant residual value of the assets is expected to accrue to the benefit of the landlord at the end of the lease term.

9.4.4 Accounting for Reimbursements of Repairs and Capital Improvements

Leases sometimes include provisions that require the lessor to perform routine repairs and maintenance for the underlying asset or that permit the lessor to make capital improvements to this asset (e.g., to replace the roof on a leased building). The contract may also allow the lessor to collect reimbursements of its costs for these activities from the lessee.

In determining how to account for lessee reimbursements of lessor repairs and capital improvements, the lessor should first consider whether its activities constitute a nonlease component of the contract. For example, lessee reimbursements to the lessor for routine repairs to the roof of the leased building may be part of a CAM nonlease component. See Section 4.3.1 for detailed discussion of identifying nonlease components in a contract, including Q&A 4-4 on CAM. If the activity for which the lessor is being reimbursed represents a nonlease component of the contract, the lessor should follow the steps outlined in Section 4.4.2.2 by allocating the consideration in the contract to this nonlease component and recognizing revenue in accordance with ASC 606 (or other applicable GAAP).

Q&A 9-18A discusses situations in which the lessor is reimbursed for a capital improvement that is not a nonlease component of the contract.
Q&A 9-18A  Reimbursement of Capital Improvement That Is Not a Nonlease Component

Lessors may have lease contracts that include provisions permitting them to charge their tenants for capital improvements to the leased property. Capital improvements are made at the discretion of the lessor, and the contract does not require that the lessor perform any such improvements. In many circumstances, the contract requires the lessee to reimburse the lessor for these capital improvements on a straight-line basis over the useful lives of such improvements; such reimbursements are made proportionately with respect to the lessee’s remaining lease term. If the lessee were to terminate the lease before the lease term expires, the lessor would have the right to recover all rents under the lease, including any remaining reimbursements. However, if the lessor terminates the lease early or the lease term expires, the lessee would not have any obligation to continue reimbursing the lessor.

Example

Lessee C enters into a 15-year lease of a building from Lessor B. At the end of year 5 of the lease, B spends $200,000 to replace the roof of the building and has the right to be reimbursed by C in the manner described above. Lessor B concludes that the roof has a 20-year useful life, so it bills C $10,000 ($200,000 cost ÷ 20-year useful life) in each of the 10 years remaining in the lease. Therefore, B will recover half of the total cost of the roof from C by the end of the lease term. Lessor B concludes that the roof replacement does not constitute a nonlease component of the contract, since B is not providing a separate good or service to C by replacing the roof.

Question

In the example above, when should B recognize revenue for C’s reimbursement of the capital improvement?

Answer

Provided that the lease is not modified as a result of the capital improvement, B should recognize variable lease revenue for the improvement-related reimbursements in the periods after the improvement is performed and as it continues to provide C with the right to use the leased asset (including the new roof), upon which reimbursement in future periods is contingent. Accordingly, B should recognize $10,000 of variable lease revenue per year over the remaining 10 years of the lease.

Since B knows that it will have the right to recover a total of $100,000 from C over the remaining lease term, some may argue that the condition in ASC 842-30-25-11(b) to recognize variable lease income is met as soon as the capital improvement is completed. However, we believe that it would be inappropriate for B to recognize the full $100,000 of future reimbursements as revenue when the improvement is completed because the amount is not earned at that point in time. Rather, the reimbursements depend not only on the completion of the new roof but also on the stipulation that B will continue to make the underlying leased asset available for C’s use for the remaining lease term (i.e., will continue to allow C to use the leased asset).

25 See the Connecting the Dots in Section 9.3.4 for additional discussion of when a significant asset improvement may qualify as a lease modification. If the lease is modified as a result of the capital improvement, the reimbursements would similarly be accounted for prospectively.
9.5 Leveraged Lease Accounting

9.5.1 History of and Accounting for Leveraged Leases

Under ASC 840, leveraged lease accounting is a special type of accounting that a lessor applies to certain direct financing leases because of its unique economic effect on the lessor. This unique economic effect stems from a combination of nonrecourse financing and a cash flow pattern that typically enables the lessor to recover its investment in the early years of the lease (as a result of tax benefits generated by depreciation, interest, and investment tax credit deductions) and, thereafter, affords it the temporary use of funds from which additional income can be derived.

ASC 840-10-25-43(c) requires that a lease be classified as a leveraged lease if it has all of the following characteristics:

- It meets the criteria in ASC 840-10-25-43(b) to be classified as a direct financing lease.
- “It involves at least three parties” (i.e., a long-term creditor in addition to the lessee and lessor).
- “The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor.”
- “The lessor’s net investment [in the lease] declines during the early years . . . and rises during the later years of the lease.”

The accounting for leveraged leases under ASC 840 is very complex but follows two basic premises:

1. The lessor’s balance sheet reflects the lessor’s equity in the property on an after-tax basis, net of the related debt.
2. The lessor’s income statement reflects an after-tax constant rate of return on the lessor’s net investment. During those periods in which the net investment is zero or below zero, no income is recognized.

Bridging the GAAP — No Leveraged Lease Accounting Under IFRS Standards

IFRS Standards do not address leveraged leases. Therefore, the considerations in this section and the remainder of Section 9.5 do not apply to entities applying IFRS Standards. See Appendix B for a listing of the differences between ASC 842 and IFRS 16.

9.5.2 Impact of ASC 842 on Leveraged Lease Accounting

<table>
<thead>
<tr>
<th>ASC 842-50 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leveraged Lease</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 842-50</th>
</tr>
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<tbody>
<tr>
<td>05-1 This Subtopic addresses accounting for leases that meet the definition of a leveraged lease.</td>
</tr>
</tbody>
</table>
On the effective date of ASC 842, leases previously classified as leveraged leases under ASC 840 will be subject to the guidance in ASC 842-50. The legacy accounting requirements are grandfathered in for leases that were entered into and accounted for as leveraged leases before the effective date of ASC 842. A leveraged lease modified on or after the effective date of ASC 842 would be accounted for as a new lease under the lessor model in ASC 842, which is discussed throughout this chapter. Entities are not permitted to account for any new or subsequently amended lease arrangements as leveraged leases after the effective date of ASC 842.

Paragraph BC397 of ASU 2016-02 summarizes the FASB’s reasoning for eliminating leveraged lease accounting for new leases under ASC 842 and grandfathering in the guidance for existing leveraged leases in ASC 842-50:

The Board decided that the existing accounting model for leveraged leases should not be retained. That is, all leases should be accounted for in a consistent manner and special rules should not exist for leases with certain characteristics. One reason is because leveraged lease accounting provides net presentation and some Board members do not agree with allowing a net presentation for only a subset of certain lease transactions. Another reason is to limit some of the complexity in the lease accounting guidance by eliminating the unique accounting for leveraged leases. As such, lessors should not distinguish leveraged leases from other leases in Topic 842. This is consistent with the proposed requirements in the 2010 and 2013 Exposure Drafts. However, the Board decided to grandfather existing leveraged leases during transition. Respondents to the 2013 Exposure Draft noted that the transition of existing leveraged leases to the current lessor model would require particular challenges when unwinding the income tax effects of the leveraged leases and income statement results on transition that would not properly depict the economics of the transaction. The Board recognized that there would be significant complexities relating to unwinding existing leveraged leases and that the outcome of doing so would not be beneficial to users. Therefore, the Board decided to grandfather the accounting under previous guidance for existing leveraged lease transactions.

ASC 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).
Q&A 9-19  Impact of Exercising Renewal Options on Leveraged Leases

ASC 842-10-65-1(z) states that if a leveraged lease is modified after the effective date of ASC 842, the lease would be accounted for as a new lease under ASC 842 and thus would no longer be classified as a leveraged lease.

**Question**

With respect to the transition guidance related to leveraged leases in ASC 842-10-65-1(z), does a lessee’s exercise of a renewal option constitute a lease modification?

**Answer**

It depends. ASC 842-50-15-1 states, in part, “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)” (emphasis added).

That is, to determine whether the exercise of a renewal option represents a lease modification, a lessor should consider whether the exercised option was previously contemplated and whether its exercise was deemed reasonably assured. In such circumstances, the option period would have been included in the original lease classification test and would have been reflected in the lessor’s net investment in the lease. If the lessor previously determined that the lessee’s exercise of the renewal option was reasonably assured, the actual exercise of the renewal option would not represent a lease modification. Because the leveraged lease is not modified in this scenario, the lessor would continue to account for the leveraged lease in accordance with ASC 842-50 upon the lessee’s exercise of the renewal option.

If, on the other hand, the lessor did not previously consider the exercise of the renewal option to be reasonably assured, the lessee’s exercise of the renewal option would represent a lease modification in accordance with ASC 842-50-15-1. In this case, upon the lessee’s exercise of the renewal option, the lessor would account for the modification in accordance with ASC 842-10 and ASC 842-30 and would no longer apply the guidance in ASC 842-50 on leveraged lease accounting.
Chapter 9 — Lessor Accounting

9.5.3 Accounting for Existing Leveraged Leases Upon Adoption of ASC 842

As noted in Section 9.5.2, existing leveraged leases currently accounted for under ASC 840 will be grandfathered during the transition to ASC 842 and subsequently accounted for in accordance with ASC 842-50. The guidance quoted in this section (Section 9.5.3) is carried forward from ASC 840.26

<table>
<thead>
<tr>
<th>Recognition of Leveraged Leases</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Location of Guidance in ASC 840</strong></td>
</tr>
<tr>
<td>ASC 840-30-25-8</td>
</tr>
<tr>
<td>ASC 840-30-25-9</td>
</tr>
</tbody>
</table>

### Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity

| **Location of Guidance in ASC 840** | **Location of Guidance in ASC 842** |
|--------------------------------|
| ASC 840-30-25-10 | ASC 842-50-25-2 |

#### ASC 842-50

**General**

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.

**Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity**

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.

As noted in the table above, the existing leveraged lease guidance in ASC 840-30-25-9 was not carried forward under ASC 842. ASC 840-30-25-9 states the following:

If the projected net cash receipts (that is, gross cash receipts minus gross cash disbursements exclusive of the lessor’s initial investment) over the term of the leveraged lease are less than the lessor’s initial investment, the deficiency shall be recognized by the lessor as a loss at lease inception.

26 There are minor grammatical differences between the leveraged lease guidance in ASC 840 and that in ASC 842; however, such differences are minor and not expected to result in a change in the interpretation or application of the guidance for lessors. Therefore, those differences are not highlighted in this chapter.
The reason that this guidance was not carried forward under ASC 842 is because it addresses the recognition of a loss at lease inception for leases classified as leveraged leases. Upon adoption of ASC 842, new leases (and modified leases) will not be classified as leveraged leases. Therefore, this guidance is no longer relevant for lessors upon adoption of ASC 842.

### Initial Measurement of Leveraged Leases

<table>
<thead>
<tr>
<th>Location of Guidance in ASC 840</th>
<th>Location of Guidance in ASC 842</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 840-30-30-14</td>
<td>ASC 842-50-30-1</td>
</tr>
</tbody>
</table>

**Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity**

<table>
<thead>
<tr>
<th>Location of Guidance in ASC 840</th>
<th>Location of Guidance in ASC 842</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 840-30-30-15</td>
<td>ASC 842-50-30-2</td>
</tr>
</tbody>
</table>

### ASC 842-50

**General**

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.

**Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity**

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.

### Q&A 9-20 Tax Considerations Related to Leveraged Leases Acquired in a Business Combination

In a business combination, an acquired entity's individual assets and liabilities are generally assigned fair values before taxes are considered.

**Question**

In a business combination, how should an acquirer initially record an acquired leveraged lease?
**Answer**

In accordance with ASC 842-50-30-2, the acquiring entity should record an acquired leveraged lease on the basis of the remaining future cash flows while giving appropriate recognition to the estimated future tax effects of those cash flows. Therefore, the fair value assigned to an acquired leveraged lease is determined on an after-tax basis (i.e., net of tax), and deferred taxes should not be established for temporary differences related to acquired leveraged leases as of the acquisition date.

See ASC 842-50-55-27 through 55-33 (reproduced later in this chapter) for an example of the accounting for a leveraged lease acquired in a business combination.

<table>
<thead>
<tr>
<th>Subsequent Measurement of Leveraged Leases</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Location of Guidance in ASC 840</strong></td>
<td><strong>Location of Guidance in ASC 842</strong></td>
</tr>
<tr>
<td>Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity</td>
<td></td>
</tr>
<tr>
<td>ASC 840-30-35-32</td>
<td>ASC 842-50-35-1</td>
</tr>
<tr>
<td>Income Recognition on a Leveraged Lease</td>
<td></td>
</tr>
<tr>
<td>ASC 840-30-35-33 through 35-36</td>
<td>ASC 842-50-35-2 through 35-5</td>
</tr>
<tr>
<td>Changes in Assumptions</td>
<td></td>
</tr>
<tr>
<td>ASC 840-30-35-38 through 35-47</td>
<td>ASC 842-50-35-6 through 35-15</td>
</tr>
<tr>
<td>Effect of Alternative Minimum Tax</td>
<td></td>
</tr>
<tr>
<td>ASC 840-30-35-48 through 35-52</td>
<td>ASC 842-50-35-16 through 35-20</td>
</tr>
<tr>
<td>Transfer of Minimum Rental Payments</td>
<td></td>
</tr>
<tr>
<td>ASC 840-30-35-53</td>
<td>ASC 842-50-35-21</td>
</tr>
</tbody>
</table>

**ASC 842-50**

**General**

Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity

**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.

**Income Recognition on a Leveraged Lease**

**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.
The net income (or loss) that a lessor recognizes on a leveraged lease shall be composed of the following three elements:

- Pretax lease income (or loss)
- Investment tax credit
- Tax effect of pretax lease income (or loss).

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.

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).

Changes in Assumptions

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:

- 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.
- The revision of another important assumption changes the estimated total net income from the lease.
- The projected timing of the income tax cash flows is revised.

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.

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:

- 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.
- The tax effect of the gain or loss shall be included in the income tax line item.
- An upward adjustment of the estimated residual value (including any guaranteed portion) shall not be made.

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.
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.

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.

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.

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.

35-14 The recalculation of income from the leveraged lease shall not include interest or penalties in the cash flows from the leveraged lease.

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.

Effect of Alternative Minimum Tax

35-16 An entity shall include assumptions about the effect of the alternative minimum tax, considering its consolidated tax position, in leveraged lease computations.

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.

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.

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.
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.

Transfer of Minimum Rental Payments

If a lessor sells substantially all of the minimum rental payments associated with a leveraged lease and retains an interest in the residual value of the leased asset, the lessor shall not recognize increases in the value of the lease residual to its estimated value over the remaining lease term. The lessor shall report any remaining interest thereafter at its carrying amount at the date of the sale of the lease payments. If it is determined subsequently that the fair value of the residual value of the leased asset has declined below the carrying amount of the interest retained 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.

Q&A 9-21 Accounting for the Sale of a Leveraged Lease

ASC 842 does not specifically address the accounting for sales of leveraged leases. ASC 842-50-35-6 states that if changes in the significant cash flow assumptions will change the estimated total net income for the lease, the “rate of return and the allocation of income to positive investment years shall be recalculated from lease inception.”

Question

Should the sale of a leveraged lease be treated as a change to the projected cash flows of the lease and be accounted for in accordance with ASC 842-50-35-6?

Answer

No. The sale of a leveraged lease should not be treated as a revision of an important assumption that would result in a recalculation of the estimated total net income for the lease and affect the rate of return and the allocation of income to the positive investment years of the lease.

Q&A 9-22 Impact of Altering Significant Assumptions

Question

What is the appropriate accounting treatment for situations in which an assumption in a leveraged lease is altered in such a way that the lease would not have qualified as a leveraged lease had the revised assumptions existed at the inception of the lease?

Answer

It depends on the change in assumptions. First, the lessor would need to consider whether the leveraged lease has been modified in accordance with the lease modification guidance in
Chapter 9 — Lessor Accounting

ASC 842 (if the lease is considered modified, leveraged lease accounting would no longer be appropriate — see Section 9.3.4). If it is determined that the leveraged lease has not been modified, the lease must be reviewed in accordance with ASC 842-50-35-6, which states:

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.

Example

Assume that a lessor is in current negotiations with a lessee regarding its leveraged lease investments. The lessor is proposing to alter the residual value of the leased properties. The change in residual values would be considered a change in estimate and thus would not represent a lease modification for accounting purposes. However, the leveraged lease would have to be reviewed in accordance with ASC 842-50-35-6 because this might be considered an event that would affect the estimated total income from the leveraged lease. If the estimated total income were changed, the lessor would record the adjustment in accordance with ASC 842-50-35-6.

Q&A 9-23 Impact of Altering Significant Tax Assumptions

Question

What is the accounting treatment if the tax rate or timing of deductions is changed in a leveraged lease?

Answer

When there is a change in income tax rates, an entity should recalculate a leveraged lease from its inception and record any differences in current-period earnings. In accordance with ASC 842-50-35-9, the entity would record the effect of the tax rate change on a leveraged lease “in the first accounting period ending on or after the date on which the legislation effecting a rate change becomes law.” ASC 842-50-S99-1 further clarifies that the “difference between the amounts originally recorded and the recalculated amounts must be included in income of the year in which the tax law is enacted.”

If the timing of deductions is changed, the entity would perform a review in accordance with ASC 842-50-35-6. On the basis of that review, if the total estimated income is changed, the entity would recalculate (1) the estimated total net income from the lease, (2) the rate of return, and (3) the allocation of income to positive investment years. To recalculate these amounts, the entity would apply the method described in ASC 842-50-35-2 through 35-5 and use the revised assumption. The accounts constituting the net investment balance would be adjusted to conform to the recalculated balances, and the change in the net investment would be recognized as a gain or loss in the year in which the assumption is changed. The estimated residual value would not be adjusted upward.
Q&A 9-24  Accounting for a Change or Projected Change in the Timing of Cash Flows Related to Income Taxes Generated by a Leveraged Lease Transaction

A change or projected change in the timing of cash flows related to income taxes generated by a leveraged lease should be accounted for in accordance with ASC 842-50-35-6 through 35-15. Tax cash flows should be reflected in the lessor’s initial calculation or subsequent recalculation on the basis of the recognition, derecognition, and measurement criteria in ASC 740. The following example illustrates the application when the only assumption that has changed is the timing of cash flows related to income taxes generated by a leveraged lease.

Example

Assumptions:

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<table>
<thead>
<tr>
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<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Asset cost</td>
<td>$ 10,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonrecourse debt</td>
<td>$ 8,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated residual value</td>
<td>$ 3,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease term</td>
<td>5 years</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Interest rate on nonrecourse debt</td>
<td>10%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax rate</td>
<td>40%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual rent</td>
<td>$ 2,110</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Annual (total) debt service</td>
<td>$ 2,110</td>
<td></td>
<td></td>
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</tbody>
</table>

At the inception of the arrangement, the lessor is expected to deduct one-half of the cost of the asset in its tax returns for each of the first two years of the lease (i.e., accelerated tax depreciation). Accordingly, the lessor’s estimated cash flows from the leveraged lease were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Asset Cost</th>
<th>Nonrecourse Debt</th>
<th>Principal</th>
<th>Interest</th>
<th>Total</th>
<th>Rent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inception</td>
<td>$ 10,000</td>
<td>$ 8,000</td>
<td>$ 1,310</td>
<td>$ 800</td>
<td>$ 2,110</td>
<td>$ 2,110</td>
</tr>
<tr>
<td>1</td>
<td>—</td>
<td>—</td>
<td>$ 1,441</td>
<td>669</td>
<td>2,110</td>
<td>2,110</td>
</tr>
<tr>
<td>2</td>
<td>—</td>
<td>—</td>
<td>1,586</td>
<td>524</td>
<td>2,110</td>
<td>2,110</td>
</tr>
<tr>
<td>3</td>
<td>—</td>
<td>—</td>
<td>1,744</td>
<td>366</td>
<td>2,110</td>
<td>2,110</td>
</tr>
<tr>
<td>4</td>
<td>—</td>
<td>—</td>
<td>1,919</td>
<td>191</td>
<td>2,110</td>
<td>2,110</td>
</tr>
<tr>
<td>5</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>2,110</td>
<td>2,110</td>
</tr>
<tr>
<td></td>
<td>$ 10,000</td>
<td>$ 8,000</td>
<td>$ 8,000</td>
<td>$ 2,550</td>
<td>$ 10,550</td>
<td>$ 10,550</td>
</tr>
</tbody>
</table>
Example (continued)

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated Residual</th>
<th>Tax Depreciation</th>
<th>Taxable Income/ (Loss)</th>
<th>Tax (Refund)/ Payment</th>
<th>Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inception</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>$ (2,000)</td>
</tr>
<tr>
<td>1</td>
<td>—</td>
<td>$ 5,000</td>
<td>$(3,690)</td>
<td>$(1,476)</td>
<td>1,476</td>
</tr>
<tr>
<td>2</td>
<td>—</td>
<td>5,000</td>
<td>(3,559)</td>
<td>(1,424)</td>
<td>1,424</td>
</tr>
<tr>
<td>3</td>
<td>—</td>
<td>—</td>
<td>1,586</td>
<td>634</td>
<td>(634)</td>
</tr>
<tr>
<td>4</td>
<td>—</td>
<td>—</td>
<td>1,744</td>
<td>698</td>
<td>(698)</td>
</tr>
<tr>
<td>5</td>
<td>$ 3,000</td>
<td>—</td>
<td>4,919</td>
<td>1,968</td>
<td>1,032</td>
</tr>
<tr>
<td></td>
<td>$ 3,000</td>
<td>$ 10,000</td>
<td>$ 1,000</td>
<td>$ 400</td>
<td>$ 600</td>
</tr>
</tbody>
</table>

To allocate the earnings of the leveraged lease, the lessor has to determine the rate of return necessary to distribute the net income from the lease to only those years in which the net investment is positive. From the following, the lessor would have determined that the appropriate rate was approximately 15.4 percent:

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Investment</th>
<th>(Investment) Recovery</th>
<th>Income</th>
<th>Total</th>
<th>Ending Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 2,000</td>
<td>$ 1,168</td>
<td>$ 308</td>
<td>$ 1,476</td>
<td>$ 832</td>
</tr>
<tr>
<td>2</td>
<td>832</td>
<td>1,296</td>
<td>128</td>
<td>1,424</td>
<td>(464)</td>
</tr>
<tr>
<td>3</td>
<td>(464)</td>
<td>(634)</td>
<td>—</td>
<td>(634)</td>
<td>170</td>
</tr>
<tr>
<td>4</td>
<td>170</td>
<td>(724)</td>
<td>26</td>
<td>(698)</td>
<td>894</td>
</tr>
<tr>
<td>5</td>
<td>$ 894</td>
<td>894</td>
<td>138</td>
<td>1,032</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>$ 2,000</td>
<td>$ 600</td>
<td>$ 2,600</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Accordingly, at the inception of the leveraged lease, the lessor would have recorded the following net accounting entries:

- Lease rentals receivable, net of debt service —
- Estimated unguaranteed residual value 3,000
- Unearned income 1,000
- Cash 2,000
During the first year of the leveraged lease, the lessor would have recorded the following net accounting entries:

- **Unearned income**: 513
- **Current taxes receivable**: 1,476
- **Deferred income tax provision**: 1,681
  - **Leveraged lease income**: 513
  - **Current income tax benefit**: 1,476
  - **Deferred income taxes payable**: 1,681

Note that pre-tax income is recognized in proportion to after-tax income. In year one, for example, $308 of $600 of after-tax income was allocated to year one. Accordingly, 308/600 of $1,000 of pre-tax income is recognized in year one. Also note that deferred income taxes are provided for the difference between book and taxable income at the applicable tax rate.

Similarly, in year two of the leveraged lease, the lessor would have recorded the following net accounting entries:

- **Unearned income**: 213
- **Current taxes receivable**: 1,424
- **Deferred income tax provision**: 1,509
  - **Leveraged lease income**: 213
  - **Current income tax benefit**: 1,424
  - **Deferred income taxes payable**: 1,509

To illustrate this guidance, assume that at the end of year two, the lessor concludes, in a manner consistent with ASC 740, that the taxing authority is more likely than not to deny the previously taken accelerated depreciation deduction and, rather, will require that it be recognized on a straight-line basis over the term of the lease. As a result, the lessor’s expected cash flows (recalculated from the inception of the lease in accordance with the method described in ASC 842-50-35-2 through 35-4) are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Asset Cost</th>
<th>Nonrecourse Debt</th>
<th>Principal</th>
<th>Interest</th>
<th>Total</th>
<th>Rent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inception</td>
<td>$10,000</td>
<td>$8,000</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>1</td>
<td>—</td>
<td>—</td>
<td>$1,310</td>
<td>$800</td>
<td>$2,110</td>
<td>$2,110</td>
</tr>
<tr>
<td>2</td>
<td>—</td>
<td>—</td>
<td>1,441</td>
<td>669</td>
<td>2,110</td>
<td>2,110</td>
</tr>
<tr>
<td>3</td>
<td>—</td>
<td>—</td>
<td>1,586</td>
<td>524</td>
<td>2,110</td>
<td>2,110</td>
</tr>
<tr>
<td>4</td>
<td>—</td>
<td>—</td>
<td>1,744</td>
<td>366</td>
<td>2,110</td>
<td>2,110</td>
</tr>
<tr>
<td>5</td>
<td>—</td>
<td>—</td>
<td>1,919</td>
<td>191</td>
<td>2,110</td>
<td>2,110</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$10,000</strong></td>
<td><strong>$8,000</strong></td>
<td><strong>$8,000</strong></td>
<td><strong>$2,550</strong></td>
<td><strong>$10,550</strong></td>
<td><strong>$10,550</strong></td>
</tr>
</tbody>
</table>

Note that this example assumes that the lessor did not make any advance, deposit, or settlement payments to the taxing authority up to the date of the recalculation and that a projected settlement amount was not included in the recalculation. ASC 842-50-35-13 provides guidance on how, when a lessor has entered into (or expects to enter into) a settlement with a taxing authority, such payments, cash flow projections, or both should be included in a recalculation.
Example (continued)

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated Residual</th>
<th>Tax Depreciation</th>
<th>Taxable Income/ (Loss)</th>
<th>Tax (Refund)/ Payment</th>
<th>Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inception</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>$ (2,000)</td>
</tr>
<tr>
<td>1</td>
<td>—</td>
<td>$ 2,000</td>
<td>$ (690)</td>
<td>$ (276)</td>
<td>276</td>
</tr>
<tr>
<td>2</td>
<td>—</td>
<td>2,000</td>
<td>(559)</td>
<td>(224)</td>
<td>224</td>
</tr>
<tr>
<td>3</td>
<td>—</td>
<td>2,000</td>
<td>(414)</td>
<td>(166)</td>
<td>166</td>
</tr>
<tr>
<td>4</td>
<td>—</td>
<td>2,000</td>
<td>(256)</td>
<td>(102)</td>
<td>102</td>
</tr>
<tr>
<td>5</td>
<td>$ 3,000</td>
<td>2,000</td>
<td>2,919</td>
<td>1,168</td>
<td>1,832</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Investment</th>
<th>(Investment) Recovery</th>
<th>Income</th>
<th>Total</th>
<th>Ending Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 2,000</td>
<td>$ 143</td>
<td>$ 133</td>
<td>$ 276</td>
<td>$ 1,857</td>
</tr>
<tr>
<td>2</td>
<td>1,857</td>
<td>100</td>
<td>123</td>
<td>224</td>
<td>1,756</td>
</tr>
<tr>
<td>3</td>
<td>1,756</td>
<td>49</td>
<td>117</td>
<td>166</td>
<td>1,707</td>
</tr>
<tr>
<td>4</td>
<td>1,707</td>
<td>(11)</td>
<td>113</td>
<td>102</td>
<td>1,718</td>
</tr>
<tr>
<td>5</td>
<td>$ 1,718</td>
<td>$ 1,718</td>
<td>114</td>
<td>1,832</td>
<td>$ —</td>
</tr>
</tbody>
</table>

At the end of year two, the lessor’s net investment in the leveraged lease would have been:

<table>
<thead>
<tr>
<th></th>
<th>Booked</th>
<th>Revised</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental receivable</td>
<td>$ 6,331</td>
<td>$ 6,331</td>
</tr>
<tr>
<td>Debt service</td>
<td>(6,331)</td>
<td>(6,331)</td>
</tr>
<tr>
<td>Net receivable</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Estimated residual value</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Unearned income</td>
<td>(274)</td>
<td>(573)</td>
</tr>
<tr>
<td>Pre-tax investment</td>
<td>2,726</td>
<td>2,427</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>(3,190)</td>
<td>(670)</td>
</tr>
<tr>
<td>Net investment</td>
<td>$ (464)</td>
<td>$ 1,757</td>
</tr>
</tbody>
</table>
Example (continued)

At the end of year two, after the lessor has revised its expected timing of income-tax-related cash flows, the lessor's net investment of the lease should be $1,757 (not the negative $464 actually recognized). As a result, the lessor needs to recognize a (net) $2,221 adjustment to appropriately state its net investment after determining the effects of the revised cash flows. The accounting entries to record the net adjustment are as follows:28

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leveraged lease income</td>
<td>299</td>
<td></td>
</tr>
<tr>
<td>Unearned income</td>
<td></td>
<td>299</td>
</tr>
<tr>
<td>Deferred income tax payable</td>
<td>120</td>
<td></td>
</tr>
<tr>
<td>Deferred income tax provision</td>
<td></td>
<td>120</td>
</tr>
<tr>
<td>Deferred income taxes payable</td>
<td>2,400</td>
<td></td>
</tr>
<tr>
<td>FIN 48 liability</td>
<td></td>
<td>2,400</td>
</tr>
</tbody>
</table>

These entries have the effect of (1) revising the amount of unearned income so that the current balance is equal to the amount that would exist had the revised cash flows been known at the inception of the lease, (2) recognizing an income tax benefit attributable to the reversal of leveraged lease income, and (3) appropriately recognizing a liability for unrecognized tax benefits for income tax deductions taken that have not been determined to be more likely than not to be realized.

Note that the amount of the liability for unrecognized tax benefits to recognize should equal the tax-effected difference between the “unrecognized tax benefit liability” basis and the “as filed” tax basis of an asset or liability. In this example, at the end of year two, the lessor had an as-filed tax basis of the leased equipment of $0 ($10,000 original cost less accelerated depreciation of $10,000 over the first two years of the lease). However, at the end of year two, the lessor concluded, on a more-likely-than-not measurement basis, that the unrecognized tax benefit liability basis of the leased equipment was $6,000 ($10,000 original cost less two years of straight-line depreciation totaling $4,000). The tax-effected difference equals $2,400 ($[0 – $6,000] × 40%).

Note that it is inappropriate to reflect the liability for unrecognized tax benefits as a component of the lessor's net investment in the leveraged lease.

## Presentation of Leveraged Leases

<table>
<thead>
<tr>
<th>Location of Guidance in ASC 840</th>
<th>Location of Guidance in ASC 842</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 840-30-45-5</td>
<td>ASC 842-50-45-1</td>
</tr>
</tbody>
</table>

### Income Taxes and Leveraged Leases

| ASC 840-30-45-6 and 45-7         | ASC 842-50-45-2 and 45-3       |

---

28 Note that if these journal entries were being made as of the lessor's initial adoption of this guidance, the amounts affecting the statement of operations would be recorded as an adjustment to the beginning balance of retained earnings as of the beginning of the period in which the guidance is adopted.
### ASC 842-50

#### General

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.

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.

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.

### Disclosure of Leveraged Leases

<table>
<thead>
<tr>
<th>Location of Guidance in ASC 840</th>
<th>Location of Guidance in ASC 842</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 840-30-50-5 and 50-6</td>
<td>ASC 842-50-50-1 through 50-3</td>
</tr>
</tbody>
</table>

#### ASC 842-50

#### General

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.

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 in Subtopic 326-20 on financial instruments measured at amortized cost and paragraph 310-10-50-31.

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.
Implementation Guidance for Leveraged Leases

<table>
<thead>
<tr>
<th>Location of Guidance in ASC 840</th>
<th>Location of Guidance in ASC 842</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leveraged Lease Involving an Existing Asset of a Regulated Entity</td>
<td>ASC 840-30-55-14</td>
</tr>
<tr>
<td>Delayed Equity Investment</td>
<td>ASC 840-30-55-15 and 55-16</td>
</tr>
<tr>
<td>Income Taxes Related to Leveraged Leases</td>
<td>ASC 840-30-55-17 and 55-18</td>
</tr>
<tr>
<td>Example: Lessor’s Accounting for a Leveraged Lease</td>
<td>ASC 840-30-55-29 through 55-38</td>
</tr>
<tr>
<td>Example: Income Taxes Related to a Leveraged Lease</td>
<td>ASC 840-30-55-39 through 55-46</td>
</tr>
<tr>
<td>Example: Effect of Advance Payments and Deposits on Recalculation of a Leveraged Lease</td>
<td>ASC 840-30-55-47 through 55-49</td>
</tr>
<tr>
<td>Example: Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity</td>
<td>ASC 840-30-55-50 through 55-56</td>
</tr>
</tbody>
</table>

ASC 842-50

General

Implementation Guidance

Leveraged Lease Involving an Existing Asset of a Regulated Entity

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.

Delayed Equity Investment

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.

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.

Income Taxes Related to Leveraged Leases

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.
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 limits 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.

**Example 1: Lessor’s Accounting for a Leveraged Lease**

55-6 This Example illustrates a lessor’s accounting for a leveraged lease in accordance with the guidance in this Subtopic. It also illustrates one way of meeting the disclosure requirements in paragraphs 842-50-45-1 and 842-50-50-1 as applied to a leveraged lease. The Example does not encompass all circumstances that may arise about leveraged leases; rather, the Example is based on a single instance of a leveraged lease. The elements of accounting and reporting illustrated for this Example of a leveraged lease are as follows:

a. Cash flow analysis by years (see paragraph 842-50-55-8)
b. Allocation of annual cash flow to investment and income (see paragraph 842-50-55-9)
c. Journal entries for lessor’s initial investment and first year of operation (see paragraph 842-50-55-10)
d. Financial statements including notes at end of second year (see paragraph 842-50-55-11)
e. Accounting for a revision in the estimated residual value of the leased asset assumed to occur in the eleventh year of the lease (from $200,000 to $120,000):
   1. Revised allocation of annual cash flow to investment and income (see paragraph 842-50-55-12)
   2. Balances in investment accounts at beginning of the eleventh year before revised estimate (see paragraph 842-50-55-13)
   3. Journal entries (see paragraph 842-50-55-14)
   4. Adjustment of investment accounts (see paragraph 842-50-55-15).
### ASC 842-50 (continued)

#### 55-7

This Example has the following terms and assumptions.

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of leased asset (equipment)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Lease term</td>
<td>15 years, dating from January 1, 1975</td>
</tr>
<tr>
<td>Lease rental payments</td>
<td>$90,000 per year (payable last day of each year)</td>
</tr>
<tr>
<td>Residual value</td>
<td>$200,000 estimated to be realized 1 year after lease termination; in the eleventh year of the lease the estimate is reduced to $120,000</td>
</tr>
</tbody>
</table>

**Financing:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity investment by lessor</td>
<td>$400,000</td>
</tr>
<tr>
<td>Long-term nonrecourse debt</td>
<td>$600,000, bearing interest at 9% and repayable in annual installments (on last day of each year) of $74,435.30</td>
</tr>
<tr>
<td>Depreciation allowable to lessor for income tax purposes</td>
<td>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</td>
</tr>
<tr>
<td>Lessor's income tax rate (federal and state)</td>
<td>50.4% (assumed to continue in existence throughout the term of the lease)</td>
</tr>
<tr>
<td>Investment tax credit</td>
<td>10% of equipment cost or $100,000 (realized by the lessor on last day of first year of lease)</td>
</tr>
<tr>
<td>Initial direct costs</td>
<td>For simplicity, initial direct costs have not been included in the illustration</td>
</tr>
</tbody>
</table>
ASC 842-50 (continued)

55-8 Cash flow analysis by years follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Gross Lease Rentals and Residual Value</td>
<td>Depreciation (for Income Tax Purposes)</td>
<td>Loan Interest Payments</td>
<td>Taxable Income (Loss) (Col. 1 - 2 - 3)</td>
<td>Income Tax Credits (Col. 4 × 50.4%)</td>
<td>Loan Principal Payments</td>
<td>Investment Tax Credit Realized</td>
<td>Annual Cash Flow (Col. 1 – 3 + 5 – 6 + 7)</td>
<td>Cumulative Cash Flow</td>
</tr>
<tr>
<td>Initial Investment</td>
<td>$90,000</td>
<td>$142,857</td>
<td>$54,000</td>
<td>$106,857</td>
<td>$53,856</td>
<td>$20,435</td>
<td>$100,000</td>
<td>$169,421</td>
<td>$(400,000)</td>
</tr>
<tr>
<td>1</td>
<td>$90,000</td>
<td>$244,898</td>
<td>$52,161</td>
<td>$(207,059)</td>
<td>$104,358</td>
<td>$22,274</td>
<td>—</td>
<td>$119,923</td>
<td>$(110,656)</td>
</tr>
<tr>
<td>2</td>
<td>$90,000</td>
<td>$187,075</td>
<td>$50,156</td>
<td>$(147,231)</td>
<td>$74,204</td>
<td>$24,279</td>
<td>—</td>
<td>$89,769</td>
<td>$(20,887)</td>
</tr>
<tr>
<td>3</td>
<td>$90,000</td>
<td>$153,061</td>
<td>$47,971</td>
<td>$(111,032)</td>
<td>$55,960</td>
<td>$26,464</td>
<td>—</td>
<td>$71,525</td>
<td>50,638</td>
</tr>
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<td>$90,000</td>
<td>$119,048</td>
<td>$45,589</td>
<td>$(74,637)</td>
<td>$37,617</td>
<td>$28,846</td>
<td>—</td>
<td>$53,182</td>
<td>103,820</td>
</tr>
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<td>$90,000</td>
<td>$87,061</td>
<td>$42,993</td>
<td>$(60,54)</td>
<td>$3,051</td>
<td>$24,279</td>
<td>—</td>
<td>$18,616</td>
<td>122,436</td>
</tr>
<tr>
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<td>$90,000</td>
<td>—</td>
<td>$40,163</td>
<td>$(25,118)</td>
<td>$34,272</td>
<td>$11,108</td>
<td>—</td>
<td>$9,553</td>
<td>112,883</td>
</tr>
<tr>
<td>7</td>
<td>$90,000</td>
<td>—</td>
<td>$37,079</td>
<td>$(26,672)</td>
<td>$37,357</td>
<td>—</td>
<td>$(16,663)</td>
<td>74,323</td>
<td></td>
</tr>
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<td>$90,000</td>
<td>—</td>
<td>$33,717</td>
<td>$(28,367)</td>
<td>$40,719</td>
<td>—</td>
<td>$(12,803)</td>
<td>57,660</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>$90,000</td>
<td>—</td>
<td>$30,052</td>
<td>$(30,214)</td>
<td>$44,383</td>
<td>—</td>
<td>$(14,649)</td>
<td>48,972</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>$90,000</td>
<td>—</td>
<td>$26,058</td>
<td>$(32,227)</td>
<td>$48,378</td>
<td>—</td>
<td>$(16,663)</td>
<td>57,660</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>$90,000</td>
<td>—</td>
<td>$21,704</td>
<td>$(34,421)</td>
<td>$52,732</td>
<td>—</td>
<td>$(18,857)</td>
<td>38,803</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>$90,000</td>
<td>—</td>
<td>$16,957</td>
<td>$(36,813)</td>
<td>$57,478</td>
<td>—</td>
<td>$(21,248)</td>
<td>17,555</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>$90,000</td>
<td>—</td>
<td>$11,785</td>
<td>$(39,420)</td>
<td>$62,651</td>
<td>—</td>
<td>$(23,856)</td>
<td>6,301</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>$90,000</td>
<td>—</td>
<td>$6,145</td>
<td>$(42,263)</td>
<td>$68,290</td>
<td>—</td>
<td>$(26,698)</td>
<td>32,999</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>$90,000</td>
<td>—</td>
<td>—</td>
<td>$(50,400)</td>
<td>—</td>
<td>—</td>
<td>$149,600</td>
<td>116,601</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$1,650,000</td>
<td>$1,000,000</td>
<td>$516,530</td>
<td>$33,470</td>
<td>$(16,869)</td>
<td>$600,000</td>
<td>$100,000</td>
<td>$116,601</td>
<td>569</td>
</tr>
</tbody>
</table>
**ASC 842-50 (continued)**

### 55-9 Allocation of annual cash flow to investment and income follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lessor's Net Investment at Beginning of Year</th>
<th>Total Annual Cash Flow</th>
<th>Components of Income⁽ᵃ⁾</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(from Col. 8 of Paragraph 842-50-55-8)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Allocated to Investment</td>
<td>Allocated to Income⁽ᵇ⁾</td>
<td>Pretax Income</td>
</tr>
<tr>
<td>1</td>
<td>$400,000</td>
<td>$169,421</td>
<td>$134,833</td>
</tr>
<tr>
<td>2</td>
<td>265,167</td>
<td>119,923</td>
<td>96,994</td>
</tr>
<tr>
<td>3</td>
<td>168,173</td>
<td>89,769</td>
<td>75,227</td>
</tr>
<tr>
<td>4</td>
<td>92,946</td>
<td>71,525</td>
<td>63,488</td>
</tr>
<tr>
<td>5</td>
<td>29,458</td>
<td>53,182</td>
<td>50,635</td>
</tr>
<tr>
<td>6</td>
<td>(21,177)</td>
<td>18,616</td>
<td>18,616</td>
</tr>
<tr>
<td>7</td>
<td>(39,793)</td>
<td>(9,553)</td>
<td>(9,553)</td>
</tr>
<tr>
<td>8</td>
<td>(30,240)</td>
<td>(11,108)</td>
<td>(11,108)</td>
</tr>
<tr>
<td>9</td>
<td>(19,132)</td>
<td>(12,803)</td>
<td>(12,803)</td>
</tr>
<tr>
<td>10</td>
<td>(6,329)</td>
<td>(14,649)</td>
<td>(14,649)</td>
</tr>
<tr>
<td>11</td>
<td>8,320</td>
<td>(16,663)</td>
<td>(17,382)</td>
</tr>
<tr>
<td>12</td>
<td>25,702</td>
<td>(18,857)</td>
<td>(21,079)</td>
</tr>
<tr>
<td>13</td>
<td>46,781</td>
<td>(21,248)</td>
<td>(25,293)</td>
</tr>
<tr>
<td>14</td>
<td>72,074</td>
<td>(23,856)</td>
<td>(30,088)</td>
</tr>
<tr>
<td>15</td>
<td>102,162</td>
<td>(26,698)</td>
<td>(35,532)</td>
</tr>
<tr>
<td>16</td>
<td>137,694</td>
<td>149,600</td>
<td>137,694</td>
</tr>
<tr>
<td>Totals</td>
<td>$516,601</td>
<td>$400,000</td>
<td>$116,601</td>
</tr>
</tbody>
</table>

⁽ᵃ⁾ Lease income is recognized as 8.647% 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.
ILLUSTRATIVE JOURNAL ENTRIES FOR THE YEAR ENDING DECEMBER 31, 1975, FOLLOW.

LESSOR'S INITIAL INVESTMENT

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$233,470</td>
<td></td>
</tr>
<tr>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>$133,470</td>
<td></td>
</tr>
</tbody>
</table>

FIRST YEAR OF OPERATION

JOURNAL ENTRY 1

Cash 15,565
Rentals receivable (table in paragraph 842-50-55-8, column 1 minus columns 3 and 6) 15,565
Collection of first year's net rental

JOURNAL ENTRY 2

Cash(a) 100,000
Investment tax credit receivable (table in paragraph 842-50-55-8, column 7) 100,000
Receipt of investment tax credit

JOURNAL ENTRY 3

Unearned and deferred income 9,929
Income from leveraged leases (table in paragraph 842-50-55-9, column 5) 9,929
Recognition of first year's portion of pretax income allocated in the same proportion as the allocation of total income

(34,588 + 116,601) × 33,470 = 9,929

JOURNAL ENTRY 4

Unearned and deferred income 29,663
Investment tax credit recognized (table in paragraph 842-50-55-9, column 7) 29,663
Recognition of first year's portion of investment tax credit allocated in the same proportion as the allocation of total income

(34,588 + 116,601) × 100,000 = 29,663
Journal Entry 5

Cash (table in paragraph 842-50-55-8, column 5)\(^{(a)}\) 53,856
Income tax expense (table in paragraph 842-50-55-9, column 6) 5,004
Deferred taxes 58,860

To record receipt of first year's tax credit from lease operation, to charge income tax expense for tax effect of pretax accounting income, and to recognize as deferred taxes the tax effect of the difference between pretax accounting income and the tax loss for the year, calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>1976</th>
<th>1975</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax loss (table in paragraph 842-50-55-8, column 4)</td>
<td>(106,857)</td>
<td></td>
</tr>
<tr>
<td>Pretax accounting income</td>
<td>9,929</td>
<td></td>
</tr>
<tr>
<td>Difference</td>
<td>(116,786)</td>
<td></td>
</tr>
<tr>
<td>Deferred taxes ($116,786 × 50.4%)</td>
<td>58,860</td>
<td></td>
</tr>
</tbody>
</table>

\(^{(a)}\) Receipts of the investment tax credit and other tax benefits are shown as cash receipts for simplicity only. Those receipts probably would not be in the form of immediate cash inflow. Instead, they likely would be in the form of reduced payments of taxes on other income of the lessor or on the combined income of the lessor and other entities whose operations are joined with the lessor's operations in a consolidated tax return.

55-11 The following are illustrative partial financial statements including notes.

### Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>December 31, 1976</th>
<th>December 31, 1975</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in leveraged leases</td>
<td>$334,708</td>
<td>$324,027</td>
</tr>
<tr>
<td>Deferred taxes arising from leveraged leases</td>
<td>$166,535</td>
<td>$58,860</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1976</td>
<td>1975</td>
</tr>
<tr>
<td></td>
<td>1976</td>
<td>1975</td>
</tr>
</tbody>
</table>

### Income Statement

(Ignoring all income and expense items other than those relating to leveraged leasing)

<table>
<thead>
<tr>
<th></th>
<th>1976</th>
<th>1975</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from leveraged leases</td>
<td>$6,582</td>
<td>$9,929</td>
</tr>
<tr>
<td>Income before taxes and investment tax credit</td>
<td>6,582</td>
<td>9,929</td>
</tr>
<tr>
<td>Less: Income tax expense(^{(a)})</td>
<td>(3,317)</td>
<td>(5,004)</td>
</tr>
<tr>
<td>Investment tax credit recognized(^{(a)})</td>
<td>3,265</td>
<td>4,925</td>
</tr>
<tr>
<td>Net income</td>
<td>$22,929</td>
<td>$34,588</td>
</tr>
</tbody>
</table>

\(^{(a)}\) These two items may be netted for purposes of presentation in the income statement, provided that the separate amounts are disclosed in a note to financial statements.
The following are notes to the illustrative financial statements included in this Example.

Investment in Leveraged Leases

Entity is the lessor in a leveraged lease agreement entered into in 1975 under which mining equipment having an estimated economic life of 18 years was leased for a term of 15 years. Entity’s equity investment represented 40 percent of the purchase price; the remaining 60 percent was furnished by third-party financing in the form of long-term debt that provides for no recourse against Entity and is secured by a first lien on the property. At the end of the lease term, the equipment is turned back to Entity. The residual value at that time is estimated to be 20 percent of cost. For federal income tax purposes, Entity receives the investment tax credit and has the benefit of tax deductions for depreciation on the entire leased asset and for interest on the long-term debt. During the early years of the lease, those deductions exceed the lease rental income, and substantial excess deductions are available to be applied against Entity’s other income. In the later years of the lease, rental income will exceed the deductions and taxes will be payable. Deferred taxes are provided to reflect this reversal. Entity’s net investment in leveraged leases is composed of the following elements.

<table>
<thead>
<tr>
<th>December 31,</th>
<th>1976</th>
<th>1975</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rentals receivable (net of principal and interest on the nonrecourse debt)</td>
<td>$ 202,340</td>
<td>$ 217,905</td>
</tr>
<tr>
<td>Estimated residual value of leased assets</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Less: Unearned and deferred income</td>
<td>(67,632)</td>
<td>(93,878)</td>
</tr>
<tr>
<td>Investment in leveraged leases</td>
<td>334,708</td>
<td>324,027</td>
</tr>
<tr>
<td>Less: Deferred taxes arising from leveraged leases</td>
<td>(166,535)</td>
<td>(58,860)</td>
</tr>
<tr>
<td>Net investment in leveraged leases</td>
<td>$ 168,173</td>
<td>$ 265,167</td>
</tr>
</tbody>
</table>
### ASC 842-50 (continued)

#### 55-12 Allocation of annual cash flow to investment and income follows, revised to include new residual value estimate.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lessor’s Net Investment at Beginning of Year</th>
<th>Total</th>
<th>Allocated to Investment</th>
<th>Allocated to Income(^{(a)})</th>
<th>Pretax Loss</th>
<th>Tax Effect of Pretax Loss</th>
<th>Investment Tax Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$400,000</td>
<td>$169,421</td>
<td>$142,458</td>
<td>$26,963</td>
<td>$(16,309)</td>
<td>$8,220</td>
<td>$35,052</td>
</tr>
<tr>
<td>2</td>
<td>257,542</td>
<td>119,923</td>
<td>102,563</td>
<td>17,360</td>
<td>(10,501)</td>
<td>5,293</td>
<td>22,568</td>
</tr>
<tr>
<td>3</td>
<td>154,979</td>
<td>89,769</td>
<td>79,323</td>
<td>10,446</td>
<td>(6,319)</td>
<td>3,184</td>
<td>13,581</td>
</tr>
<tr>
<td>4</td>
<td>75,656</td>
<td>71,525</td>
<td>66,425</td>
<td>5,100</td>
<td>(3,085)</td>
<td>1,555</td>
<td>6,630</td>
</tr>
<tr>
<td>5</td>
<td>9,231</td>
<td>53,182</td>
<td>52,560</td>
<td>622</td>
<td>(377)</td>
<td>190</td>
<td>809</td>
</tr>
<tr>
<td>6</td>
<td>(43,329)</td>
<td>18,616</td>
<td>18,616</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>7</td>
<td>(61,945)</td>
<td>(9,553)</td>
<td>(9,553)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>8</td>
<td>(52,392)</td>
<td>(11,108)</td>
<td>(11,108)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
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<tr>
<td>9</td>
<td>(41,284)</td>
<td>(12,803)</td>
<td>(12,803)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>10</td>
<td>(28,481)</td>
<td>(14,649)</td>
<td>(14,649)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>11</td>
<td>(13,832)</td>
<td>(16,663)</td>
<td>(16,663)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>12</td>
<td>2,831</td>
<td>(18,857)</td>
<td>(19,048)</td>
<td>191</td>
<td>(115)</td>
<td>58</td>
<td>248</td>
</tr>
<tr>
<td>13</td>
<td>21,879</td>
<td>(21,248)</td>
<td>(22,723)</td>
<td>1,475</td>
<td>(892)</td>
<td>450</td>
<td>1,917</td>
</tr>
<tr>
<td>14</td>
<td>44,602</td>
<td>(23,856)</td>
<td>(26,862)</td>
<td>3,006</td>
<td>(1,819)</td>
<td>916</td>
<td>3,909</td>
</tr>
<tr>
<td>15</td>
<td>71,464</td>
<td>(26,698)</td>
<td>(31,515)</td>
<td>4,817</td>
<td>(2,914)</td>
<td>1,469</td>
<td>6,262</td>
</tr>
<tr>
<td>16</td>
<td>102,979</td>
<td>109,920</td>
<td>102,979</td>
<td>6,941</td>
<td>(4,199)</td>
<td>2,116</td>
<td>9,024</td>
</tr>
<tr>
<td>Totals</td>
<td>$476,921</td>
<td>$400,000</td>
<td>$76,921</td>
<td>$46,530</td>
<td>$23,451</td>
<td>$100,000</td>
<td></td>
</tr>
</tbody>
</table>

\(^{(a)}\) The revised allocation rate is 6.741%.
55-13 Balances in investment accounts before revised estimate of residual value follow.

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Rentals Receivable</strong>(a)</td>
<td><strong>Estimated Residual Value</strong></td>
<td><strong>Investment Tax Receivable</strong></td>
<td><strong>Pretax Income (Loss)</strong>(b)</td>
<td><strong>Investment Tax Credit</strong>(c)</td>
<td><strong>Deferred Taxes</strong>(d)</td>
<td><strong>Net Investment (Col. 1 + 2 + 3) Less (Col. 4 + 5 + 6)</strong></td>
</tr>
<tr>
<td>Initial investment</td>
<td>$233,470</td>
<td>$200,000</td>
<td>$100,000</td>
<td>$33,470</td>
<td>$100,000</td>
<td>$—</td>
<td>$400,000</td>
</tr>
<tr>
<td>Changes in year of operation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>(15,565)</td>
<td>—</td>
<td>(100,000)</td>
<td>(9,929)</td>
<td>(29,663)</td>
<td>58,860</td>
<td>(134,833)</td>
</tr>
<tr>
<td>2</td>
<td>(15,565)</td>
<td>—</td>
<td>—</td>
<td>(6,582)</td>
<td>(19,664)</td>
<td>107,675</td>
<td>(96,994)</td>
</tr>
<tr>
<td>3</td>
<td>(15,565)</td>
<td>—</td>
<td>—</td>
<td>(4,174)</td>
<td>(12,472)</td>
<td>76,308</td>
<td>(75,227)</td>
</tr>
<tr>
<td>4</td>
<td>(15,565)</td>
<td>—</td>
<td>—</td>
<td>(2,307)</td>
<td>(6,893)</td>
<td>57,123</td>
<td>(63,488)</td>
</tr>
<tr>
<td>5</td>
<td>(15,565)</td>
<td>—</td>
<td>—</td>
<td>(731)</td>
<td>(2,184)</td>
<td>37,985</td>
<td>(50,635)</td>
</tr>
<tr>
<td>6</td>
<td>(15,565)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>3,051</td>
<td>(18,616)</td>
</tr>
<tr>
<td>7</td>
<td>(15,565)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>(25,118)</td>
<td>9,553</td>
</tr>
<tr>
<td>8</td>
<td>(15,564)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>(26,762)</td>
<td>11,108</td>
</tr>
<tr>
<td>9</td>
<td>(15,564)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>(28,367)</td>
<td>12,803</td>
</tr>
<tr>
<td>10</td>
<td>(15,565)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>(30,214)</td>
<td>14,649</td>
</tr>
<tr>
<td>Balances, beginning of eleventh year</td>
<td>$77,822</td>
<td>$200,000</td>
<td>—</td>
<td>$9,747</td>
<td>$29,124</td>
<td>$230,631</td>
<td>$8,320</td>
</tr>
</tbody>
</table>

(a) Table in paragraph 842-50-55-8, column 1, excluding residual value, minus columns 3 and 6.
(b) Table in paragraph 842-50-55-9, column 5.
(c) Table in paragraph 842-50-55-9, column 7.
(d) 50.4% of difference between taxable income (loss) in column 4 of the table in paragraph 842-50-55-8 and pretax accounting income (loss) in column 5 of the table in paragraph 842-50-55-9.
### ASC 842-50 (continued)

#### 55-14

Illustrative journal entries involving a reduction in residual value follow.

#### Journal Entry 1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax income (or loss)</td>
<td>$60,314</td>
</tr>
<tr>
<td>Unearned and deferred income</td>
<td>27,450</td>
</tr>
</tbody>
</table>

Pretax income (loss):

- Balance at end of tenth year: $9,747[^a]
- Revised balance: (9,939[^b])
- Adjustment: (19,686)

Deferred investment tax credit:

- Balance at end of tenth year: 29,124[^c]
- Revised balance: 21,360[^d]
- Adjustment: (7,764)

Investment tax credit recognized: $7,764

Estimated residual value: 80,000

To record:

a. The cumulative effect on pretax income and the effect on future income resulting from the decrease in estimated residual value:

   - Reduction in estimated residual value: $80,000
   - Less portion attributable to future years (unearned and deferred income): (19,686)
   - Cumulative effect (charged against current income): $60,314

b. The cumulative and future effect of the change in allocation of the investment tax credit resulting from the reduction in estimated residual value
ASC 842-50 (continued)

**Journal Entry 2**

Deferred taxes $30,398
Income tax expense $30,398

To recognize deferred taxes for the difference between pretax accounting income (or loss) and taxable income (or loss) for the effect of the reduction in estimated residual value:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax accounting loss per Journal Entry 1</td>
<td>$(60,314)</td>
</tr>
<tr>
<td>Tax income (or loss)</td>
<td>—</td>
</tr>
<tr>
<td>Difference</td>
<td>$(60,314)</td>
</tr>
<tr>
<td>Deferred taxes ($60,314 × 50.4%)</td>
<td>$(30,398)</td>
</tr>
</tbody>
</table>

(a) Table in paragraph 842-50-55-13, column 4.
(b) Table in paragraph 842-50-55-12, total of column 5 minus amounts applicable to the first 10 years.
(c) Table in paragraph 842-50-55-13, column 5.
(d) Table in paragraph 842-50-55-12, total of column 7 minus amounts applicable to the first 10 years.

55-15 Adjustment of investment accounts for revised estimates of residual value follows.

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rentals</td>
<td>Estimated</td>
<td>Pretax</td>
<td>Investment</td>
<td>Deferred</td>
<td>Net</td>
</tr>
<tr>
<td>Receivable</td>
<td>Residual</td>
<td>Income (Loss)</td>
<td>Tax Credit</td>
<td>Taxes</td>
<td>Investment</td>
</tr>
<tr>
<td>Value</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Less</td>
</tr>
<tr>
<td>Balances, beginning of eleventh year (table in paragraph 842-50-55-13)</td>
<td>$77,822</td>
<td>$200,000</td>
<td>$9,747</td>
<td>$29,124</td>
<td>$230,631</td>
</tr>
<tr>
<td>Adjustment of estimated residual value and unearned and deferred income (table in paragraph 842-50-55-14, Journal Entry 1)</td>
<td>—</td>
<td>(80,000)</td>
<td>(19,686)</td>
<td>(7,764)</td>
<td>—</td>
</tr>
<tr>
<td>Adjustment of deferred taxes for the cumulative effect on pretax accounting income (table in paragraph 842-50-55-14, Journal Entry 2)</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Adjusted balances, beginning of eleventh year</td>
<td>$77,822</td>
<td>$120,000</td>
<td>$(9,939)</td>
<td>$21,360</td>
<td>$200,233</td>
</tr>
</tbody>
</table>

(a) Table in paragraph 842-50-55-12, column 1.
ASC 842-50 (continued)

Example 2: Income Taxes Related to a Leveraged Lease

55-16 This Example illustrates integration of the results of a lessor’s income tax accounting for leveraged leases (in accordance with the guidance in this Subtopic) with the other results of accounting for income taxes as required by Topic 740.

55-17 At the end of Year 1 (the current year), an entity has two temporary differences.

55-18 The first temporary difference is for a leveraged lease that was entered into in a prior year. During Year 1, the enacted tax rate for Year 2 and thereafter changes from 40 percent to 35 percent.

55-19 After adjusting for the change in estimated total net income from the lease as a result of the change in tax rates, the components of the investment in the leveraged lease at the end of Year 1 are as follows.

| Net rentals receivable plus residual value minus unearned pretax income | $ 150,000 |
| Reduced by: |
| Deferred investment tax credit | $ 9,000 |
| Deferred tax credits | 39,000 |
| Net investment in leveraged lease for financial reporting | $ 102,000 |

55-20 The second temporary difference is a $120,000 estimated liability for warranty expense that will result in a tax deduction in Year 5 when the liability is expected to be paid. Absent consideration of the deferred tax credits attributable to the leveraged lease, the weight of available evidence indicates that a valuation allowance is needed for the entire amount of the deferred tax asset related to that $120,000 deductible temporary difference.

55-21 The tax basis of the investment in the leveraged lease at the end of Year 1 is $41,000. The amount of the deferred tax liability for that leveraged lease that would otherwise result from the application of guidance in Topic 740 on income taxes is determined as follows.

| Net rentals receivable plus residual value minus unearned pretax income | $ 150,000 |
| Temporary difference for deferred investment tax credit | 9,000 |
| Tax basis of leveraged lease | 41,000 |
| Temporary difference | $ 100,000 |
| Deferred tax liability (35 percent) | $ 35,000 |

55-22 Loss carryback (to Year 2) and loss carryforward (to Year 20) of the $120,000 tax deduction for warranty expense in Year 5 would offset the $100,000 of taxable amounts resulting from future recovery of the net investment in the leveraged lease over the remainder of the lease term.
ASC 842-50 (continued)

55-23 At the end of Year 1, the entity recognizes a $42,000 ($120,000 at 35 percent) deferred tax asset and a related $7,000 valuation allowance. The effect is to recognize a $35,000 net deferred tax benefit for the reduction in deferred tax credits attributable to the leveraged lease. Deferred tax credits attributable to the leveraged lease determined under the guidance in this Subtopic are $39,000. However, the deferred tax liability determined is only $35,000. The $4,000 difference is not available for offsetting.

Example 3: Effect of Advance Payments and Deposits on Recalculation of a Leveraged Lease

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.

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.

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.

Example 4: Leveraged Lease Acquired in a Business Combination or an Acquisition by a Not-for-Profit Entity

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).
### ASC 842-50 (continued)

**55-28** This Example has the following terms and assumptions.

<table>
<thead>
<tr>
<th>Description</th>
<th>Value/Detail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of leased asset (equipment)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Lease term</td>
<td>15 years, dating from January 1, 1975</td>
</tr>
<tr>
<td>Lease rental payments</td>
<td>$90,000 per year (payable last day of each year)</td>
</tr>
<tr>
<td>Residual value</td>
<td>$200,000 estimated to be realized 1 year after lease termination</td>
</tr>
<tr>
<td>Financing:</td>
<td></td>
</tr>
<tr>
<td>Equity investment by lessor</td>
<td>$400,000</td>
</tr>
<tr>
<td>Long-term nonrecourse debt</td>
<td>$600,000, bearing interest at 9% and repayable in annual installments</td>
</tr>
<tr>
<td></td>
<td>(on last day of each year) of $74,435.30</td>
</tr>
<tr>
<td>Depreciation allowable to lessor for income tax purposes</td>
<td>7-year asset depreciation range life using double-declining-balance method</td>
</tr>
<tr>
<td></td>
<td>for the first 2 years (with the half-year convention election applied in</td>
</tr>
<tr>
<td></td>
<td>the first year) and sum-of-years digits method for remaining life,</td>
</tr>
<tr>
<td></td>
<td>depreciated to $100,000 salvage value</td>
</tr>
<tr>
<td>Lessor's income tax rate (federal and state)</td>
<td>50.4% (assumed to continue in existence throughout the term of the lease)</td>
</tr>
<tr>
<td>Investment tax credit</td>
<td>10% of equipment cost or $100,000 (realized by the lessor on last day of</td>
</tr>
<tr>
<td></td>
<td>first year of lease)</td>
</tr>
<tr>
<td>Initial direct costs</td>
<td>For simplicity, initial direct costs have not been included in the</td>
</tr>
<tr>
<td></td>
<td>illustration</td>
</tr>
<tr>
<td>Date of business combination</td>
<td>January 1, 1982</td>
</tr>
<tr>
<td>Tax status of business combination</td>
<td>Nontaxable transaction</td>
</tr>
<tr>
<td>Appropriate interest rate for valuing net-of-tax return on investment</td>
<td>4½%</td>
</tr>
</tbody>
</table>
### 55-29 Acquiring entity's cash flow analysis by years follows.

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Lease Rentals and Residual Value</th>
<th>Depreciation (for Income Tax Purposes)</th>
<th>Loan Interest Payments</th>
<th>Taxable Income (Col. 1 – 2 – 3)</th>
<th>Income Tax (Charges) (Col. 4 × 50.4%)</th>
<th>Loan Principal Payments</th>
<th>Annual Cash Flow (Col. 1 – 3 + 5 – 6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>$90,000</td>
<td>$37,079</td>
<td>$52,921</td>
<td>$26,672</td>
<td>$37,357</td>
<td>$11,108</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>$90,000</td>
<td>$33,717</td>
<td>$56,283</td>
<td>$28,367</td>
<td>$40,719</td>
<td>(12,803)</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>$90,000</td>
<td>$30,052</td>
<td>$59,948</td>
<td>$30,214</td>
<td>$44,383</td>
<td>(14,649)</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>$90,000</td>
<td>$26,058</td>
<td>$63,942</td>
<td>$32,227</td>
<td>$48,378</td>
<td>(16,663)</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>$90,000</td>
<td>$21,704</td>
<td>$68,296</td>
<td>$34,421</td>
<td>$52,732</td>
<td>(18,857)</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>$90,000</td>
<td>$16,957</td>
<td>$73,043</td>
<td>$36,813</td>
<td>$57,478</td>
<td>(21,248)</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>$90,000</td>
<td>$11,785</td>
<td>$78,215</td>
<td>$39,420</td>
<td>$62,651</td>
<td>(23,856)</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>$90,000</td>
<td>$6,145</td>
<td>$83,855</td>
<td>$42,263</td>
<td>$68,290</td>
<td>(26,698)</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>$200,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$50,400</td>
<td>$149,600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$920,000</td>
<td>$100,000</td>
<td>$183,497</td>
<td>$636,503</td>
<td>$411,988</td>
<td>$3,718</td>
<td></td>
</tr>
</tbody>
</table>

### 55-30 Acquiring entity's valuation of investment in the leveraged lease follows.

<table>
<thead>
<tr>
<th>Cash Flow</th>
<th>Present Value at 4½% Net-of-Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Rentals receivable (net of principal and interest on the nonrecourse debt) ($15,564.70 at the end of each year for 8 years)</td>
<td>$102,663</td>
</tr>
<tr>
<td>2. Estimated residual value ($200,000 realizable at the end of 9 years)</td>
<td>134,581</td>
</tr>
<tr>
<td>3. Future tax payments (various amounts payable over 9 years — see the table in paragraph 842-50-55-29)</td>
<td>(253,489)</td>
</tr>
</tbody>
</table>

Net present value: $16,245
### ASC 842-50 (continued)

#### 55-31

Acquiring entity’s allocation of annual cash flow to investment and income follows (see footnote (a)).

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Investment at Beginning of Year</th>
<th>Total From Col. 7 of the Table in Paragraph 842-50-55-29</th>
<th>Allocated to Investment</th>
<th>Allocated to Income&lt;sup&gt;(a)&lt;/sup&gt;</th>
<th>Pretax Income</th>
<th>Tax Effect of Pretax Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>$(16,245)</td>
<td>$(11,108)</td>
<td>$(11,108)</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>9</td>
<td>$(5,137)</td>
<td>$(12,803)</td>
<td>$(12,803)</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>10</td>
<td>7,666</td>
<td>$(14,649)</td>
<td>$(14,973)</td>
<td>324</td>
<td>$5,530</td>
<td>$(5,206)</td>
</tr>
<tr>
<td>11</td>
<td>22,639</td>
<td>$(16,663)</td>
<td>$(17,621)</td>
<td>958</td>
<td>16,353</td>
<td>$(15,395)</td>
</tr>
<tr>
<td>12</td>
<td>40,260</td>
<td>$(18,857)</td>
<td>$(20,561)</td>
<td>1,704</td>
<td>29,087</td>
<td>$(27,383)</td>
</tr>
<tr>
<td>13</td>
<td>60,821</td>
<td>$(21,248)</td>
<td>$(23,822)</td>
<td>2,574</td>
<td>43,937</td>
<td>$(41,363)</td>
</tr>
<tr>
<td>14</td>
<td>84,643</td>
<td>$(23,856)</td>
<td>$(27,439)</td>
<td>3,583</td>
<td>61,160</td>
<td>$(57,577)</td>
</tr>
<tr>
<td>15</td>
<td>112,082</td>
<td>$(26,698)</td>
<td>$(31,443)</td>
<td>4,745</td>
<td>80,995</td>
<td>$(76,250)</td>
</tr>
<tr>
<td>16</td>
<td>143,525</td>
<td>149,600</td>
<td>143,525</td>
<td>6,075</td>
<td>103,698</td>
<td>$(97,623)</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td></td>
<td><strong>$3,718</strong></td>
<td><strong>$(16,245)</strong></td>
<td><strong>19,963</strong></td>
<td><strong>$340,760</strong></td>
<td><strong>$(320,797)</strong></td>
</tr>
</tbody>
</table>

<sup>(a)</sup> 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.

<sup>(b)</sup> 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 the table in paragraph 842-50-55-33 includes an example of this computation.

#### 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 842-50-55-30, 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
### ASC 842-50 (continued)

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)

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong></td>
<td>Cash</td>
<td>$15,565</td>
</tr>
<tr>
<td></td>
<td>Collections receivable (table in paragraph 842-50-55-29, column 1 minus columns 3 and 6)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Collection of year's net rental</td>
<td>$15,565</td>
</tr>
<tr>
<td><strong>2</strong></td>
<td>Unearned and deferred income</td>
<td>$5,530</td>
</tr>
<tr>
<td></td>
<td>Income from leveraged leases (table in paragraph 842-50-55-31, column 5)</td>
<td>$5,530</td>
</tr>
<tr>
<td></td>
<td>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)</td>
<td></td>
</tr>
<tr>
<td><strong>3</strong></td>
<td>Deferred taxes (table in paragraph 842-50-55-29, column 5, minus table in paragraph 842-50-55-31, column 6)</td>
<td>$25,008</td>
</tr>
<tr>
<td></td>
<td>Income tax expense (table in paragraph 842-50-55-31, column 6)</td>
<td>$5,206</td>
</tr>
<tr>
<td></td>
<td>Cash (table in paragraph 842-50-55-29, column 5)</td>
<td>$30,214</td>
</tr>
</tbody>
</table>

To record payment of tax for the year.
Chapter 10 — Sale-and-Leaseback Transactions

10.1 Introduction and Overview

10.2 Scope of the Sale-and-Leaseback Accounting Guidance
   10.2.1 General Scope Considerations
   10.2.2 Control of the Underlying Asset Before Lease Commencement
   10.2.3 Other Scope Considerations

10.3 Determining Whether the Transfer of an Asset Is a Sale
   10.3.1 Transfer of Control in Accordance With ASC 606
   10.3.2 Leaseback Is a Finance Lease or a Sales-Type Lease
   10.3.3 Repurchase Options
   10.3.4 Transfer of Tax Benefits

10.4 Recognition and Measurement
   10.4.1 Transfer of the Asset Is a Sale
   10.4.2 Transfer of the Asset Is Not a Sale
10.1 Introduction and Overview

A sale-and-leaseback transaction is a common and important financing method for many companies; these transactions involve the transfer of an asset by an owner ("seller-lessee") to an acquirer ("buyer-lessee") and a transfer of the right to control the use of that same asset back to the original owner for a period of time.

Sale-and-leaseback transactions offer seller-lessees a number of advantages, including:

- The ability to free up the cash invested in the asset and invest that cash in more profitable or more pressing projects (e.g., paying off corporate debt, reinvesting the cash into operations, funding stock buybacks). This may be particularly advantageous in tight credit markets.
- In a sale-and-leaseback arrangement, essentially 100 percent of the asset is financed. This may be a higher level of financing than the seller-lessee ordinarily would be able to obtain.
- Under the sale-and-leaseback accounting requirements in ASC 840, a seller-lessee is often allowed to remove the asset and any related debt from its balance sheet; as a result, the seller-lessee's financial ratios may improve. However, the lessee accounting model in ASC 842 (see Chapter 8) will remove the off-balance-sheet benefits of sale-and-leaseback transaction structures for seller-lessees.
- The transaction also may improve the seller-lessee's income statement. Depreciation expense and interest expense could be reduced, and the cash freed up by the transaction could be invested to obtain a greater return than could be obtained when the cash was invested in the asset. In addition, the seller-lessee may have lower income tax expense, since tax deductions arising from the rental payments could exceed the deductions that had been generated by debt payments. These favorable income statement effects may be offset to some extent by the additional rental expense that will be recognized and reduced tax deductions for depreciation expense.
- The transaction allows the seller-lessee to refocus its resources on its primary business operations instead of managing and maintaining fixed assets or real estate.

The buyer-lessee in a sale-and-leaseback transaction benefits from receiving a steady return on its investment in the form of annual rental payments and may receive certain tax advantages. Furthermore, the buyer-lessee will receive benefits through owning the asset, including any future asset appreciation.

10.2 Scope of the Sale-and-Leaseback Accounting Guidance

10.2.1 General Scope Considerations

<table>
<thead>
<tr>
<th>ASC 842-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-1</strong> This Subtopic addresses accounting for sale and leaseback transactions when a lease has been accounted for in accordance with Subtopic 842-10 and either Subtopic 842-20 or Subtopic 842-30.</td>
</tr>
<tr>
<td><strong>15-1</strong> This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic; see Section 842-10-15.</td>
</tr>
</tbody>
</table>
ASC 842-40 (continued)

15-2 If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessee) and leases that asset back from the buyer-lessee, both the seller-lessee and the buyer-lessee shall account for the transfer contract and the lease in accordance with Sections 842-40-25, 842-40-30, and 842-40-50.

15-3 See paragraphs 842-40-55-1 through 55-21 for implementation guidance on the scope of this Subtopic. See Example 3 (paragraphs 842-40-55-39 through 55-44) for an illustration of the scope of this Subtopic.

As noted in paragraph BC349 of ASU 2016-02, the guidance on accounting for sale-and-leaseback transactions in ASC 842-40 substantially differs from that in ASC 840-40. The following decision tree illustrates how an entity would apply the guidance in ASC 842-40 to identify the appropriate accounting for situations in which it transfers an asset to another entity and obtains the right to use that asset:
Chapter 10 — Sale-and-Leaseback Transactions

Changing Lanes — Scope of Sale-and-Leaseback Accounting Guidance for Buyer-Lessors

As illustrated in the decision tree above, the scope of ASC 842-40 applies to both the seller-lessee and the buyer-lessor in a sale-and-leaseback transaction. Thus, the scope of sale-and-leaseback accounting in ASC 842-40 differs from the scope in ASC 840-40, which applies only to the seller-lessee. ASC 842 will therefore result in a significant change for buyer-lessors in sale-and-leaseback transactions, since they must now also assess whether the seller-lessee has transferred control of the underlying asset in the sale leg of the transaction (i.e., they must assess whether they have obtained control).

The scope guidance in ASC 842-40 (and thus the decision tree above) may fail to identify all transactions that the FASB intended to be accounted for under the sale-and-leaseback guidance in ASC 842-40. Accordingly, the implementation guidance in ASC 842-40-55 addresses specific transactions (not all-inclusive) that may be within the scope of the sale-and-leaseback guidance in ASC 842-40.

10.2.2 Control of the Underlying Asset Before Lease Commencement

Under ASC 842-40-55-1 through 55-6, transactions in which a lessee controls an underlying asset before the commencement date of the lease are within the scope of the sale-and-leaseback guidance. That is, under ASC 842-40, if a lessee controls an underlying asset before commencement, it would recognize the entire asset on its balance sheet and determine whether derecognition is appropriate as a sale-and-leaseback transaction. ASC 842-40-55-1 and 55-2 cover transactions in which the lessee obtains control of the asset before transferring it to the lessor, and ASC 842-40-55-3 through 55-6 address transactions in which the lessee obtains control of a construction project (i.e., the underlying asset that will be subject to the lease is in the process of being constructed).

See Chapter 11 for further details on the guidance in ASC 842-40-55-1 through 55-6 on when the lessee controls an underlying asset before the commencement date of the lease as well as on the subsequent accounting that results.

Q&A 10-1 Sale or Transfer of a Purchase Option by a Lessee

Question

Would the scope of ASC 842-40 include transactions in which (1) a company transfers an option to purchase an asset to an unaffiliated third party and the third party is required to exercise the option and lease back the asset to the company, (2) the third party exercises the option, and (3) the company leases back the asset?

Answer

If the entity only held the option to purchase the asset but never held title to the asset itself, it must analyze the substance of the purchase option to determine whether possession of the option was substantially the same as control of the asset before it was owned by the unaffiliated third party. The entity must assess the purchase option itself by applying the guidance in ASC 842-40-25-1 to determine whether and, if so, when (further discussed in Section 10.3.1) it transfers control of the asset to the buyer-lessee.
An option that grants the right to purchase the underlying asset may convey control of the asset before exercise. Although certain risks and rewards of the asset may be transferred to a company when the option is first conveyed to the company (e.g., a fixed-price purchase option that conveys the right to participate in any future appreciation in the asset’s value), we believe that the company typically does not control the underlying asset at that point. Rather, we think that the company controls the underlying asset at the point when it effectively exercises the option by transferring it to an unaffiliated third party and requiring that the third party exercise it. At that point, the company controls the underlying asset and what happens to it in effectively exercising the option by requiring someone else to exercise it (the owner of the asset is compelled to transfer the asset in accordance with the option) and requiring the buyer to provide the company with the right to use the asset. Therefore, such a transaction would be subject to the sale-and-leaseback accounting guidance in ASC 842-40. In contrast, simply negotiating the sale of an underlying asset between two unaffiliated third parties with an agreement to lease the asset from the buyer would not by itself convey control of the underlying asset to a company.

Example

Company A writes a call option on real estate in Orange County, California, to Company B on January 1, 2020. Company B transfers the call option to Company C on December 31, 2021, requiring that C exercise the call option and lease the real estate to B. In accordance with this requirement, C exercises the option on December 31, 2021, and leases the real estate to B for five years.

On December 31, 2021, B controls the underlying real estate because it effectively exercised the option by transferring it to C under the condition of exercise. Accordingly, on December 31, 2021, for both B and C, the transaction is subject to the sale-and-leaseback accounting guidance in ASC 842-40.

The discussion and example above represent our perspective on these arrangements. This issue continues to evolve, and it is possible that the FASB and SEC staffs will want to share perspectives on this or related fact patterns. Companies that are involved in these types of arrangements should consult with their accounting advisers and monitor developments on the topic.

10.2.3 Other Scope Considerations

The sections below address other scope considerations related to the sale-and-leaseback accounting guidance in ASC 842-40.

10.2.3.1 Lessee Indemnification for Environmental Contamination

ASC 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.
10.2.3.2 Sale Subject to a Preexisting Lease

ASC 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.

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.

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.

The example below illustrates the application of the guidance in ASC 842-40-55-8 and 55-9.

**Example 10-1**

Company A has a 50 percent ownership interest in a property that consists of warehouse space and office space. Currently, A leases all of the warehouse space, which comprises 75 percent of the building's total square footage. Company A proposes to sell its entire ownership interest in the property to an unrelated third party, Acquirer X, but to continue to lease the warehouse space.

To the extent that A and X do not modify the price or scope of A's lease of the warehouse space, neither party would need to assess this transaction by using the sale-and-leaseback accounting guidance in ASC 842-40.

The Q&A below further discusses the application of the guidance in ASC 842-40-55-10.

**Q&A 10-2 Intercompany Sale-and-Leaseback Transactions**

A subsidiary owns equipment that it leases to its parent company or to other subsidiaries, and the subsidiary sells the equipment subject to the existing intercompany lease to an unrelated third party. The subsidiaries are consolidated with the parent company for financial reporting purposes. Neither of the parties to the transaction is a regulated entity.

**Question**

What is the appropriate accounting for this transaction?

**Answer**

The sale of equipment subject to an existing intercompany lease should be assessed in accordance with the sale-and-leaseback accounting guidance in ASC 842-40. The equipment lease that was in effect before the sale was eliminated in consolidation. Therefore, at the consolidated level, there was no lease. Since the parent and the subsidiary had the ability
to cancel the lease before the sale to the unrelated third party but chose not to, there is a presumption that the sale and the terms of the leaseback were considered together in the seller-lessee’s discussions with the buyer-lessee and that the transactions should be treated as one integrated transaction within the scope of ASC 842-40. It would not be appropriate to consider the lease a preexisting lease in such cases.

**Q&A 10-2A Third-Party Lessor Involvement in a Business Combination**

In a business combination, a third party may acquire assets directly from the acquiree before the business combination and subsequently lease those assets to the acquirer after the acquisition.

**Question**

How should the acquirer/lessee account for the transaction?

**Answer**

When a third party acquires assets directly from an acquiree before a business combination to subsequently lease those assets to the acquirer, and that transaction is either contingent on or in contemplation of the business combination, we believe the assets have been transferred to the acquirer (i.e., the acquirer has obtained control of the assets) just before, or concurrently with, the business combination. This is because the acquirer could preclude the sale of the assets to the third party by not completing the business combination. Therefore, the assets acquired by the third party are effectively controlled by the acquirer, albeit momentarily, before the sale to the third party can be completed. In this scenario, we believe that it should be presumed that sale of the assets from the acquiree to the third party and subsequent leaseback of the assets from the third party to the acquirer were entered into in contemplation of one another and in connection with the business combination. In substance, the acquirer/lessee directed the acquiree to sell the assets to the third party with a subsequent leaseback to the acquirer, which has the effect of financing part of the business combination.

We believe that the acquirer/lessee has gained control of the assets before the third party (lessor) and therefore that the guidance in ASC 842-40-55-1 would be applicable. This guidance states, in part:

> 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.

Accordingly, we believe the acquirer/lessee should account for the transaction as (1) a business combination in which the assets are included in the acquired asset set and (2) a sale-and-leaseback transaction with the third party for the assets in accordance with ASC 842-40; it would not be appropriate to instead exclude the assets from the acquired asset set in the business combination and record a separate lease of the assets from a third party. The amount of consideration transferred by the acquirer to effect the business combination should include the amount paid by the third party to the acquiree for the assets,\(^1\) since it is in effect a payment being made on behalf of the acquirer.

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\(^1\) We have assumed that the amount paid by the third party to the acquiree would be known by the acquirer. However, to the extent this amount is not known, the acquirer should impute a purchase price for the assets by considering the fair market value of the assets purchased and any off-market lease terms in the leaseback.
10.2.3.3 Sale-Leaseback-Sublease Transactions

ASC 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.

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.

A seller-lessee (seller-sublessor) and buyer-lessor may enter into a sale-and-leaseback transaction involving an asset that either (1) is subject to an existing operating lease (i.e., such that the original owner sells the asset subject to the operating lease and leases it back to continue performing economically as a lessor) or (2) is or will be subleased to a third party under an operating lease (i.e., such that the original owner sells the asset, leases it back, and executes a sublease agreement with a third party). Contractual provisions allowing a seller-lessee to sublease the underlying asset are common in leaseback arrangements because they allow the seller-lessee to sublease the property without having to renegotiate the terms of its lease with the buyer-lessor. The seller-lessee may wish to retain a right to sublease the property in case its continued leasing of the property becomes uneconomic in light of its business plan. For example, a restaurant owner may want to retain its right to sublease the property in case several years into the lease term the surrounding area’s demographics change and adversely affect the restaurant’s operations.

Such transactions are within the scope of the sale-and-leaseback accounting guidance in ASC 842-40. The seller-sublessor and buyer-lessor must follow the steps in the decision tree in Section 10.2.1 and assess whether the seller-sublessor transfers control of the asset to the buyer-lessor.

See Chapter 12 for a detailed discussion of the sublease accounting requirements in ASC 842.

10.2.3.4 Other Transaction Types

Although ASC 842-40-55 identifies certain scope considerations, it may be difficult to tell whether other, complex transaction types reflect the economic substance of a sale and leaseback or a financing arrangement. The Q&As below address various transaction types that we think should be assessed in accordance with the guidance in ASC 842-40 on sale-and-leaseback transactions.

Q&A 10-3 Separate Analysis of the Land and Building Components of a Lease

Question
If undeveloped land is sold to a developer to construct a building and the developer leases the completed building and land back to the seller, should the lease of the land and the building be accounted for as a single sale-and-leaseback transaction?
**Answer**

No. In this circumstance, the lease of the land and the building should be accounted for as separate lease components in accordance with ASC 842-10-15-29. Since the land element was previously controlled by the lessee, the leaseback of the land should be accounted for as a sale-and-leaseback transaction. The lease of the building element is not within the scope of the sale-and-leaseback guidance in ASC 842-40 because the building was never controlled by the lessee. The building lease should be accounted for in accordance with the lease classification criteria in ASC 842-10-25-1 and 25-2.

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**Q&A 10-4 Treatment of Sales Agreements in Which the Seller Retains an Option to Lease the Asset Transferred**

**Question**

Does ASC 842-40 apply to a transaction involving real estate in which a seller transfers an asset to a purchaser but retains an option to lease that asset from the purchaser?

**Answer**

Yes, such a transaction is within the scope of ASC 842-40. In general, for any transaction involving the transfer of real estate to a purchaser, if the seller has the contractual obligation, or has been granted the option, to enter into a leasing arrangement with the purchaser for use of that same real estate, the transaction should be accounted for in accordance with ASC 842-40. The same is presumed when a real estate transfer is subsequently followed by a separate transaction in which the original seller agrees to lease the same property from the original purchaser.

An entity would need to have persuasive evidence to support an assertion that such a transaction is not within the scope of ASC 842-40.

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**Q&A 10-5 Concurrent Sale and Leasing Transactions That Involve Different Assets but the Same Counterparty**

**Question**

If an entity transfers an asset to a purchaser while entering into a concurrent arrangement to lease a similar, but not the same, asset from the same purchaser, should the seller and purchaser account for the two arrangements as an integrated sale-and-leaseback transaction?

**Answer**

There is a rebuttable presumption that concurrent sale and leasing arrangements entered into with the same counterparty for substantially similar assets should be accounted for as one integrated sale-and-leaseback transaction, even if the asset being leased is not the exact asset that was sold. This presumption can only be overcome when there is sufficient evidence that the transactions are, in fact, independent transactions. If the presumption cannot be overcome, the seller-lessee and buyer-lessor should account for the transactions together as a sale-and-leaseback transaction in accordance with ASC 842-40.

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2 This Q&A addresses the applicability of sale-and-leaseback guidance to concurrent sales and leases of similar, completed assets. See Q&A 10-5A for a discussion of the applicability of sale-and-leaseback guidance to sales of construction-in-process with a leaseback of the completed asset.
Q&A 10-5A Sale of Construction in Process With a Leaseback of the Asset After Completion of Construction

A company (the “seller” or “seller-lessee”) may enter into an arrangement with a developer (the “buyer” or “buyer-lessee”) to transfer construction in process (CIP) to the developer. In such an arrangement, the developer will complete construction of the asset (the “completed construction”) and lease it back to the seller. The CIP that the seller transfers to the buyer can be in different phases of development. For example, a building may be in the following phases of construction when transferred to a buyer:

- Only soft costs have been incurred.
- The land has been cleared or graded to prepare for construction of the building.
- A physical structure has begun to take form, such as a foundation and steel beams.
- Progress has been made toward a building with an unfinished interior.
- Substantial progress has been made toward completion of a building.

Under ASC 840-40-55-44, an entity was subject to the ASC 840 sale-and-leaseback requirements if the entity had begun construction activities, including the following:

a. Begun construction (broken ground)

b. Incurred hard costs (no matter how insignificant the hard costs incurred may be in relation to the fair value of the property to be constructed)

c. Incurred soft costs that represent more than a minor amount of the fair value of the leased property (that is, more than 10 percent of the expected fair value of the leased property).

ASC 840 included indicators of when an entity with CIP may be subject to the sale-and-leaseback requirements. However, ASC 842 is less clear on when an entity should apply the sale-and-leaseback guidance in a transaction in which CIP is sold as part of an agreement to lease the asset after construction has been completed.

**Question 1**

Is the sale of CIP as part of an agreement to lease back the completed construction subject to the sale-and-leaseback guidance in ASC 842?

**Answer**

It depends. ASC 842 does not explicitly address whether the sale of CIP that will be leased back at completion of the construction is subject to sale-and-leaseback guidance. On the basis of a technical inquiry with the FASB staff, we understand that there may be a range of acceptable approaches to determining whether the transfer of CIP is subject to sale-and-leaseback accounting. For example, we understand that it would be acceptable to conclude that the transfer of CIP accompanied by an agreement to lease the completed construction is always subject to sale-and-leaseback accounting (regardless of the stage of construction or the amount of costs incurred). On the other end of the spectrum, we also understand that it would be acceptable for entities to consider whether (on the basis of the stage of construction) the CIP sold is substantially similar to the underlying asset that will be leased back. That is, in some cases, the CIP might not yet be substantially similar to the asset to be leased back and, as a result, sale-and-leaseback accounting may not be required. In determining whether this is the case, the following considerations may be relevant:

3 In this Q&A, assume that the agreement between the buyer and seller to sell the CIP and the lease arrangement were entered into contemporaneously and in contemplation of one another.
case, an entity will most likely need to use judgment and consider various qualitative factors. We believe that it also may be appropriate for an entity to consider quantitative thresholds (e.g., whether the fair value of the CIP represents 90 percent or more of the expected value of the completed construction) to help inform an overall qualitative assessment of whether the CIP is substantially similar to the underlying asset to be leased back at the end of construction.

Although the approaches described above result in very different accounting treatments, on the basis of the technical inquiry with the FASB staff, we believe that each of these approaches represents a reasonable application of the guidance. We believe that companies should elect one approach as an accounting policy and should apply it consistently.

**Question 2**

How should a seller-lessee subsequently account for arrangements involving the transfer of CIP that is subject to the sale-and-leaseback guidance in ASC 842?

**Answer**

Under ASC 842-40, one of the primary conditions for derecognizing an asset in a sale-and-leaseback transaction is that the leaseback is not a finance lease. Since certain components of the lease classification analysis cannot be known as of the date of the transfer of CIP, such as the discount rate and the fair value of the property as of the commencement date, it is not possible to assess and achieve sale-and-leaseback accounting until the lease commencement date. This conclusion holds true even if the seller-lessee expects the leaseback to be an operating lease and no purchase option will exist after the lease commencement date. That is, once the seller-lessee is deemed the owner of an asset under construction (even if the seller-lessee loses control of the asset), it will not be possible to achieve sale-and-leaseback accounting until lease classification is determined, which is not possible under ASC 842 until lease commencement.

In addition, we believe that costs incurred both before and after the transfer of CIP to the buyer-lessee are related to a single unit of account. Therefore, the seller-lessee would perform the following accounting when the transfer of CIP is subject to the sale-and-leaseback guidance in ASC 842:

1. Continue to record the existing CIP on the balance sheet (i.e., do not derecognize the partially completed asset).
2. Capitalize all incremental costs of construction (whether funded by the seller-lessee or the buyer-lessee).
3. Record an associated financing obligation (see Section 10.4.2) for costs funded by the buyer-lessee, including any funds received for the transfer of CIP.
4. Upon completion of construction, apply the sale-and-leaseback guidance to determine whether the completed construction can be derecognized (see Section 10.3).

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4 In addition, we believe that there may be a range of other acceptable approaches between the two approaches outlined above. Companies that are involved in these types of arrangements should consult with their accounting advisers when electing an approach.
10.3 Determining Whether the Transfer of an Asset Is a Sale

The sale-and-leaseback accounting guidance in ASC 842-40 is aligned with ASC 606 in that both focus on the notion of control transfer. In other words, the seller-lessee and buyer-lessee must determine whether the seller-lessee transfers to the buyer-lessee control of the underlying asset. If so, the transfer of the asset is a sale and both parties may apply sale-and-leaseback accounting. If not, the transaction is economically a financing arrangement for both parties and must be accounted for as such.

The following flowchart illustrates how the seller-lessee and buyer-lessee would perform the control transfer assessment:
Changing Lanes — Transfer of Control Is a Simpler Concept for All Asset Types

ASC 842-40 is simpler than ASC 840-40 with respect to using the transfer of control of an underlying asset in a transaction to determine when a sale has occurred and sale-and-leaseback accounting may be applied. The sale-and-leaseback accounting guidance in ASC 840 differs depending on the type of asset and is, by design, very onerous for real estate assets. Specifically, under ASC 840-40, a seller-lessee of real estate must perform a comprehensive and complex assessment of the continuing-involvement provisions of the legacy real estate sales guidance in ASC 360-20.

Going forward, and in a manner consistent with ASC 606, transferring control of — and thus selling — real estate is treated no differently than transferring control of any other type of asset. In other words, while there is an intentionally high hurdle under ASC 360-20 with respect to demonstrating that real estate has been sold for accounting purposes (and thus that a sale-and-leaseback has occurred) and control has been transferred, ASC 606 (and thus ASC 842-40) establishes no such hurdle.

As a result, we think that seller-lessees will find that the sale-and-leaseback accounting guidance in ASC 842-40 will be easier to apply to real estate than the accounting requirements in ASC 840-40.

Connecting the Dots — Seller-Lessee and Buyer-Lessor May Reach Different Conclusions

As noted in Section 10.2.1, the buyer-lessor in a transaction involving the transfer and lease of an underlying asset is subject to the sale-and-leaseback accounting guidance in ASC 842-40. That is, the buyer-lessor must assess whether it obtains control of the underlying asset before leasing it back to the seller-lessee.

However, although the accounting requirements are symmetrical, there is no requirement in ASC 842-40 for the seller-lessee and buyer-lessor to reach symmetrical conclusions about whether a sale has occurred. Accordingly, it may be reasonable for the seller-lessee and buyer-lessor to reach different conclusions about whether control of the underlying asset is transferred from the seller-lessee to the buyer-lessor. This could be the case when the two entities’ judgments about the following are different:

- Lease classification assumptions (e.g., the economic life and fair value of the asset; the discount rate to be used), when one entity concludes that the lease is a finance lease or a sales-type lease and the other does not.

- Control indicators in ASC 606-10-25-30, when one entity concludes that control has been transferred to the buyer-lessor and the other does not (see Section 10.3.1 below).

10.3.1 Transfer of Control in Accordance With ASC 606

<table>
<thead>
<tr>
<th>ASC 842-40</th>
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<tbody>
<tr>
<td><strong>25-1</strong> 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:</td>
</tr>
<tr>
<td>a. Paragraphs 606-10-25-1 through 25-8 on the existence of a contract</td>
</tr>
<tr>
<td>b. Paragraph 606-10-25-30 on when an entity satisfies a performance obligation by transferring control of an asset.</td>
</tr>
</tbody>
</table>
The FASB decided that for an entity to apply the sale-and-leaseback accounting guidance in ASC 842-40, it is necessary for control of the asset to be transferred in accordance with ASC 606. Under ASC 606, the notion of control transfer governs the determination of when to recognize revenue. That is, an entity recognizes revenue when it transfers control of a good or service to a customer. For more information about the control transfer notion in ASC 606, see Deloitte’s Revenue Roadmap.

When appropriate, the FASB has tried to make its use of the control transfer notion consistent with that in ASC 606. For example, like ASC 842-40, the guidance in ASC 610-20 on sales of nonfinancial assets to noncustomers relies on the concepts in ASC 606 related to determining when control of a nonfinancial asset is transferred. (See Chapter 17 of Deloitte’s Revenue Roadmap for further discussion.) In addition, when developing ASC 842, the FASB changed the lessor model to make it more consistent with the control transfer concepts in ASC 606. (See Chapter 9 for further discussion of the lessor accounting model in its entirety.)

Accordingly, having developed a robust control transfer framework related to determining when a sale occurs, the FASB acknowledges in paragraph BC350 of ASU 2016-02 that it was appropriate to use that same framework to determine when to apply sale-and-leaseback accounting.

10.3.1.1 Identifying the Contract

Step 1 of the revenue model requires that a contract exist. This requirement is necessary to establish that there is a valid transaction with economic substance and that it is thus appropriate to proceed with applying the rest of the model in ASC 606 and recognize revenue. The same can be said for the requirements in ASC 842-40-25-1(a); if a contract does not exist for accounting purposes, it would be inappropriate to conclude that the seller-lessee has transferred control of — and sold — an asset to the buyer-lessor.

Generally, when a contract has legally enforceable rights and obligations, it will meet the criterion in ASC 842-40-25-1(a). However, both the seller-lessee and the buyer-lessor should assess any such transaction in accordance with ASC 606-10-25-1 through 25-8. Chapter 4 of Deloitte’s Revenue Roadmap contains a comprehensive analysis of these requirements in ASC 606, and an entity should use that analysis in evaluating whether the criterion in ASC 842-40-25-1(a) is met.

10.3.1.2 Transferring Control at a Point in Time

Once a seller-lessee and a buyer-lessor apply the guidance on identifying a contract in ASC 606 and conclude that a contract exists, each party must assess whether control of the underlying asset has been transferred to the buyer-lessor at a point in time.

Connecting the Dots — Buyer-Lessor Must Use ASC 606 to Determine Whether It Has Purchased the Asset

As noted in Section 10.2.1, a buyer-lessor must assess whether it has obtained control of the underlying asset in a transfer and lease arrangement to determine whether it has purchased the asset and must apply the sale-and-leaseback accounting guidance in ASC 842-40. Accordingly, the buyer-lessor effectively applies the revenue recognition guidance in ASC 606 to determine whether it has obtained control of the underlying asset. If so, the arrangement reflects a purchase of the underlying asset and the buyer-lessor must recognize that asset.
No other standards in U.S. GAAP (e.g., ASC 805, ASC 330, ASC 350, ASC 360) contain a requirement under which a buyer of an asset uses the control transfer notion developed for revenue recognition to determine when it has obtained control of the asset and must recognize that asset.

In accordance with the control transfer principle in ASC 606-10-25-25, to have control, the buyer-lessor must have “the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.” Further, underASC 842-40-25-1(b), the parties to the contract should use the guidance and indicators in ASC 606-10-25-30 to determine whether and, if so, when control has been transferred to the buyer-lessor:

- Accepted the asset
- A present obligation to pay for the asset
- Significant risks and rewards of owning the asset
- Legal title to the asset
- Physical possession of the asset

However, paragraph BC155 of ASU 2014-09 cautions that the indicators in ASC 606-10-25-30 “are not a list of conditions that must be met before an entity can conclude that control of a good . . . has transferred to a customer.” Rather, the indicators “are a list of factors that are often present if a customer has control of an asset and that list is provided to assist entities in applying the principle of control.” Accordingly, an entity must assess all relevant facts and circumstances to determine when control has been transferred to the buyer-lessor.

The implementation guidance in ASC 842-40 contains an example of when certain contractual provisions — in this case, a seller-provided residual value guarantee — may lead to different conclusions about whether control of the asset has been transferred to the buyer-lessor in accordance with ASC 606-10-25-30:

<table>
<thead>
<tr>
<th>ASC 842-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-20</strong> 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.</td>
</tr>
<tr>
<td><strong>55-21</strong> 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).</td>
</tr>
</tbody>
</table>
ASC 842-40-55-21 above is careful to note that (1) the seller-provided residual value guarantee may (or may not) affect an entity’s assessment of the indicator in ASC 606-10-25-30(d) (i.e., whether significant risks and rewards of ownership have been transferred to the buyer-lessee) and (2) an entity’s assessment of the indicator in ASC 606-10-25-30(d), by itself, is not determinative of whether control of the asset has been transferred. These points are further emphasized in paragraph BC353 of ASU 2016-02, where the FASB acknowledges that “there may be substantial judgment involved in determining whether a sale has occurred.”

Paragraph BC353 of ASU 2016-02 goes on to note that, because of the significant judgments involved, an assessment of the indicators in ASC 606-10-25-30 may depend on the facts and circumstances of an arrangement:

For example, in determining when and whether a sale occurs, a seller-lessee may conclude that the buyer-lessee has obtained control of the asset if the buyer-lessee has obtained legal title to the asset, the seller-lessee has a present right to payment for the asset for the sale price, and the buyer-lessee has accepted the significant risks and rewards of ownership. In contrast, an entity may not reach the same conclusion if, for example, the seller-lessee provides a significant residual value guarantee such that the buyer-lessee has not accepted the significant risks and rewards of ownership. If the buyer-lessee has not accepted the significant risks and rewards of ownership..., careful evaluation of the facts and circumstances to determine when and whether a sale occurs in accordance with the principle in Topic 606 may be required.

Connecting the Dots — Potential for Additional Emphasis on Risks and Rewards

In applying the indicators in ASC 606-10-25-30 to a typical sale-and-leaseback transaction, an entity may need to place additional emphasis on its assessment of whether the buyer-lessee has obtained the significant risks and rewards of owning the underlying asset. In a typical sale-and-leaseback transaction, the buyer-lessee takes legal title to the underlying asset and is obligated to pay the seller-lessee for the asset. However, the seller-lessee generally retains physical possession of the underlying asset through the leaseback, and the buyer-lessee’s acceptance of the asset is generally not applicable. Accordingly, additional emphasis may need to be placed on (1) assessing contractual provisions that affect whether the risks and rewards of owning the underlying asset are conveyed to the buyer-lessee and (2) the control principle in ASC 606, to the extent that an assessment of the indicators in ASC 606-10-25-30 alone does not prove conclusive in the determination of which party has control.

In addition, ASC 606-10-25-30 directs entities to consider not only the indicators listed therein but also the guidance in ASC 606 on repurchase agreements and their effect on control transfer. See Section 10.3.3 for further discussion of repurchase options.

Therefore, we think that a seller-lessee and a buyer-lessee should consider the comprehensive discussion in Section 8.6 of Deloitte’s Revenue Roadmap about when control of an asset is transferred at a point in time. Further, Section 8.7 of Deloitte’s Revenue Roadmap includes a robust discussion of the guidance that applies when repurchase agreements affect an entity’s conclusion about whether control of a good has been transferred.

Connecting the Dots — Relinquishing Control Is Not Enough

Conceptually, the transfer of control can be assessed from both the buyer’s and the seller’s perspective; however, the principle in ASC 606 is clear that control should be viewed from the buyer’s perspective. While the timing of control transfer will often be the same from both perspectives (i.e., when the seller surrenders control and the buyer obtains control), under ASC 606-10-25-30 — and thus under ASC 842-40-25-1(b) — the seller’s relinquishment of control is not a sufficient indication that control has been transferred. Rather, to proceed with applying the sale-and-leaseback accounting guidance in ASC 842-40, an entity must conclude that (1) the seller has relinquished control of the asset and (2) the buyer has obtained control of the asset.
While the FASB decided that an entity should use the control transfer notion in ASC 606 to determine when a seller-lessee has sold an underlying asset to a buyer lessor in a sale-and-leaseback transaction, the Board acknowledges in paragraph BC352 of ASU 2016-02 that the leaseback is a unique feature of such arrangements. Accordingly, the Board decided to clarify the application of ASC 606’s control transfer notion in sale-and-leaseback transactions as follows:

1. Under ASC 842-40-25-2, the existence of the leaseback, by itself, does not prevent the seller-lessee from transferring control of the underlying asset to the buyer-lessor. See Section 10.3.2 below for further discussion.

2. ASC 842-40-25-2 further suggests that if the leaseback is classified by the seller-lessee as a finance lease (by the buyer-lessor as a sales-type lease), the seller-lessee retains control of the underlying asset. See Section 10.3.2 below for further discussion.

3. In accordance with ASC 842-40-25-3, the seller-lessee retains control of the underlying asset if it holds an option to repurchase the asset, unless (1) the option is exercisable only at fair value and (2) there are alternative assets, readily available in the marketplace, that are substantially the same as the underlying asset. See Section 10.3.3 for further discussion.

### 10.3.2 Leaseback Is a Finance Lease or a Sales-Type Lease

**ASC 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.

An operating lease, by itself, does not transfer control of the entire underlying asset to the lessee; rather, the operating lease transfers control of the **right to use** the underlying asset to the lessee for a period of time. The right to use an underlying asset for a period of time represents only certain rights associated with the entirety of the asset. The lessor retains all rights associated with the asset once it is returned by the lessee as well as other rights of ownership while the asset is out on lease. In addition, the lessor obtains benefits from the asset through payments made by the lessee during the lease and controls all benefits associated with the residual asset. Accordingly, while the underlying asset is out on lease, a lessor, when considering the principle in ASC 606-10-25-25 and the indicators in ASC 606-10-25-30, still controls the asset.

In paragraph BC352(a) of ASU 2016-02, the FASB indicates that the same is true when a buyer-lessor obtains control of the underlying asset in a sale-and-leaseback transaction. The fact that the buyer-lessor is a lessor of the underlying asset in an operating lease does not preclude the buyer-lessor from obtaining control of that asset. Paragraph BC352(a) of ASU 2016-02 further notes that a sale-and-leaseback transaction is no different from other types of lease arrangements, in which a lessor purchases an asset from a third-party dealer only when all the terms of the lease are in place and the lessor never receives physical possession until the end of the lease term.

However, paragraph BC352(b) of ASU 2016-02 states that when a lessor leases an underlying asset to a lessee under a finance lease or a sales-type lease, “the lessee, in effect, obtains the ability to direct the use of, and obtain substantially all the remaining benefits from, the underlying asset.” That is, the lessee obtains control of the entire underlying asset. See Chapters 8 and 9 for further discussion of the concepts behind lease classification by lessees and lessors, respectively.
Accordingly, when an asset is transferred and leased back through a finance lease or a sales-type lease, the seller-lessee never effectively transfers control of the underlying asset to the buyer-lessor. Thus, a sale of the underlying asset has not occurred and both parties should account for the arrangement as a financing.

### 10.3.3 Repurchase Options

<table>
<thead>
<tr>
<th>ASC 842-40</th>
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<tbody>
<tr>
<td><strong>25-3</strong> 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:</td>
</tr>
<tr>
<td>a. The exercise price of the option is the fair value of the asset at the time the option is exercised.</td>
</tr>
<tr>
<td>b. There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.</td>
</tr>
</tbody>
</table>

As stated in ASC 606-10-55-68 (and further discussed in Section 8.7 of Deloitte’s Revenue Roadmap), a seller’s option or obligation to repurchase an asset generally precludes a buyer from obtaining control of that asset because the buyer “is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the [buyer] may have physical possession of the asset.” In short, an arrangement to transfer an asset when the seller retains an option, or is obligated, to repurchase that asset is not a sale. The guidance that follows in ASC 606 describes the accounting, which will depend on the facts and circumstances of the repurchase agreement.

The control transfer notion from ASC 606, as applied in ASC 842-40, is no different — control of the underlying asset generally is not transferred to the buyer-lessor when the seller-lessee has the option or obligation to repurchase the same asset. However, paragraph BC352(c) of ASU 2016-02 notes that when an option (1) only permits the seller-lessee to repurchase the asset at its then fair value **and** (2) other, similar assets are available in the marketplace such that the buyer-lessor could easily obtain a replacement, the buyer-lessor is not “constrained in its ability to direct the use of and obtain substantially all the remaining benefits from the asset.” Accordingly, when a sale of an underlying asset with a call option meets both of the conditions in ASC 842-40-25-3, neither the seller-lessee nor the buyer-lessor is prevented from applying sale-and-leaseback accounting because of the existence of a repurchase option.

### Q&A 10-6 Alternative Assets for Real Estate

**Question**

Are there ever alternative assets for real estate, substantially the same as the asset transferred, that are readily available in the marketplace?

**Answer**

No. Paragraph BC352(c) of ASU 2016-02 states, in part:

Board members generally observed that real estate assets would not meet [the] criterion [in ASC 842-40-25-3(b)]. 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.”
Accordingly, an entity could never apply sale-and-leaseback accounting under ASC 842-40 in an arrangement involving (1) the transfer of real estate and a leaseback of that same real estate and (2) an option (or obligation) held by the seller to repurchase that real estate. This would be the case regardless of the option’s (or obligation’s) pricing. The seller and buyer would account for the arrangement as a financing. (See Section 10.4.2 for further discussion of the accounting requirements that apply when an arrangement subject to the scope of ASC 842-40 does not qualify as a sale.)

Example

Developer A develops and owns four office buildings as well as the land on which they are built. All of the buildings are designed and built to the same specifications, and all are located on the same street next to each other. Developer A uses building 1, in its entirety, for its own office space.

Developer A sells buildings 2–4 to REIT B. Control of all three buildings is transferred to REIT B in accordance with ASC 610-20. In a separate transaction, Developer A sells building 1 to Partnership C, a real estate venture, and leases the entire building back for 15 years to continue to use it as office space. As part of the arrangement with Partnership C, Developer A holds a call option, exercisable at the then-prevailing market value of the building, to repurchase building 1 at any point during the lease term.

Although there are three other office buildings in the marketplace that (1) could serve as alternative office space for Developer A, (2) are located in substantially the same location, and (3) are designed and built substantially the same, Developer A’s repurchase option on building 1 would not meet the condition in ASC 842-40-25-3(b). This is because land and real estate are so unique that they cannot occupy the exact same spot; therefore, they cannot be “substantially the same” by definition.

Q&A 10-6A  Sale and Leaseback With a Residual Value Guarantee and a Fair Value Purchase Option

In assessing sale-and-leaseback transactions under ASC 842-40-25-3, some have asked whether the existence of a residual value guarantee that includes a fair value purchase option would preclude sale accounting. This concern stems from a view that the existence of the residual value guarantee effectively changes the exercise price of the purchase option from “fair value at date of exercise” to “the greater of fair value at date of exercise or the guaranteed residual value,” thus deviating from the prescriptive pricing guidance in ASC 842-40-25-3(a).

Question

Does the existence of a residual value guarantee combined with a fair value purchase option in an operating leaseback preclude accounting for the transfer of the asset as a sale of the asset?

Answer

No. The existence of a residual value guarantee in combination with a fair value purchase option does not preclude the buyer-lessee from obtaining control of the equipment and therefore should not preclude a sale from being achieved.

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5 Assume that the residual value guarantee, in and of itself, would not preclude transfer of control in the assessment of the risk/reward control indicator in ASC 606-10-25-30(d). See ASC 842-40-55-21 and paragraph BC353 of ASU 2016-02 for further discussion.

6 Assume that the fair value purchase option would satisfy the conditions in ASC 842-40-25-3 to achieve sale accounting. That is, the exercise price of the option is the fair value of the asset at the time the option is exercised and alternative assets, substantially the same as the transferred asset, are readily available in the marketplace.
The notion of control used in determining whether a sale has occurred is generally the same as that used in assessing when control of an asset is transferred to a customer in accordance with ASC 606 or ASC 610-20. In paragraph BC352(c) of ASU 2016-02, the FASB described the impact of a fair value purchase option on this control assessment, stating, “a buyer-lessor is not constrained in its ability to direct the use of and obtain substantially all the remaining benefits from the asset if the seller-lessee can only repurchase the asset at its then-prevailing fair market value and the buyer-lessor could use the proceeds from the repurchase to acquire an asset that is substantially the same in the marketplace. This notion was expressed in a similar manner in the basis for conclusions in Update 2014-09.”

The addition of a residual value guarantee does not result in a conclusion that the buyer-lessor does not obtain control of the asset. Paragraph BC431 of ASU 2014-09 explains that “when the entity guarantees that the customer will receive a minimum amount of sales proceeds, the customer is not constrained in its ability to direct the use of, and obtain substantially all of the benefits from, the asset.” Further, the residual value guarantee would only be triggered if the fair value of the asset declined below that guaranteed amount. That is, the buyer-lessor would always receive consideration at least equal to the fair value of the asset.

In these situations, the buyer-lessor obtains control of the equipment because it is not restricted by either the residual value guarantee or the fair value purchase option (individually or together) from directing the use of and obtaining substantially all the economic benefits from the underlying asset.

Changing Lanes — Sale-and-Leaseback Accounting May Be Harder to Achieve for Equipment

Under ASC 840-40, a repurchase option generally does not preclude sale-and-leaseback accounting for non-real-estate assets (i.e., equipment) unless the option is a bargain. Therefore, it is common for sale-and-leaseback transactions of equipment that are structured under the accounting requirements in ASC 840-40 to contain a fixed-price repurchase option. Contrastingly, any repurchase option on real estate — at any strike price — is generally a form of continuing involvement that precludes sale-and-leaseback accounting under ASC 840-40.

However, under ASC 842-40, it will be harder for sale-and-leaseback transactions of equipment that contain a repurchase option to meet the conditions in ASC 842-40-25-3 (reproduced above). Accordingly, we expect that fewer equipment transactions either (1) will be able to apply the sale-and-leaseback accounting guidance in ASC 842-40 or (2) will be structured with fixed-price repurchase options.

As discussed in Q&A 10-6, any repurchase option on real estate will continue to preclude sale-and-leaseback accounting under ASC 842.
Although the guidance in ASC 842-40-25-3 is derived from, and consistent with, principles in ASC 606, the relationship between the guidance in ASC 842-40-25-3 and that in ASC 606-10-55 on repurchase agreements (through ASC 842-40-25-1) can be difficult to navigate. The decision tree below\(^7\) helps clarify this relationship with respect to situations in which there is a forward or call option on the underlying asset; the Q&A thereafter helps clarify this relationship with respect to situations in which there is a put option.

\(^7\) Note that this decision tree is intended to reflect how an entity would proceed with applying the relevant guidance (the appropriate Codification paragraphs are cited) when a contract contains a forward or call option to repurchase the asset for less than its original selling price; it should be read in conjunction with the referenced Codification paragraphs. For example, if such a contract is not with a customer, an entity would be required to apply the scoping guidance in ASC 610-20 to determine whether the contract is part of a sale-and-leaseback transaction. If not, the entity must consider the control transfer guidance in ASC 606-10-25-30 as well as the guidance on repurchase agreements in ASC 606-10-55.
Chapter 10 — Sale-and-Leaseback Transactions

Q&A 10-7  Buyer-Lessor Holds a Put Option

ASC 606 contains guidance on sales of assets in which the buyer is written an option to put the asset back to the seller. ASC 606-10-55-72 and ASC 606-10-55-74 through 55-76 state the following with respect to the effect of that put option on determining whether control of the asset has been transferred:

ASC 606-10

55-72 If an entity has an obligation to repurchase the asset at the customer’s request (a put option) at a price that is lower than the original selling price of the asset, the entity should consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer’s exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right, the entity should account for the agreement as a lease in accordance with Topic 842 on leases unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with Subtopic 842-40.

55-74 If the customer does not have a significant economic incentive to exercise its right at a price that is lower than the original selling price of the asset, the entity should account for the agreement as if it were the sale of a product with a right of return as described in paragraphs 606-10-55-22 through 55-29.

55-75 If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is in effect a financing arrangement and, therefore, should be accounted for as described in paragraph 606-10-55-70.

55-76 If the repurchase price of the asset is equal to or greater than the original selling price and is less than or equal to the expected market value of the asset, and the customer does not have a significant economic incentive to exercise its right, then the entity should account for the agreement as if it were the sale of a product with a right of return as described in paragraphs 606-10-55-22 through 55-29.

Question

In an arrangement in which an asset is transferred and leased back and the buyer holds an option to put the asset back to the seller, is the put option subject to the guidance in ASC 842-40-25-3 in the determination of whether sale-and-leaseback accounting may be applied?

Answer

No. ASC 842-40-25-3 only addresses “option[s] for the seller-lessee to repurchase the asset” (i.e., call options). However, ASC 606 contains guidance on accounting for the sale of an asset in which the seller is obligated to repurchase that asset at the buyer’s request. ASC 606-10-55-72 specifically addresses arrangements in which the transfer with the put option is part of a potential sale-and-leaseback transaction and, accordingly, circumstances in which the transaction would be accounted for as a financing arrangement.

The Q&As below address other facts and circumstances related to sale-and-leaseback transactions in which the seller-lessee holds (in substance) a repurchase option.
Q&A 10-8  Impact of Contingent Repurchase Provisions on Sale-and-Leaseback Accounting

Question
Does a seller-lessee’s option\(^8\) to repurchase the underlying asset, subject to the occurrence of a contingent event, preclude sale-and-leaseback accounting?

Answer
It depends. A seller-lessee’s option to repurchase the underlying asset generally precludes sale-and-leaseback accounting unless the conditions in ASC 842-40-25-3 are met.\(^9\) However, ASC 842 does not address whether an option to repurchase the underlying asset upon the occurrence of a contingent event should preclude sale-and-leaseback accounting.

If the seller-lessee can unilaterally trigger the contingent event, the repurchase option would generally be assessed in the same manner as a repurchase option without a contingency (see Section 10.3.3). Conversely, if the contingent event is entirely within the control of the buyer-lessee, the repurchase option should generally be assessed in the same manner as a buyer-lessee put option (see Q&A 10-7). If the contingency is not entirely within the control of the seller-lessee or buyer-lessee, an entity must consider the substance of the contingent event to determine whether control has been transferred to the buyer-lessee in a manner consistent with the framework in ASC 606 (see Q&A 8-37 and Section 8.7 in Deloitte’s Revenue Roadmap for a detailed discussion of analyzing contingent call options).

Q&A 10-9  Renewal Options in Which a Leaseback Could Potentially Be Extended for the Entire Economic Life of the Underlying Asset

Question
Is sale-and-leaseback accounting precluded when a leaseback grants a seller-lessee the right to renew the lease for a term that comprises substantially all of the estimated economic life of the underlying asset?

Answer
It depends. The mere existence of renewal rights that cover substantially all of the estimated economic life of the asset is not determinative that a sale is not achieved. If it is reasonably certain that the renewal options will be exercised, the lease term would represent a major part of the economic life of the asset and the leaseback would be classified as a finance lease. In that case, the transaction would fail to qualify for sale-and-leaseback accounting in accordance with ASC 842-40-25-2. Key to this failed-sale determination is the conclusion that the inclusion of the renewal option(s) will result in finance lease (or sales-type lease) classification and, because control of the leased asset has thus not been transferred (see ASC 842-40-25-2), a sale has not been achieved. However, the existence of renewal rights that do not result in a finance lease (or sales-type lease) classification would not automatically lead to a failed sale even when such rights cover a term that comprises substantially all of the estimated economic life of the

\(^8\) Although this Q&A focuses on a seller-lessee’s option to repurchase the underlying asset, we believe that the same concepts would apply to a seller-lessee’s obligation to repurchase the underlying asset upon the occurrence of a contingent event.

\(^9\) If the underlying asset is real estate, as discussed in Q&A 10-6, the condition in ASC 842-40-25-3(b) cannot be met and sale-and-leaseback accounting is therefore always precluded for a transaction that includes an unconditional repurchase option (or obligation) because there are no alternative assets available in the marketplace that are substantially the same as the real estate transferred in the arrangement.
underlying asset. Rather, if the renewal rights do not result in a finance lease classification, the transaction should be assessed in a manner consistent with the discussion below.

Legacy guidance in ASC 840-40 indicates that the buyer-lessor's obligation to share any portion of the appreciation of the property with the seller-lessee is a form of continuing involvement that precludes sale-and-leaseback accounting. Therefore, under ASC 840, renewal options for substantially all of the remaining estimated economic life of the leased asset, at any rate other than a fair market value rate as determined at the time of renewal (e.g., rents that increase by the CPI but are not otherwise adjusted to a market rate at renewal), represent continuing involvement that precludes sale-and-leaseback accounting.

However, the sale-and-leaseback accounting guidance in ASC 842-40 moves away from focusing on continuing involvement to determining whether a sale in a sale-and-leaseback transaction has occurred. Under ASC 842-40, the control transfer principle in ASC 606 is used to determine whether the transfer of the underlying asset is a sale. Specifically, under ASC 842-40-25-1, an entity must consider the guidance in ASC 606-10-25-30 on when it satisfies a performance obligation by transferring control of an asset (see Section 10.3.1.2).

ASC 606-10-25-30 refers to the guidance on control transfer in ASC 606-10-25-23 through 25-26 and the guidance on repurchase agreements in ASC 606-10-55 and provides five indicators for an entity to consider when determining whether a customer has obtained control of an asset. However, as discussed in Section 10.3.1.2, paragraph BC155 of ASU 2014-09 cautions that the indicators in ASC 606-10-25-30 are not a list of conditions that need to be met for an entity to conclude that control has been transferred. Rather, the assessment should be based on the underlying principle in ASC 606-10-25-25, which states that “control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset” and that “control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.”

Accordingly, under ASC 842-40, a sale-and-leaseback transaction in which the leaseback grants a seller-lessee the right to renew the lease for a term that comprises substantially all of the economic life of the underlying asset should be assessed to determine whether the buyer-lessor has obtained control of that asset. In such transactions, at least three of the indicators in ASC 606-10-25-30 often will be met (i.e., the buyer-lessor has accepted the asset, has a present obligation to pay for the asset, and has legal title to the asset). Therefore, in line with the discussion in the Connecting the Dots in Section 10.3.1.2, the assessment is likely to focus on whether the renewal options affect the buyer-lessor's ability to direct the use of, and obtain, substantially all of the remaining economic benefits of the asset.

In a manner similar to the guidance in legacy GAAP noted above, we do not believe that fair market value renewal options that extend throughout the economic life of the underlying asset would preclude a successful sale determination. In addition, under the control principle that underlies ASC 842 (and ASC 606), we believe that fixed-price renewal options that extend throughout the entire economic life of the underlying asset would not automatically preclude a successful sale conclusion. In each of these circumstances, the buyer-lessor and seller-lessee must evaluate whether the buyer-lessor obtains control of the underlying asset. If the buyer-lessor is able to control the asset (i.e., has the ability to direct the use of and obtain substantially all of the economic benefits from the asset), we believe that sale recognition is appropriate.

In developing our view, we considered the discussion in paragraph BC218 of ASU 2016-02, which suggests that purchase options and extension options for all of the remaining economic life of the underlying asset should be accounted for in the same way. Ultimately, however, we did not think that the Board's intent was to create a form of double jeopardy for sale-and-leasebacks that satisfy the condition in ASC 842-40-25-2 after considering the probability of exercise of the lessee's extension options.
However, if the seller-lessee retains control of the asset, the transaction would represent a failed sale-and-leaseback and should be accounted for as a financing arrangement.

10.3.4 Transfer of Tax Benefits

The frequency of cross-border tax-benefit lease transactions has declined because many foreign countries have eliminated the related tax advantages. However, ASC 842 contains certain implementation guidance on applying the sale-and-leaseback accounting provisions of ASC 842-40 to determine whether it is appropriate to recognize income in such transactions.

ASC 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.

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.

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.

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.

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.

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.

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.
10.4 Recognition and Measurement

As illustrated in the decision tree in Section 10.2.1, the analysis performed to determine whether the transfer of the underlying asset is a sale (as discussed in Section 10.3) governs the recognition and measurement of the transaction. Effectively, if the transfer of the asset by the seller-lessee to the buyer-lessor is determined to be a sale, the transaction is accounted for as a sale and leaseback. In addition, if the transfer of the asset is a sale, the measurement of the sale and leaseback further depends on whether the transfer is at fair value. However, if the transfer of the asset by the seller-lessee to the buyer-lessor is not determined to be a sale, both parties would account for the transaction as a financing arrangement.

The decision tree below illustrates the recognition and measurement guidance.
Do not recognize the asset, and recognize amounts paid as a financial asset. (See Section 10.4.2.2)

Do not derecognize the asset, and recognize amounts received as a financial liability. (See Section 10.4.2.1)

Start

Is the transfer of the asset by the seller-lessee to the buyer-lessee a sale? (See Section 10.3)

Yes

Account for the transaction as a sale and leaseback. (See Section 10.4.1)

Buyer-lessee

Derecognize the asset and recognize profit or loss on the sale. Account for the leaseback in accordance with lessee accounting guidance (see Chapter 8). (See Section 10.4.1)

Seller-lessee

Account for the transaction as a financing arrangement. (See Section 10.4.2)

No

Is the asset transferred at fair value? (See Section 10.4.1.1)

Yes

The transaction is at market; do not adjust the purchase price.

Buyer-lessee

The transaction is at market; do not adjust the sale price.

Seller-lessee

No

Is the asset transferred at fair value? (See Section 10.4.1.1)

No

Adjust the purchase price of the asset for off-market terms; an increase to the purchase price is a prepayment of rent, and a reduction of the purchase price is a financial asset (rent receivable). (See Section 10.4.1.2)

Adjust the sale price of the asset for off-market terms; an increase to the sale price is a prepayment of rent, and a reduction of the sale price is a financial liability (rent payable). (See Section 10.4.1.2)
10.4.1 Transfer of the Asset Is a Sale

ASC 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.

Effectively, when the transfer of the asset is determined to be a sale, both the seller-lessee’s and the buyer-lessor’s accounting can be divided into two steps:

<table>
<thead>
<tr>
<th>Step</th>
<th>Seller-Lessee</th>
<th>Buyer-Lessor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>At the time the buyer-lessor obtains control of the underlying asset in accordance with ASC 606-10-25-30 (see Section 10.3.1), (1) derecognize the carrying amount of the asset and (2) recognize the profit or loss on sale, calculated as the difference between the transaction price determined in accordance with ASC 606 and the carrying amount of the asset</td>
<td>At the time the buyer-lessor obtains control of the underlying asset in accordance with ASC 606-10-25-30 (see Section 10.3.1), recognize the underlying asset under other U.S. GAAP (e.g., ASC 330, ASC 360)</td>
</tr>
<tr>
<td>2</td>
<td>Account for the lease in accordance with the lessee accounting model in ASC 842-20 (see Chapter 8)</td>
<td>Account for the lease in accordance with the lessor accounting model in ASC 842-30 (see Chapter 9)</td>
</tr>
</tbody>
</table>

ASC 842-40-25-4(a)(1) requires the seller-lessee to consider the transaction price guidance in ASC 606. Therefore, we think that a seller-lessee should consider the comprehensive discussion in Chapter 6 of Deloitte’s Revenue Roadmap to determine the transaction price for the sale. If the sale-and-leaseback transaction is at market, the transaction price and the fair value of the underlying asset should be equal. However, as indicated in ASC 842-40-30-1 and ASC 842-40-30-3 (reproduced below) and further discussed in Section 10.4.1.1, the transaction price for the seller-lessee’s profit recognition would include an “adjustment” to arrive at market-based terms.

Connecting the Dots — Buyer-Lessor’s Measurement of the Underlying Asset

ASC 842-40-25-4 (reproduced above) clarifies that ASC 842’s sale-and-leaseback accounting guidance is more prescriptive regarding the seller-lessee’s recognition and initial measurement requirements than it is regarding the buyer-lessor’s. ASC 842-40-25-4(b) does not address the transaction price determined in accordance with ASC 606 and directs the buyer-lessee to other U.S. GAAP for guidance on determining the appropriate recognition and measurement requirements for the underlying asset. Therefore, as discussed in Section 10.3.1.2, while a buyer-lessor clearly must apply ASC 606 to determine whether and, if so, when it obtains control of an asset (i.e., step 5 of the revenue model), it is unclear whether it should apply the measurement concepts in ASC 606 (i.e., step 3 of the revenue model) to initially measure the
asset it must recognize. For example, it is unclear whether the buyer-lessee should apply the guidance in ASC 606 on estimating variable consideration. This could create an inconsistency in the extent to which the concepts in ASC 606 are used in sale-and-leaseback accounting.

The buyer-lessee should consider the relevant measurement concepts in other applicable U.S. GAAP (e.g., ASC 330, ASC 360).

### Changing Lanes — All or None

The existing sale-and-leaseback accounting guidance in ASC 840-40 restricts the amount of profit that a seller-lessee may recognize and requires deferral of profit amounts depending on the extent of the seller-lessee's retained use of, or continuing involvement in, the underlying asset.

This is not the case under ASC 842's sale-and-leaseback accounting guidance. That is, if the transfer of the underlying asset is a sale, the full profit or loss (to the extent that the terms of the sale are at fair value) is recognized when the buyer-lessee obtains control of the asset. Alternatively, if the transfer of the asset is not a sale, no profit or loss may be recognized. There is no accounting that is “in between” those two recognition requirements, so either all or none of the profit or loss on the transaction is recognized.

In paragraph BC360 of ASU 2016-02, the FASB noted that certain stakeholders had suggested that the sale-and-leaseback guidance should require deferral of profit or loss in certain situations. Accordingly, the Board considered recognition and measurement guidance that would have precluded recognizing the amount of profit or loss associated with the rights in the underlying asset retained by the seller-lessee through the leaseback. However, the Board ultimately rejected such an approach on the basis that the accounting for the transfer of control (i.e., the sale) of the underlying asset, as well as the accounting for the transfer of the right to use (i.e., the lease of) the asset, should not be affected by each other when the transaction in its entirety is priced at fair value.

### 10.4.1.1 Determining Whether the Sale Is at Fair Value

<table>
<thead>
<tr>
<th><strong>ASC 842-40</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-1</strong> 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:</td>
</tr>
<tr>
<td>a. The sale price of the asset and the fair value of the asset</td>
</tr>
<tr>
<td>b. The present value of the lease payments and the present value of market rental payments.</td>
</tr>
<tr>
<td><strong>30-3</strong> 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.</td>
</tr>
<tr>
<td><strong>30-5</strong> See Examples 1 and 2 (paragraphs 842-40-55-22 through 55-38) for illustrations of the requirements for a sale and leaseback transaction.</td>
</tr>
</tbody>
</table>
ASC 842-40 requires that a sale-and-leaseback transaction be accounted for at market (i.e., at fair value). Accordingly, the seller-lessee’s profit or loss on the transaction will always be calculated as the difference between the carrying amount of the underlying asset and its fair value.

**Connecting the Dots — Off-Market Terms**

Because the sale and the leaseback are negotiated together as a single transaction, there is an opportunity to structure payment terms and move cash flows between the two to achieve a certain result. The FASB acknowledged this in paragraph BC361 of ASU 2016-02:

> The lease payments and the sales price in a sale and leaseback transaction are interdependent because they are negotiated as a package (for example, as part of the same contract or in two or more contracts that will be combined in accordance with the contract combinations guidance in paragraph 842-10-25-19). That is, the sales price might be more than the fair value of the asset because the leaseback lease payments are above a market rate; conversely, the sales price might be less than the fair value because the leaseback lease payments are below a market rate. That could result in the misstatement of both gains and losses on disposal of the asset for the seller-lessee and the carrying amount of the asset for the buyer-lessor, as well as result in misleading lease expense (for the seller-lessee) or lease income (for the buyer-lessor) related to the leaseback.

To remove this structuring opportunity, the Board decided to require that the accounting for sale-and-leaseback transactions be at fair value. Any difference from market terms is reflected as an adjustment in the amount of profit or loss (see Section 10.4.1.3).

ASC 842-40-30-1 indicates that in determining whether the transaction is at fair value, the parties to the transaction must compare either the (1) sale price and fair value or (2) present value of lease payments and present value of market rental rates. The parties are required to use whichever benchmark is more readily determinable. In addition, paragraph BC364 of ASU 2016-02 notes that the parties should “maximize the use of observable prices and observable information” when selecting the most appropriate benchmark.

In a transaction negotiated between independent parties, the sale price of the asset is generally the best indicator of its fair value. However, there may be instances in which the stated fair value of the asset does not equal its sale price. In those instances, a valuation specialist should determine the fair value of the asset by using other standard valuation techniques (e.g., comparison to the sale price of comparable assets, discounted cash flow analysis, calculation of replacement cost), keeping in mind the guidance noted above from ASC 842-40-30-1 and paragraph BC364 of ASU 2016-02.

In accordance with ASC 842-40-30-3, the “sale price” referred to in ASC 842-40-30-1(a) could be described as the transaction price determined in accordance with ASC 606 before constraining any estimate of variable consideration. (The same could be said for the “present value of lease payments” referred to in ASC 842-40-30-1(b).) That is, the transaction is not off-market solely because the sale price (or lease payments) includes variable amounts. To determine whether the sale-and-leaseback transaction is at fair value, the sale price (or present value of lease payments) should include an estimate of variable payments.
Example 10-2

Seller-Lessee agrees to sell tower assets to Buyer-Lessor and lease them back under the following terms:

- Carrying amount of assets: $3 million.
- Fair value of assets: $9 million.
- Economic life of assets: 7 years.
- Sale price of assets: $7 million paid up front, with a bonus of $2 million if certain local government permits are approved.
- Lease term: 5 years.
- Lease payments: $2 million fixed annually.
- Seller-Lessee’s incremental borrowing rate: 9.00 percent.\(^{11}\)
- Buyer-Lessor’s rate implicit in the lease: 7.35 percent.

Seller-Lessee concludes that the transfer of the tower assets is a sale (i.e., control has been transferred to Buyer-Lessor) in accordance with ASC 842-40-25-1 through 25-3.

Seller-Lessee estimates its sale price to be $9 million in accordance with ASC 842-40-30-3. Seller-Lessee used a most likely amount of $2 million to estimate variable consideration (before any constraint) in the sale price. Seller-Lessee recognizes the full profit on the sale of the tower assets. Profit is unadjusted because, in accordance with ASC 842-40-30-1, the sale price is equal to fair value.

<table>
<thead>
<tr>
<th>Cash</th>
<th>7,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract asset</td>
<td>2,000,000</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>6,000,000</td>
</tr>
<tr>
<td>ROU asset</td>
<td>7,779,303*</td>
</tr>
<tr>
<td>Lease liability</td>
<td>7,779,303</td>
</tr>
</tbody>
</table>

* Calculated on the basis of a fixed annual lease payment of $2 million and an incremental borrowing rate of 9 percent.

In accordance with ASC 842-40-25-2, control has not been transferred to Buyer-Lessor from Buyer-Lessor’s perspective. In using the rate implicit in the lease (which is lower than Seller-Lessee’s incremental borrowing rate), Buyer-Lessor concludes that the present value of the lease payments represents substantially all of the fair value of the tower assets and the lease is therefore a sales-type lease. As noted in Section 10.3, it may be reasonable for a seller-lessee and a buyer-lessor to reach different conclusions about whether control of the asset is transferred to the buyer-lessor.

See Example 10-4 in Section 10.4.2.2 for Buyer-Lessor’s accounting for this transaction as well as its basis for the lease classification conclusions described above.

\(^{11}\) The rate implicit in the lease is not readily determinable by Seller-Lessee.
Q&A 10-10  Sale and Leaseback of an Asset Portfolio

Question
May a company that sells a portfolio of assets to a single purchaser, and leases back all of the assets under the terms of a master leasing arrangement, calculate its gain on the sale on a portfolio basis?

Answer
Each sale-and-leaseback transaction in the portfolio should be accounted for separately as long as there is sufficient evidence that the terms of the transaction were not affected by other sale-and-leaseback transactions in the portfolio entered into at approximately the same time. If the terms of a transaction are such that the sale price of the asset does not represent a market price or the lease arrangement provides for off-market rental rates, that transaction should be accounted for collectively with other similar transactions.

Regardless of whether the transactions are accounted for individually or collectively, each individual transaction must be evaluated to determine whether the fair value of the individual asset is less than its carrying amount. In such circumstances, a loss should be recognized immediately.

Example
Company A sells and leases back five shopping centers, all of which are physically separated and in different locations. The transfer of the assets is a sale in accordance with ASC 842-40-25-1 through 25-3. The sale price of the properties equals their fair market value on a portfolio basis but not on an individual property basis. Because the terms of the individual transactions were affected by the fact that they were negotiated at the same time, A should calculate its gain on a portfolio basis. If, however, A determines that there is a loss on one or more of the shopping centers (i.e., the carrying value of the shopping center exceeds its fair value), that loss should be recognized immediately and should not be offset against the gain for the portfolio.

10.4.1.2  Sale Is Not at Fair Value

ASC 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.
As indicated in Section 10.4.1.1 and in ASC 842-40-30-1, sale-and-leaseback transactions are always accounted for at fair value. The profit or loss on the transactions is determined by reference to the fair value of the asset and its carrying value. Accordingly, the sale price may need to be adjusted to reflect the appropriate profit or loss calculation, resulting in the following:

<table>
<thead>
<tr>
<th>Situation</th>
<th>Seller-Lessee</th>
<th>Buyer-Lessor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value &gt; sale price (i.e., sale price is “below market”)</td>
<td>↑ Sale price</td>
<td>↑ Purchase price</td>
</tr>
<tr>
<td></td>
<td>↑ Profit recognized</td>
<td>↑ Deferred rent credit</td>
</tr>
<tr>
<td></td>
<td>↓ Loss recognized</td>
<td></td>
</tr>
<tr>
<td></td>
<td>↑ Rent prepayment</td>
<td></td>
</tr>
<tr>
<td>Fair value &lt; sale price (i.e., sale price is “above market”)</td>
<td>↓ Sale price</td>
<td>↓ Purchase price</td>
</tr>
<tr>
<td></td>
<td>↓ Profit recognized</td>
<td>↑ Financial asset (rent receivable)</td>
</tr>
<tr>
<td></td>
<td>↑ Loss recognized</td>
<td></td>
</tr>
<tr>
<td></td>
<td>↑ Financial liability (rent payable)</td>
<td></td>
</tr>
</tbody>
</table>

When the sale price is above market, both the seller-lessee and the buyer-lessee in the transaction must allocate the payments under the leaseback between those for the lease and those for the additional financing (i.e., for the financial liability or the financial asset). For the seller-lessee, the allocation must result in a zero balance at the end of the lease term for both the financial liability and the lease liability. For the buyer-lessee, the allocation must result in a zero balance at the end of the lease term for the financial asset (and if the lease is classified as a direct-financing lease, a zero balance in the lease receivable in the net investment).

Example 1 in ASC 842-40-55-23 through 55-30 illustrates the accounting by both parties in a sale-and-leaseback transaction when the sale is not at fair value:

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### ASC 842-40

#### Illustration of Sale and Leaseback Transaction

55-22 Examples 1 and 2 illustrate the accounting for sale and leaseback transactions.

#### Example 1 — Sale and Leaseback Transaction

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.
### ASC 842-40 (continued)

#### 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.

#### 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.

#### 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.

#### 55-27
At the end of the lease term, the financing obligation and the lease liability equal $0.

#### 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.

#### 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.

#### 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.
Example 10-3

Seller-Lessee agrees to sell a ship to Buyer-Lessor and lease it back under the following terms:

- Carrying amount of assets: $10 million.
- Fair value of assets: $8 million.
- Economic life of assets: 20 years.
- Sale price of assets: $6 million.
- Lease term: 5 years.
- Lease payments: $500,000 fixed annually.
- Seller-Lessee's incremental borrowing rate: 10.00 percent.\(^\text{12}\)
- Buyer-Lessor's rate implicit in the lease: 10.32 percent.

Both Seller-Lessee and Buyer-Lessor conclude that the transfer of the ship is a sale (i.e., control of the ship has been transferred to Buyer-Lessor) in accordance with ASC 842-40-25-1 through 25-3. As part of that analysis, both classify the lease as an operating lease in accordance with ASC 842-10-25-2.

In accordance with ASC 842-40-30-1, the sale is off-market because the sale price is below market (i.e., sale price is less than fair value). Accordingly, Seller-Lessee and Buyer-Lessor must adjust both the sale price and purchase price, respectively, to account for the transaction at fair value in accordance with ASC 842-40-30-2.

Each party would record the transaction at commencement as follows:

**Seller-Lessee**

<table>
<thead>
<tr>
<th>Cash</th>
<th>6,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROU asset*</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Loss on sale</td>
<td>2,000,000</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>10,000,000</td>
</tr>
<tr>
<td>ROU asset</td>
<td>1,895,393</td>
</tr>
<tr>
<td>Lease liability</td>
<td>1,895,393</td>
</tr>
</tbody>
</table>

**Buyer-Lessor**

<table>
<thead>
<tr>
<th>Asset</th>
<th>8,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Deferred rent credit**</td>
<td>2,000,000</td>
</tr>
</tbody>
</table>

* The transaction is below market by $2 million. In accordance with ASC 842-40-30-2(a), an increase to the sales price to adjust for off-market terms reflects a prepayment of rent. The prepaid rent would be included in Seller-Lessee’s initial measurement of the ROU asset in accordance with ASC 842-20-30-5. See Chapter 8 for a detailed discussion of a lessee’s accounting for an operating lease.

** Because Buyer-Lessor classified the lease as an operating lease in accordance with ASC 842-10-25-2, this deferred rent credit would be recognized as lease income ratably over the five-year lease term. See Chapter 9 for a detailed discussion of a lessor’s accounting for an operating lease.

\(^\text{12}\) The rate implicit in the lease is not readily determinable by Seller-Lessee.

10.4.1.3 Related-Party Leases

**ASC 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.
In a manner similar to the guidance in ASC 842-10-55-12, a related-party lease in a sale-and-leaseback transaction should be accounted for according to its contractually stated — and legally enforceable — terms rather than according to economic substance as required by ASC 840. Accordingly, an entity is not required to adjust the sales price for off-market terms in these arrangements.

See Section 13.2 for more information about related-party leases. See Chapter 15 for a detailed discussion of the disclosure requirements in ASC 842.

10.4.2 Transfer of the Asset Is Not a Sale

10.4.2.1 Seller-Lessee Accounting

<table>
<thead>
<tr>
<th>ASC 842-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-5</strong> 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:</td>
</tr>
<tr>
<td>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. . . .</td>
</tr>
</tbody>
</table>

The accounting by a seller-lessee for a failed sale and leaseback is fairly straightforward. The substance of the transaction when control of the underlying asset is not transferred to the buyer-lessee is that of a financing arrangement. Accordingly, in such cases, the seller-lessee should keep the asset on its books and recognize a corresponding financial liability for the cash received from the buyer-lessee.

The seller-lessee's accounting for a failed sale-and-leaseback transaction is consistent with the accounting for failed sale-and-leaseback transactions in ASC 840 as well as with the accounting for a failed sale in ASC 606 (e.g., when a sale with a repurchase agreement prevents the customer from obtaining control of the good or service). The FASB acknowledges the consistency with both standards in paragraph BC368 of ASU 2016-02.

The asset should continue to be subsequently measured as any other owned asset in accordance with ASC 360 (e.g., depreciated, subject to impairment testing). See Q&A 11-5 for additional discussion of the subsequent measurement of an asset in a failed sale-and-leaseback transaction. The initial and subsequent measurement of the financial liability should generally be determined in accordance with other applicable GAAP (e.g., ASC 470, ASC 835-30). However, ASC 842-40 does provide limited guidance on the interest rate to be used in measuring the financial liability:

<table>
<thead>
<tr>
<th>ASC 842-40</th>
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<tbody>
<tr>
<td><strong>30-6</strong> 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:</td>
</tr>
<tr>
<td>a. Interest on the financial liability is not greater than the 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.</td>
</tr>
<tr>
<td>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-lessee (for example, the date at which a repurchase option expires if that date is earlier than the end of the lease term).</td>
</tr>
</tbody>
</table>
In paragraph BC370 of ASU 2016-02, the FASB notes that the guidance in ASC 842-40-30-6 under which an entity must adjust the seller-lessee interest rate “is generally consistent with practice in previous GAAP” (i.e., with practice under the sale-and-leaseback accounting guidance in ASC 840-40).

In addition, paragraph BC369 of ASU 2016-02 clarifies certain aspects of the subsequent measurement of the financial liability recognized by the seller-lessee:

As the seller-lessee makes the scheduled payments in the contract, it will allocate those payments between interest expense on the financial liability and repayment of principal on the financial liability. At the end of the “leaseback” period (or at the point in time the buyer-lesser obtains control of the underlying asset), the seller-lessee will recognize any remaining balance of the financial liability as the proceeds on the sale of the asset. The gain or loss recognized at that point will reflect any difference between those proceeds and the carrying amount of the asset.

**Connecting the Dots — Transaction Subsequently Qualifies as a Sale and Leaseback**

Paragraph BC369 of ASU 2016-02 (reproduced above) notes an additional important point: control of the underlying asset may be transferred to the buyer-lessee after contract commencement. In other words, the “failed” sale may be rectified, and the transaction may qualify for sale-and-leaseback accounting, at the point when the buyer-lessee obtains control of the underlying asset. This could occur if a seller-lessee repurchase option expires unexercised, the classification of the leaseback changes from a finance lease to an operating lease in accordance with ASC 842-10-25-1, or control is transferred before the end of the contract term in a manner consistent with the control principle and indicators in ASC 606.

When this happens, in a manner similar to the seller-lessee’s accounting at the end of the contract term when control of the asset is never transferred, the seller-lessee would derecognize the underlying asset, derecognize the financial liability, and recognize profit or loss for the difference between the two. The leaseback would be accounted for in accordance with the lessee accounting model in ASC 842-20 (see Chapter 8), as indicated in Section 10.4.1.

However, the guidance in ASC 842-40-30-6 indicates that the interest rate on the financial liability should be adjusted to avoid recognition of a loss at the time when control of the asset is transferred. Therefore, when control of the underlying asset is subsequently transferred, we would expect loss recognition to be rare (i.e., only in situations in which control is transferred earlier than expected).

Example 2 in ASC 842-40-55-31 through 55-38 (reproduced in Section 10.4.2.3) illustrates the accounting for a transaction that subsequently qualifies as a sale and leaseback.

**Q&A 10-11 Recognition of an Impairment Loss in a Failed Sale and Leaseback**

**Question**

If the carrying value of an asset exceeds its fair value, should the seller-lessee recognize an immediate loss if the transaction does not meet the requirements for sale-and-leaseback accounting under ASC 842-40?
Answer

If the transaction is a financing arrangement because the buyer-lessor does not obtain control of the underlying asset, the seller-lessee should determine whether an impairment charge is required under ASC 360. Under the ASC 360 model, an impairment charge is required if the sum of the cash flows (undiscounted) expected to result from the use of the asset and its eventual disposition is less than the carrying amount of the asset. The amount of the impairment is measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset.

If, thereafter, control of the underlying asset is subsequently transferred to the buyer-lessor and the transaction subsequently meets the requirements in ASC 842-40 for sale-and-leaseback accounting, an immediate loss should be recognized for the excess of the carrying amount of the underlying asset over the carrying amount of the financial liability as of the date on which sale-and-leaseback accounting becomes appropriate.

Q&A 10-12  Interest Rate Considerations for a Failed Sale and Leaseback

Under ASC 842-40-30-6(b), the seller-lessee’s interest rate applied to the deemed financing arrangement in a failed sale and leaseback must be adjusted to avoid a “built-in loss” at the end of the arrangement. Specifically, ASC 842-40-30-6(b) stipulates that the interest rate on a seller-lessee’s financial liability must be adjusted, as necessary, to ensure that “[t]he 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.” However, ASC 842-40-30-6(b) is silent on whether the interest rate should be subsequently adjusted if the underlying asset is impaired, thereby reducing or eliminating the original built-in loss.

Question

If a seller-lessee expected a built-in loss and therefore increased the interest rate to eliminate it, can the rate subsequently be adjusted (i.e., lowered) if the underlying asset is impaired (thereby reducing or eliminating the original built-in loss)?

Answer

No. Under a financing model, the asset accounting is divorced or delinked from the liability accounting after initial recognition and measurement of the financing arrangement. Accordingly, we believe that it would not be appropriate to make corresponding adjustments to the interest rate on the liability upon the recognition of an impairment of the underlying asset.

10.4.2.2  Buyer-Lessor Accounting

<table>
<thead>
<tr>
<th>ASC 842-40</th>
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</thead>
<tbody>
<tr>
<td>25-5</td>
</tr>
<tr>
<td>b.</td>
</tr>
</tbody>
</table>
A buyer-lessee’s accounting for a failed sale and leaseback is also straightforward. The substance of the transaction when the buyer-lessee does not obtain control of the underlying asset is that of a financing arrangement. Accordingly, under ASC 842, the buyer-lessee should not recognize the underlying asset but should instead recognize a financial asset for the cash paid. The buyer-lessee should look to other GAAP (e.g., ASC 310, ASC 835-30, ASC 326) to determine the appropriate initial and subsequent measurement of the financial asset. Note that the seller-lessee interest rate guidance in ASC 842-40-30-6 does not apply to the buyer-lessee’s accounting for the financial asset.

Changing Lanes — Accounting for a Failed Purchase and Leaseback

As mentioned previously in this chapter, ASC 842-40 provides guidance on the buyer-lessee’s accounting. The same is true when the transfer of the underlying asset in the transaction is not a sale. The sale-and-leaseback accounting guidance in ASC 840 does not prescribe accounting requirements for buyer-lessees in a failed sale and leaseback. Accordingly, it was entirely possible for the asset to remain on the books of the seller-lessee but for the buyer-lessee to recognize that same asset in accordance with ASC 360, ASC 805, or both. That is no longer the case under ASC 842, which requires both parties to account for the substance of a failed sale-and-leaseback transaction as a financing arrangement.

Connecting the Dots — Transaction Subsequently Qualifies as a Purchase and Leaseback

Paragraph BC369 of ASU 2016-02 and Section 10.4.2.1 indicate that the buyer-lessee may obtain control of the underlying asset after contract commencement (i.e., after the initial assessment of whether control has been transferred). However, paragraph BC369 of ASU 2016-02 does not mention the buyer-lessee’s accounting for situations in which this occurs, nor does it discuss the buyer-lessee’s accounting at the end of the contract term.

In either situation, the buyer-lessee would derecognize the financial asset and recognize the underlying asset at the same amount. The leaseback would be accounted for in accordance with the lessor accounting model in ASC 842-30 (see Chapter 9), as indicated in Section 10.4.1.

Example 2 in ASC 842-40-55-31 through 55-38 (reproduced in Section 10.4.2.3) illustrates the accounting for a transaction that subsequently qualifies as a sale and leaseback.

Example 10-4

This example is a continuation of the fact pattern from Example 10-2. Buyer-Lessor has concluded that the present value of the lease payments ($8,123,347) represents substantially all (90.26 percent) of the fair value of the tower assets ($9,000,000). The lease would therefore be classified as a sales-type lease and, in accordance with ASC 842-40-25-2, Buyer-Lessor has not obtained control of the tower assets.

Buyer-Lessor accounts for the financing arrangement at commencement as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset</td>
<td>7,000,000*</td>
</tr>
<tr>
<td>Cash</td>
<td>7,000,000</td>
</tr>
</tbody>
</table>

* If and when the local government permits are approved and the $2 million bonus is received, Buyer-Lessor would include that consideration as additional financing.

---

13 Calculated on the basis of a fixed annual lease payment of $2 million and a rate implicit in the lease of 7.35 percent.
10.4.2.3 **Illustrative Example**

Example 2 in ASC 842-40-55-31 through 55-38 illustrates the accounting by both parties when the transfer of the underlying asset is not a sale.

### ASC 842-40

**Example 2 — Accounting for a Failed Sale and Leaseback Transaction**

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.

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.

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 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-lessee; 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.

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.

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).
ASC 842-40 (continued)

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.

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).

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.
Chapter 11 — Control of the Underlying Asset Before Lease Commencement

11.1 Overview
11.2 Lessee's Involvement With an Asset Before Lease Commencement
11.3 Lessee's Involvement in Construction Before Lease Commencement (Build-to-Suit Arrangements)
   11.3.1 Costs Related to the Construction or Design of an Underlying Asset
   11.3.2 Control of the Underlying Asset During Construction
11.4 Accounting by the Deemed Owner of an Asset
11.1 Overview
Transactions in which a lessee controls an underlying asset before the commencement date of the lease (in a manner discussed below) are within the scope of the sale-and-leaseback guidance in ASC 842-40. That is, if a lessee controls an underlying asset in the manner discussed in ASC 842-40-55 before the commencement date, the lessee must determine whether derecognition is appropriate as a sale-and-leaseback transaction. Sections 10.2.2 and 10.3 discuss control transfer in accordance with the sale-and-leaseback guidance in ASC 842-40.

The guidance in ASC 842-40-55 effectively categorizes these transactions into two groups:

1. ASC 842-40-55-1 and 55-2 cover transactions in which the lessee is involved with an asset before that asset is transferred to the lessor. See Section 11.2 below for more information.
2. ASC 842-40-55-3 through 55-6 address transactions in which the lessee is involved with a construction project (i.e., the underlying asset that will be subject to the lease is in the process of being constructed). See Section 11.3 for more information.

In addition, see Section 11.4 for a discussion of the lessee's accounting for an underlying asset it controls before lease commencement (i.e., accounting by the “deemed owner” of the asset).

Changing Lanes — Scope of Accounting Guidance for a Future Lessor in Transactions in Which a Future Lessee (Potentially a Seller-Lessee) Controls the Underlying Asset Before Lease Commencement

As stated above, the sale-and-leaseback guidance in ASC 842-40 addresses transactions in which a lessee controls the underlying asset before lease commencement. The scope of ASC 842-40 applies to both the future lessee and the future lessor in these types of transactions. Thus, the scope of sale-and-leaseback accounting in ASC 842-40 differs from that in ASC 840-40, which applies only to the future lessee (i.e., the seller-lessee). ASC 842 therefore results in a significant change for lessors engaged in these transactions, since they must now also assess whether the counterparty in the arrangement (the lessee) has control of the underlying asset before the commencement date of the lease (i.e., they must determine whether the seller-lessee has obtained control of the underlying asset before control is transferred to the buyer-lessor and the asset is leased back to the seller-lessee).

Entities (both parties) involved in arrangements in which a construction period is followed by a lease should carefully consider the lessee's involvement in the construction project to determine whether the arrangement is within the scope of the guidance on sale-and-leaseback accounting in ASC 842-40 as a result of such involvement. The implementation guidance in ASC 842-40-55 addresses specific situations (not all-inclusive) that would indicate that an arrangement is within the scope of the sale-and-leaseback guidance in ASC 842-40. See Section 11.3.2 for additional information.

11.2 Lessee’s Involvement With an Asset Before Lease Commencement

<table>
<thead>
<tr>
<th>ASC 842-40</th>
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<tr>
<td>55-1</td>
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</table>
ASC 842-40 (continued)

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.

ASC 842-40-55-1 and 55-2 clarify that the notion of control is used to determine whether a transaction is within the scope of the sale-and-leaseback guidance — if the lessee controls the underlying asset before transferring it to the lessor (and is thus the deemed owner), the transaction is accounted for in accordance with ASC 842-40. See Q&A 10-1 for discussion of an example of this scenario.

When the lessee obtains legal title to the underlying asset before transferring title to the lessor (i.e., the lessee obtains “flash title”) and the lessee does not control the underlying asset before transferring the asset to the lessor, the transaction is not accounted for in accordance with ASC 842-40. ASC 842-40-55-2 provides an example of such a situation, in which an entity often obtains financing or a certain tax treatment.

These same concepts apply to the transfer of an asset under construction, as discussed in Section 11.3.

11.3 Lessee’s Involvement in Construction Before Lease Commencement (Build-to-Suit Arrangements)

Build-to-suit arrangements can broadly be defined as arrangements in which a lessee is involved in construction of an asset it will eventually lease, including projects undertaken from the ground up and construction of major structural improvements related to existing assets.

Changing Lanes — Accounting for Build-to-Suit Arrangements

Under ASC 840, an entity considers whether it has taken on substantially all of the risks of construction and therefore must be considered, from an accounting perspective, the deemed owner during construction. Under this guidance, a lessee that is the deemed owner must record the entire cost of the asset and a corresponding financing obligation (for the portion of the cost funded by the lessor) on its balance sheet for amounts not directly funded during the construction period. Further, upon completion of construction, the lessee must apply sale-and-leaseback accounting to determine whether it can derecognize the project. Many entities are unable to derecognize the project after construction because of various forms of continuing involvement that preclude sale treatment. This has been a particularly pervasive outcome for build-to-suit arrangements that involve real estate. Overall, the build-to-suit rules in ASC 840 are widely considered to be overly complex to apply and to result in overly punitive accounting outcomes.

ASC 842 removes the risk principle governing the determination of the deemed owner and replaces it with a model in which a lessee will be considered to own an asset during construction only if the lessee has “control” of the asset during the construction period.
11.3.1 Costs Related to the Construction or Design of an Underlying Asset

**ASC 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.

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).

A lessee may be required to make payments related to the underlying asset before the commencement date of the lease. In such cases, the lessee and the lessor should first assess whether the lessee controls the underlying asset before commencement (see Section 11.3.2). If the lessee controls the underlying asset before commencement, the lessee should account for the asset in accordance with Section 11.4 as if it were the deemed owner. If the lessee does not control the underlying asset before commencement, the lessee should do the following in accordance with ASC 842-40-55-3 and 55-4:

- Determine whether those payments are for (1) costs related to the construction or design of the underlying asset to be leased or (2) the right to use the underlying asset.
- If the payments are for costs related to the asset’s construction or design, they should be accounted for in accordance with other applicable GAAP (e.g., ASC 330, ASC 360).
- If the payments are for the right to use the asset, they are lease payments, as discussed in Chapter 6.

**Changing Lanes — Costs Incurred by Lessee Are No Longer Determinative of Whether Lessee is the Deemed Owner of Construction**

Under ASC 840-40, the lessee’s payment of “hard costs” before inception (e.g., payments for site preparation, construction costs, or equipment that is related to components to be used in a construction project) generally results in a sale-and-leaseback transaction, since the lessee is considered the deemed owner of the construction project before entering into the lease agreement. ASC 840-40 generally requires the same outcome when the lessee pays for “soft costs” before inception (e.g., payments for architectural fees, survey costs, or zoning fees that are related to components to be used in the construction of a project) and the soft costs represent more than a minor amount of the expected fair value of the asset under construction.

However, under ASC 842-40, payments made for costs related to the asset’s construction or design are not indicative of whether the lessee is the deemed owner of the asset under construction. Provided that the lessee does not control the asset under construction before lease commencement (see Section 11.3.2), costs related to the asset’s construction or design should be accounted for in accordance with other applicable GAAP, as indicated in ASC 842-40-55-4, regardless of whether those costs are considered hard costs or soft costs. Effectively, under ASC 842-40, the concepts of hard costs and soft costs no longer exist.
Chapter 11 — Control of the Underlying Asset Before Lease Commencement

Example 11-1

Company X enters into a build-to-suit transaction to construct a building (i.e., X will be involved in the construction of the building before its lease of the building commences). Company X acts as construction agent. Before lease inception, X graded the land to prepare the site for construction of the building.

Under ASC 840, since the hard cost incurred involves construction of the asset (site preparation), X is considered the owner of the construction project and the transaction is treated as a sale-and-leaseback transaction. Under ASC 842, provided that either (1) the lease commenced before the effective date of ASC 842 (see Section 16.8) or (2) the lease has not commenced but X does not control the asset under construction before lease commencement (see Section 11.3.2), X would not be considered the deemed owner during construction and would account for the costs of preparing the site for construction under ASC 842-40-55-3 and 55-4.

Example 11-2

Company Y enters into a build-to-suit transaction to construct a building. Company Y enters into a lease agreement with the lessor before the start of construction. The lease commencement date will be 30 days after the building is fully constructed. Company Y does not control the asset under construction and therefore is not considered the deemed owner. During the construction period, Y purchases slabs of granite that it expects to use throughout the leased floors of the building. The granite purchased by Y can be seen as a leasehold improvement since it will be used by the lessee and is not related to the right to use the lessor’s asset. Therefore, Y would account for the cost incurred in accordance with ASC 360.

In determining whether payments made by the lessee before the commencement date of the lease should be considered lease payments for the future right to use the underlying asset or whether the payments should be accounted for as costs related to the asset’s construction or design that are within the scope of other applicable GAAP (e.g., ASC 330, ASC 360), the lessee should consider the nature and substance of the payments made. Factors to consider include, but are not limited to, the nature of the construction costs or activities paid for by the lessee and whether the cash lease payments negotiated with the lessor that are due after lease commencement appear to be at market rates (e.g., the cash lease payments that would have otherwise been due in the absence of lease prepayments may be decreased to below market rates as a result of those prepayments). Costs incurred by the lessee for leasehold improvements for the benefit of the lessee are generally accounted for in accordance with ASC 360. Payments made by the lessee before lease commencement for the lessee’s right to use the lessor’s asset, rather than for leasehold improvements, are generally accounted for as lease payments. An entity should use judgment in determining the appropriate guidance to apply to payments made before lease commencement.
Example 11-3

Company Y enters into a build-to-suit transaction to construct a building. Company Y enters into a lease agreement with the lessor before the start of construction. The lease commencement date will be 30 days after the building is fully constructed. Company Y does not control the asset under construction and therefore is not considered the deemed owner. During the construction period, Y purchases various construction materials specified under the terms of the lease agreement with the lessor. The construction materials purchased by Y can be viewed as consideration paid to the lessor for the right to use the lessor’s asset, which reduces the amount of future cash lease payments required after lease commencement. Therefore, Y would account for the cost incurred for construction materials as a prepayment of rent in accordance with ASC 842.

11.3.2 Control of the Underlying Asset During Construction

ASC 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-lessee. In evaluating whether the asset has an alternative use to the owner-lessee, 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.
Connecting the Dots — Control of Asset Under Construction Is Similar to Control in ASC 606

ASU 2016-02's Background Information and Basis for Conclusions notes that (1) a lessee can be, and thus should assess whether it is, the owner of an asset under construction before lease commencement and (2) the assessment should be based on control (i.e., when the lessee controls the asset under construction). This is a departure from the requirements under ASC 840-40, which focus on construction risk assumed by a lessee, and is another example of the Board’s effort to align the guidance on leases and revenue when appropriate. Two of the indicators of a lessee's control of an underlying asset that is under construction closely mirror those used by suppliers under ASC 606 to determine whether customers gain control of their work as they perform (i.e., as construction progresses). Under ASC 606, when a supplier's “performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced,” the supplier is satisfying its performance obligation over time. A lessee that controls an asset as it is created or enhanced by the supplier's performance owns the asset throughout the work in process and should therefore apply the sale-and-leaseback accounting guidance in ASC 842-40 upon lease commencement. ASC 842-40 also provides indicators of legal ownership of the asset under construction as well as control, through lease or ownership, of the underlying land.

However, it is important to differentiate control of an asset during construction from control of the right to use an asset during construction. The latter reflects the lease of an asset under construction, an arrangement that is outside the scope of ASC 842 (see Chapter 3).

Q&A 11-1 Lessee’s Control of the Asset During Construction

Question

How should a lessee that does not meet one of the criteria in ASC 842-40-55-5 determine whether it “controls an underlying asset” during construction?

Answer

This determination generally should be based on the concept of control in ASC 606. The first three criteria in ASC 842-40-55-5 are grounded in principles of ASC 606, which indicate that the lessee has control of the asset during construction if (1) the lessee holds a call option, (2) the lessor has an enforceable right to payment for performance to date and the asset does not have an alternative use, or (3) the lessee has title to the asset under construction. The concept in the last two criteria is not in ASC 606 but, in our view, is based on an assumption that the lessor should be able to legally use the underlying land (e.g., cannot be forced to vacate the property) during substantially all of the economic life of the property improvement that is being constructed on the land.

We do not believe that the concept of controlling an asset under construction should be based on the definition of a lease in ASC 842, which includes guidance on whether a contract conveys the right to control the use of an identified asset. Although the concepts sound similar, the FASB explicitly excluded from the scope of ASC 842 leases of assets under construction, partially because it is difficult to apply the lease definition before an asset is placed in service (e.g., it is difficult to assess the economic benefits associated with an asset that is not yet operational).

1 Paragraph BC400(b) of ASU 2016-02 states that the FASB “observed that, in concept, the evaluation under Subtopic 842-40 on whether an entity controls an asset that is under construction is similar to the evaluation undertaken in the revenue recognition guidance in accordance with paragraph 606-10-25-27 to determine whether a performance obligation is satisfied over time.”
When the above principles are applied, it would not be appropriate to conclude that a lessee controls the asset under construction solely because of its involvement in designing the asset or acting as the general contractor during the construction project. This involvement is typical of many “build-to-suit” arrangements. In these cases, the lessee would typically not control the asset during construction because the lessee does not (1) take title to the asset, (2) provide the lessor with an enforceable right to payment, or (3) prevent the lessor from using the underlying land for substantially all of the economic life of the property improvements.

**Example**

A lessee enters into a construction and lease agreement with a lessor to build a new corporate headquarters. The lessor will retain title to the building throughout the construction period and agrees to pay up to $50 million toward construction. The lessee designed the building to its specifications and is contracted by the lessor to be the general contractor during the construction project. Assume that none of the criteria in ASC 842-40-55-5 are met.

The lessee would not control the asset during construction because its role as general contractor and designer of an asset is not an indicator of control under the criteria in ASC 842-40-55-5 or the principles of control in ASC 606. Likewise, the lessee's exposure to overrun risk (since the lessor will pay only up to $50 million of the construction costs) does not affect the control analysis; before the adoption of ASC 842, however, the lessee would have been considered the deemed accounting owner because of its exposure to construction risk.

**11.3.2.1 Lessee Has the Right to Obtain the Partially Constructed Underlying Asset at Any Point During the Construction Period**

ASC 842-40-55-5(a), which provides one criterion under which the lessee would control the underlying asset during construction before the lease commences, states that 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).” In other words, if the lessee has a call option on the underlying asset during construction, the lessee controls the underlying asset.

**Q&A 11-2 Right to Obtain the Partially Constructed Underlying Asset at Any Point During Construction**

**Question**

For the lessee to have the right to obtain a partially constructed asset during construction, must the lessee's call option be exercisable throughout (i.e., at all points during) the construction period?

**Answer**

It depends. If a call option is exercisable by the lessee at any point during construction, the lessee controls the underlying asset and should recognize the construction-in-process. Importantly, “at any point” does not mean at all points; therefore, entities must also consider options that arise (or become exercisable) during the construction period regardless of whether they are based on the passage of time or a substantive contingency. In the case of a substantive contingency, an entity would be deemed to control the asset under construction once it has the current ability to exercise the option. On the other hand, we believe that if the only barrier preventing exercise is the passage of time, an entity would be deemed to control the asset under construction from the beginning of the construction period.
An entity should carefully analyze a call option that becomes exercisable upon the occurrence of a contingent event to determine whether the lessee can unilaterally cause the call option to become exercisable. For example, some construction and lease agreements stipulate that if the lessee defaults on its obligation to perform under the agreement, the lessee would be obligated to purchase the construction-in-process. Under this provision, the lessee would control the underlying asset because it could unilaterally default under the agreement and thereby become able to obtain the underlying asset. In contrast, if the obligation or option to purchase the construction-in-process was outside the control of the lessee (e.g., bankruptcy or third-party events), the lessee would not have control over the construction-in-process until the contingent event occurred. Once the lessee is deemed to control the construction-in-process, it must apply sale-and-leaseback accounting rules to determine whether it can derecognize the project, typically upon the completion of construction or at lease commencement. Scenarios in which the lessee must apply sale-and-leaseback accounting rules to make such a determination include those in which the lessee maintains control up to completion of construction, as well as those in which the option that conveyed control expires unexercised during the construction period.

Example

A lessee enters into a construction and lease agreement with a lessor to build a new corporate headquarters. The lessor will retain title to the building throughout the construction period and agrees to pay up to $50 million toward construction. The construction is expected to be completed in 18 months. At any point during the construction, the lessee has the right (but not the obligation) to purchase the construction-in-process at the lessor's cost plus a profit margin. If the call option is not exercised and construction is completed, the lessee will lease the asset from the lessor for a lease term of 15 years with an option to purchase the building at the end of the lease term at a fixed price.

The lessee would control the asset during construction and recognize the construction-in-process. At the end of construction, the lessee must consider the sale-and-leaseback guidance in ASC 842-40-25-1 through 25-3. In this case, the lessee would not qualify for sale accounting because of the call option that exists at the end of the lease period (see Q&A 10-6).

Connecting the Dots — Lessor Put Options

Lessor put options should also be considered in scenarios involving construction of an asset to be leased. In a manner consistent with the guidance on put options in ASC 606, an entity should assess a put option held by the lessor to determine whether the lessor has a significant economic incentive to exercise the option.

If such an incentive exists, it would be assumed that the lessee controls the construction-in-process.

11.3.2.2 Lessor Has Enforceable Right to Payment for Its Performance to Date and the Asset Does Not Have an Alternative Use

ASC 842-40-55-5(b), which provides one criterion under which the lessee would control the underlying asset during construction before the lease commences, states the following:

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-lessee. In evaluating whether the asset has an alternative use to the owner-lessee, an entity should consider the characteristics of the asset that will ultimately be leased.
Q&A 11-3  Lessor Has Enforceable Right to Payment for Its Performance to Date and the Asset Does Not Have an Alternative Use

Question
When would the criterion in ASC 842-40-55-5(b) apply?

Answer
The criterion in ASC 842-40-55-5(b) would apply only when (1) the lessor has an enforceable right to payment for all of its performance to date (i.e., throughout the development or construction of the asset) and (2) the asset has no alternative use to the owner-lessee.

This criterion is derived from the guidance in ASC 606 on recognizing revenue as control is transferred to a customer over time (e.g., when the transfer of control results in the customer's ownership of a partially completed asset during the asset's development or construction).

We expect the circumstances listed above to be uncommon for an asset under construction because a lessee is not typically required to pay for all of the performance to date throughout construction. Rather, the lessor will be paid, at least in part, through lease payments over the period of the lease term after construction has ended. A significant amount of required prepaid rent would not meet the criterion in ASC 842-40-55-5(b) unless the lease provided for the nonrefundable right to payment for all the costs incurred by the lessor plus a reasonable profit margin. That is, for the future lessee to control the asset and, therefore, to be the deemed owner of the asset during construction under this condition, the required payments must compensate the developer for all construction efforts throughout the asset's construction.

Further, many build-to-suit arrangements may require the lessee to pay the lessor upon the occurrence of certain contingent events outside the lessor's control (e.g., by default by the lessee). This requirement alone would not meet the criterion in ASC 842-40-55-5(b) because the lessor cannot force the lessee to pay in the absence of a default under the lease agreement.

Finally, in the rare circumstances in which the first part of this criterion is met, the asset under construction may have an alternative use to the lessor under ASC 842-10-55-7. This criterion is intended to be the same as that in ASC 606-10-25-27(c) and 25-28. See Section 8.4.3.1 of Deloitte’s Revenue Roadmap for a detailed discussion of this criterion.

11.3.2.3  Lessee Controls the Underlying Land

ASC 842-40-55-5(d), which provides one criterion under which the lessee would control the underlying asset during construction before the lease commences, states the following:

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. [Emphasis added]

Examples of when the transfer of land may not qualify as a sale include circumstances in which the seller-lessee retains a call option on the land or the leaseback is determined to be a finance lease.
Q&A 11-4  Controlling an Asset During Construction When the Land Is Sold in a Failed Sale and Leaseback

Question
How should the criterion in ASC 842-40-55-5(d) be assessed when land is sold to the lessor but is accounted for as a financing rather than a sale?

Answer
In our view, the concept in this criterion is based on an assumption that the lessor of the property improvements should be able to use the underlying land during substantially all of the economic life of the property improvements that are being constructed on the land. When the lessor does not have appropriate rights to the land, the lessee would control the property improvements during construction if the following conditions are met:

• **The lessee of the property improvements controls the land** — This condition is met if any of the following is true:
  - The lessee holds title to the land.
  - The lessee previously sold the land but did not qualify for sale accounting.
  - The lessor of the property improvements has title to the land, but the lessee sold the land to the lessor in a failed sale and leaseback.

• **The lessee controls the constructed asset** — Even if the first condition is met (i.e., the lessee controls the land), the lessee does not control the constructed asset if it has leased the land to the lessor for substantially all of the economic life of the to-be-constructed asset.

Read literally, the second condition can never be met in a financing of the land through a previous failed sale or sale and leaseback because the lessee cannot lease out the land that it has already legally sold to the lessor. However, we believe that the principle underlying the criterion in ASC 842-40-55-5(d) should be considered. That is, an entity should consider whether the lessor has the right to legally use the land for substantially all of the economic life of the property improvements. The entity must consider all facts and circumstances when making this determination.

**Example 1**
Company A sells land to Company B and contemporaneously enters into a construction and lease agreement for B to build a new corporate headquarters for A. Upon completing construction of the new headquarters building, B will lease the land and the building to A for a period of 40 years. At the end of 40 years, A will have the right to purchase the land and corporate headquarters at a fixed price. The corporate headquarters has an estimated economic life of 40 years. Assume that none of the other criteria in ASC 842-40-55-5 apply to the arrangement related to the to-be-constructed property improvements.

Company A determines, in accordance with ASC 842-40-25-3, that the call option precludes accounting for the transfer of the land as a sale. However, in assessing whether it controls the corporate headquarters during construction, A notes that B has the legal right to use the land for the entire 40-year economic life of the asset to be constructed. That is, the option is not exercisable until the property improvement has no remaining economic life. Therefore, on the basis of these facts and circumstances, A concludes that it does not control the corporate headquarters during construction.
Example 2

Assume the same facts as those in Example 1, except that Company A does not have a purchase option on the land. However, the leaseback of the land is determined to be a finance lease under ASC 842 because the present value of the lease payments equals or exceeds substantially all of the fair value of the land transferred.

Company A determines, in accordance with ASC 842-40-25-2, that B is not considered to have obtained control of the land because the leaseback is a finance lease. However, in assessing whether it controls the corporate headquarters during construction, A notes that B has the legal right to use the land for the entire 40-year economic life of the asset to be constructed. That is, in a manner consistent with Example 1, although A did not derecognize the land for accounting purposes, the lessor uses the land in the construction and lease of the property improvements for the entire economic life. Therefore, on the basis of these facts and circumstances, A concludes that it does not control the corporate headquarters under construction.

11.3.2.4 Codification Examples

Example 3, Cases A and B, reproduced below, illustrate applications of the guidance in ASC 842-40-55-5.

ASC 842-40

55-6 See Example 3 (paragraphs 842-40-55-39 through 55-44) for an illustration of the scope of this Subtopic.

55-39 Example 3 illustrates the guidance on determining whether a lessee controls an underlying asset that is under construction before the commencement date.

Example 3 — Lessee Control Over an Asset Under Construction

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 building 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

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.

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

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.

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).

11.4 Accounting by the Deemed Owner of an Asset

When a lessee is the deemed owner of an asset, the lessee must recognize the asset in accordance with other applicable GAAP (e.g., ASC 360). Therefore, when the lessee is the deemed owner of an asset under construction (see Section 11.3.2), the lessee must recognize construction-in-process in accordance with ASC 360 as it would for any other owned asset under construction. That is, when the lessee determines that it is the deemed owner of the construction-in-process, it must account for the asset during the construction period as if it is the party responsible for the construction costs, with a deemed loan from the lessor, as construction progresses. Accordingly, the lessee must recognize on the balance sheet (1) the costs incurred by the lessee to construct the asset, (2) the costs incurred by the lessor to construct the asset, and (3) an offsetting financing obligation for the amount funded by the lessor.

After recognizing the asset, the lessee must apply sale-and-leaseback accounting as of the commencement date of the lease (which is typically the end of the construction period) to determine whether it can derecognize the asset (see Chapter 10 for more information about sale-and-leaseback transactions). If the lessee cannot derecognize the asset because the transaction fails to meet the criteria for sale-and-leaseback accounting, the lessee would continue to account for the asset as if it were the asset’s owner. See Q&A 11-5 for further discussion of the seller-lessee’s accounting when the transaction fails to qualify for sale-and-leaseback accounting.

In addition, the seller-lessee would continue to account for the financing obligation in the same manner as it would for any other failed sale-and-leaseback transaction. If the seller-lessee expects the balance of the financing obligation to be lower than the net carrying value of the underlying asset when control of the asset is transferred to the buyer-lessee (which is typically the end of the lease term), the interest rate on the financing obligation should be increased to avoid this “built-in loss.” This adjustment generally causes the balance of the financing obligation to be equal to the net carrying value of the underlying asset when control of the asset is transferred.
On the other hand, if the seller-lessee expects the balance of the financing obligation to be higher than the net carrying value of the underlying asset when control of the asset is transferred to the buyer-lesser, the interest rate on the financing obligation should not be adjusted (i.e., a “built-in gain” is not prohibited). See Section 10.4.2.1 for further discussion of the accounting for a financing obligation in a failed sale-and-leaseback transaction.

Q&A 11-5  Depreciation Accounting When the Lessee Is the “Deemed Owner” and Fails to Qualify for Sale-and-Leaseback Accounting

**Question 1**
What depreciable life should a deemed owner use when accounting for an asset that does not qualify for sale-and-leaseback accounting?

**Answer**
If a sale-and-leaseback of the asset fails to meet the sales recognition criteria in ASC 842-40, the seller-lessee would continue to account for the asset as it always has — as the owner. However, when the lessee is deemed the accounting owner of an asset during the construction period, the lessee would not have begun depreciating the asset because the asset would not yet have been placed in service. In other words, rather than account for the asset as it always has, the deemed owner must apply an appropriate depreciation method at the end of the construction period.

The fact that the deemed owner of an asset (e.g., a constructed building) is typically not the owner of the underlying land further complicates the adoption of a depreciation method because treatment of the asset would be akin to that of a leasehold improvement. If the lease meets either the transfer-of-ownership criterion in ASC 842-10-25-2(a) or the reasonably certain purchase option criterion in ASC 842-10-25-2(b), the asset should be depreciated in a manner consistent with the lessee's normal depreciation policy for owned assets.

If the lease does not meet either criterion, the asset should be depreciated in a manner consistent with the lessee’s normal depreciation policy except that the depreciable life must not exceed the lease term.

**Question 2**
To what amount should the deemed owner depreciate an asset that does not qualify for sale-and-leaseback accounting?

**Answer**
In a manner consistent with the depreciation of other owned assets, the asset should be depreciated to its expected residual value at the end of its depreciable life. As discussed in Question 1, the depreciable life of such assets is often restricted to the lease term, which may result in a significant expected residual value. In these circumstances, the residual value of the asset is effectively the final payment against the associated financing obligation. Importantly, as discussed above, ASC 842-40-30-6 precludes the expected balance of the financing obligation from being lower than the expected residual value of the asset when control of the asset is transferred. However, this guidance stipulates that, in those cases, an entity is required to adjust the interest rate on the financing obligation to avoid a “built-in loss” rather than adjusting the residual value of the asset.
Chapter 12 — Sublease Accounting

12.1 Overview
12.2 Classification of a Sublease
12.3 Accounting for a Sublease by the Lessee/Intermediate Lessor
  12.3.1 Lessee/Intermediate Lessor Is Not Relieved of Its Primary Obligation Under the Head Lease
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12.4 Lessor's Accounting for a Sublease
12.5 Sublessee's Accounting for a Sublease
## 12.1 Overview

### ASC 842-10 — 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.

When the original lessee subleases the leased asset to an unrelated third party, the lessee becomes the intermediate lessor in the sublease arrangement. The following graphic illustrates the flow of transactions and the parties involved in a sublease:

![Sublease Flow Diagram]

For information on subleases that are part of a sale-and-leaseback transaction, see Section 10.2.3.3.

For information on required disclosures for sublease transactions, see Section 15.2.4.5.

## 12.2 Classification of a Sublease

### ASC 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.

In a manner consistent with other leases, the lessee/intermediate lessor should classify the sublease on the basis of the criteria in ASC 842-10-25-2 (see Section 9.2). In applying these criteria, the lessee/intermediate lessor should look through the sublease to the underlying asset (i.e., the lessee/intermediate lessor should not classify the sublease by reference to the ROU asset that results from the head lease). Paragraph BC116 of ASU 2016-02 explains the FASB’s rationale for using the underlying asset in this assessment:

The Board decided that when classifying a sublease, an entity (that is, the intermediate lessor) should evaluate the sublease with reference to the underlying asset rather than the right-of-use asset arising from the head lease. The lessee in a sublease may not know the terms and conditions of the head lease, and, accordingly, referring to the item of property, plant, and equipment that is subject to the lease should be easier to apply than referring to the right-of-use asset arising from the head lease. In addition, the Board noted that it may be difficult to understand and explain why a lessor would account for similar leases differently. That could occur if an entity were required to refer to the right-of-use asset when classifying a sublease. For example, if subleases were classified with reference to the right-of-use asset, a lessor that leases two similar assets on similar terms for five years could account for those leases differently if the lessor owned one of the two assets and leased the other.
Bridging the GAAP — Classification of Sublease Different Under IFRS 16

Unlike ASC 842, IFRS 16 requires the lessee/intermediate lessor to determine the classification of the sublease with reference to the ROU asset arising from the head lease rather than to the underlying asset. Therefore, because the lease term of the ROU asset is typically less than the economic life of the underlying asset, we generally believe that the lessee/intermediate lessor may classify more subleases as sales-type or direct financing under IFRS Standards than under U.S. GAAP.

Example 12-1

Company, a lessee, enters into a building lease with a third party. The term of the lease is 30 years, and the estimated economic life of the building is 40 years. Immediately after entering into the head lease arrangement, Company subleases the building to SubCo. The term of the sublease is 25 years. As an accounting policy, Company uses a 75 percent threshold when evaluating the “major part” of the economic life of the underlying asset in accordance with the classification criterion in ASC 842-10-25-2(c).

ASC 842 Evaluation

From the head lease perspective, Company (as the head lessee) will classify the lease as a finance lease since the lease term is for a “major part” of the remaining economic life of the underlying asset (i.e., Company is leasing the building for 30 years — or 75 percent — of the 40-year economic life). From the sublease perspective, Company (as the intermediate lessor) will classify the sublease as an operating lease since the lease term does not represent a “major part” of the remaining economic life of the underlying asset (i.e., a sublease with a lease term of 25 years, when evaluated against the 40-year economic life of the underlying asset, does not meet the “major part” criterion). Remember that in evaluating the sublease classification under ASC 842, an entity considers the remaining economic life of the underlying asset (i.e., the building) that is subject to the lease.

IFRS 16 Evaluation

From the head lease perspective, Company (as the head lessee) will account for the lease in a manner consistent with finance lease accounting under U.S. GAAP, since classification is not relevant for lessees under IFRS 16. From the sublease perspective, Company (as the intermediate lessor) will classify the sublease as a finance lease since the lease term represents a “major part” of the remaining economic life of the ROU asset that was recorded as a result of the head lease (i.e., a sublease with a lease term of 25 years, when evaluated against the 30-year term of the ROU asset in the head lease, represents 83.3 percent of the overall term and meets the “major part” indicator). Remember that when evaluating the sublease classification under IFRS 16, an entity considers the term of the ROU asset that is subject to the lease (versus the economic life of the underlying asset itself).

Q&A 12-1  Impact of Sublease Renewals on Head Lease Term

An entity must determine the lease term to perform lease classification and measurement. ASC 842-10-30-1 requires an entity to determine the lease term as follows:

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. [Emphasis added]

ASC 842-10-55-26 indicates that an entity should consider all economic factors in determining whether it is reasonably certain that a renewable option will be exercised. Further, an entity must consider a sublease in determining the lease term of the head lease.
**Question**

If a sublessee has contractual renewal options on a leased asset, does the head lease automatically include all periods covered by those renewal options since their exercise would force renewal of the head lease and the sublease renewals are outside the head lessee’s control?

**Answer**

Not necessarily. At the FASB's November 30, 2016, meeting, the Board indicated that the head lessee must determine whether the sublessee is reasonably certain to exercise its renewal options because the head lessee must determine the lease term for the head lease. If the exercise of the sublease renewal options is reasonably certain, the renewal of the head lease is also reasonably certain. However, if the head lessee determines that it is not reasonably certain that the sublessee will exercise its renewal options, the head lessee should not include additional renewal options that extend past the sublessee’s noncancelable term in the absence of other economic factors. That is, the sublease is one of many factors for an entity to consider in determining the lease term of the head lease.

Note that the head lessee would reassess its lease term in accordance with ASC 842-10-55-28 upon the occurrence of certain events, including “[s]ubleasing the underlying asset for a period beyond the exercise date of the option.” Therefore, upon notice by the sublessee that it is renewing or extending its sublease, the head lessee must reassess the lease term of the head lease, including whether the exercise of any remaining renewal options is reasonably certain.

**Example**

Under a lease agreement (the “head lease”), Company A leases equipment from Company B. Under another lease agreement (the “sublease”), A immediately leases the equipment to Company C. The noncancelable lease period of the head lease is 10 years, with two 5-year renewals at A’s option for a fixed amount. The sublease has a mirrored 10-year noncancelable period, with two 5-year renewals at C’s option. If C exercises its renewal option on the sublease, A will be forced to renew the head lease.

If it is not reasonably certain that C will exercise its renewal options, A could determine, in the absence of other asset- or market-based factors, that the lease term of the head lease is limited to 10 years (i.e., the noncancelable period). If and when C renews its sublease, A must reassess the lease term by including the first 5-year renewal and determining whether C’s exercise of the second 5-year renewal option is reasonably certain.

12.3 Accounting for a Sublease by the Lessee/Intermediate Lessor

A lessee/intermediate lessor should generally account for the head lease and sublease as separate contracts. Paragraph BC115 of ASU 2016-02 summarizes the rationale for accounting for the head lease and sublease separately:

In addition, the Board decided that an entity should account for a head lease and a sublease as two separate contracts unless those contracts meet the contract combinations guidance. Even if entered into at close to the same date, each contract is generally negotiated separately, with the counterparty to the sublease being a different entity from the counterparty to the head lease. Because of this, the obligations that arise from the head lease for the lessee are generally not extinguished by the terms and conditions of the sublease. Therefore, it is appropriate to account for a head lease and sublease separately, and the head lease right-of-use asset is not considered to be held for sale.

A lessee/intermediate lessor’s accounting depends on whether the lessee/intermediate lessor is relieved of its primary obligation under the head lease as a result of the sublease.
12.3.1 Lessee/Intermediate Lessor Is Not Relieved of Its Primary Obligation Under the Head Lease

**ASC 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.

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.
ASC 842-20-35-14 indicates that if the lessee/intermediate lessor is not relieved of its primary obligation under the head lease, its accounting for the lease depends on the classification of both the sublease and the head lease, as depicted in the flowchart below.

**Q&A 12-2 Accounting for a Lease Assignment**

Entity B has opted to exit a particular retail location and will assign the rights and obligations of the existing lease arrangement (the “original lease”) to the new tenant (the “sublessee”) through an agreement with the sublessee (the “lease assignment”).

The lease assignment is a contract between B and the sublessee (i.e., the lessor is not a party to the lease assignment). There is no alteration or termination to the original lease that takes place at the time of the lease assignment. Therefore, the terms in the original lease are in full effect notwithstanding execution of the lease assignment. In addition, the terms in the original lease do not state that B’s obligations would change if B enters into a lease assignment with a sublessee.
From an operational perspective, once the original lease has been assigned to the sublessee, B no longer has use of, or operational oversight over, the underlying property subject to the original lease. The sublessee and head lessor will transact directly with each other regarding lease payments and operational oversight of the leased property, and B is not involved in the management of the leased property or in the relationship between the head lessor and the sublessee.

**Question**

In the example above, would it be appropriate for B to account for the lease assignment as a lease termination?

**Answer**

No. It would not be appropriate to account for the lease assignment as a lease termination because B has not been released as the primary obligor for the original lease. Rather, the lease assignment should be accounted for as a sublease in accordance with ASC 842-20-35-14 and 35-15. In accordance with ASC 842-20-35-14 and as discussed above, B's accounting will depend on the classification of both the original lease and the lease assignment (i.e., the sublease).

### 12.3.2 Lessee/Intermediate Lessor Is Relieved of Its Primary Obligation Under the Head Lease

In a manner consistent with ASC 840-10-40-2, if the nature of the sublease is such that the lessee/intermediate lessor is relieved of its primary obligation under the head lease, the transaction would be considered a termination of the head lease. As a result, the lessee/intermediate lessor would derecognize the ROU asset and lease liability arising from the head lease and would recognize any difference in profit or loss. If the lessee/intermediate lessor remains secondarily liable under the head lease, then it is a guarantor in accordance with ASC 405-20-40-2 and its guarantee is accounted for in accordance with ASC 460.

See Section 8.7.4 for additional discussion about when the lessee/intermediate lessor is relieved of its primary obligation under the head lease.

### 12.4 Lessor's Accounting for a Sublease

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-7</strong> 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.</td>
</tr>
<tr>
<td><strong>40-3</strong> 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.</td>
</tr>
</tbody>
</table>
In a manner consistent with ASC 840-10-35-10, the lessor should continue to account for the head lease as it did before the execution of the sublease. See Chapter 9 for additional information about the lessor’s accounting model.

In addition, if the original lease is replaced by a new agreement with a new lessee, the lessor should account for the replacement as a termination of the original lease. The lessor should classify and account for the new lease as a separate transaction from the termination of the original lease.

### 12.5 Sublessee’s Accounting for a Sublease

A sublessee’s accounting for a sublease is consistent with its accounting for other leases in which it is the lessee. The existence of the head lease does not affect the sublessee’s accounting for the sublease. See Chapter 8 for additional information on the lessee’s accounting model.
Chapter 13 — Other Key Provisions

13.1 Overview
13.2 Related-Party Leases
13.3 Income Taxes
13.4 Master Lease Agreements
   13.4.1 Lessee Is Obligated or Committed to Use a Minimum Quantity
   13.4.2 Lessee Is Not Obligated or Committed to Use a Minimum Quantity

Scope
Identifying a lease
Separating lease and nonlease components

Key ingredients (lease term, lease payments, discount rate)

Lessee accounting
Lessor accounting

Sale-and-leaseback accounting
Sublease accounting and other provisions
Presentation and disclosure
13.1 Overview
This chapter discusses other key provisions in ASC 842, including those related to the following topics:

- Related-party leases (Section 13.2 below).
- Income taxes (Section 13.3).
- Master lease agreements (Section 13.4).

13.2 Related-Party Leases

ASC 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.

Related parties often enter into lease arrangements for tax structuring or other reasons. Under ASC 842, an entity should classify a lease with a related party on the basis of the legally enforceable terms and conditions of the contract rather than the substance of the arrangement (see Section 8.3.5.2 for additional discussion of a lessee’s classification of related-party leases). That is, a lease between related parties should be accounted for in a manner similar to a lease between unrelated parties.

Changing Lanes — Form Over Substance
Unlike ASC 842, ASC 840 requires entities to consider the substance of the contract when classifying and accounting for a related-party lease. Specifically, the guidance in ASC 840-10-25 states:

Except as noted in the following sentence, leases between related parties (see paragraph 840-10-55-27) shall be classified in accordance with the lease classification criteria in paragraphs 840-10-25-1, 840-10-25-31, and 840-10-25-41 through 25-44. Insofar as the separate financial statements of the related parties are concerned, the classification and accounting shall be the same as for similar leases between unrelated parties, except in circumstances in which it is clear that the terms of the transaction have been significantly affected by the fact that the lessee and lessor are related. In such circumstances the classification and accounting shall be modified as necessary to recognize economic substance rather than legal form. [Emphasis added]

On the other hand, ASC 842-10-55-12 indicates that “[l]eases 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” (emphasis added).

This change in guidance may significantly affect lessees and lessors that enter into related-party leasing arrangements. Paragraph BC374 of ASU 2016-02 explains the FASB’s rationale for changing the accounting for related-party leasing arrangements and states, in part:

In previous GAAP, entities were required to account for leases with related parties on the basis of the economic substance of the arrangement, which may be difficult when there are no legally enforceable terms and conditions of the arrangement. Examples of difficulties include related party leases that are month to month and related party leases that have payment amounts dependent on cash availability. In these situations, it is difficult and costly for preparers to apply the recognition and measurement requirements. Even when applied, the resulting information often is not useful to users of financial statements.
In addition to accounting for related-party leasing arrangements under ASC 842, lessees and lessors must disclose the information required by ASC 850 for all such arrangements. ASC 850-10-50-1 indicates that such disclosures should include the following:

- “The nature of the relationship(s) involved.”
- “A description of the transactions . . . for each of the periods for which income statements are presented” and “other information deemed necessary to an understanding of the effects of the transactions on the financial statements.”
- “The dollar amounts of [the] transactions . . . and the effects of any change.”
- “Amounts due from or to related parties as of the date of each balance sheet presented and . . . the terms and manner of settlement.”
- “The information required by paragraph 740-10-50-17.”

13.3 Income Taxes

A lease’s classification for accounting purposes does not affect its classification for tax purposes. An entity will therefore continue to be required to determine the tax classification of a lease under the applicable tax laws. While the classification may be similar for either purpose, the differences between tax and accounting principles and guidance often result in book/tax differences. Thus, once an entity implements ASU 2016-02, it will need to establish a process (or leverage its existing processes) to account for these differences.

**Connecting the Dots — Potential for Additional Deferred Tax Assets and Liabilities**

ASC 842 does not significantly affect the accounting for income taxes under ASC 740. In a manner consistent with ASC 840, differences between accounting and tax guidance will result in book/tax differences. Because the lessee will recognize a new ROU asset and lease liability for operating leases as a result of adopting ASC 842, there may be more book/tax differences under the ASC 842 than under ASC 840.

Because ASC 842 requires entities to reevaluate their leases, they may have the opportunity to reassess the tax treatment of such leases as well as their data collection and processes. Since the IRS considers a taxpayer’s tax treatment of leases to be a method of accounting, an entity may need to obtain IRS consent if it makes any changes to its existing methods.

Entities should also consider the potential state tax issues that may arise as a result of ASC 842, including how the classification of the ROU asset may affect the apportionment formula in the determination of state taxable income and how the significant increase in recorded lease assets could affect the determination of franchise tax payable.

Since the potential tax implications are many and varied, it is essential for a company’s tax department to be involved in the evaluation of the impact of ASC 842 as well as in discussions related to policy adoption and system modifications. See Appendix D for additional implementation considerations.
13.4 Master Lease Agreements

ASC 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.

55-18 If a 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.

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 may specify that the lessee will obtain control over the right to use multiple underlying assets (e.g., equipment) at various points during the term of the master lease agreement. In these cases, the lessee’s accounting depends on whether the master lease agreement commits the lessee to gaining control over the right to use a minimum quantity (units or dollar value) of assets.

13.4.1 Lessee Is Obligated or Committed to Use a Minimum Quantity

Under ASC 842-10-55-17, if the lessee is obligated or committed to the right to use a minimum quantity of assets, the entity should include the minimum quantity when separating lease components and allocating the consideration in the contract to the separate lease components (see Chapter 4). Because the minimum quantity is included in the initial separation of, and allocation to, the lease components, the lessee’s attainment of control of the right to use the underlying assets throughout the term of the master lease agreement does not result in a lease modification.

However, because the lessee may obtain control of the right to use the underlying assets at different points during the term of the master lease agreement, the separate lease components may have different lease commencement dates, as explained in ASC 842-10-55-22. For rights to use underlying assets that have yet to commence, the lessee should consider the disclosure requirements in ASC 842-20-50-3(b) (see Section 15.2.2) related to leases that have not yet commenced.
Chapter 13 — Other Key Provisions

**Example 13-1**

On January 1, 20X1, Lessor C enters into a master lease agreement with Lessee P related to various pieces of equipment throughout a five-year term. Under the master lease agreement, P leases the following pieces of equipment from C for one-year lease terms commencing on the following dates:

- March 26, 20X1: Equipment X.
- June 7, 20X2: Equipment Y.
- September 9, 20X3: Equipment Z.

The master lease agreement states that P is obligated to lease three pieces of equipment (i.e., Equipment X, Equipment Y, and Equipment Z) at some point during the five-year term of the master lease agreement.

In accordance with ASC 842-10-55-17, because P is obligated to use a minimum quantity of equipment, the entities (both C and P) must consider the minimum quantity of equipment (i.e., three pieces of equipment) when identifying the separate lease components and allocating the consideration in the contract. Because P obtains control of the right to use the equipment at different points during the master lease agreement, each lease component (i.e., for Equipment X, Equipment Y, and Equipment Z) has a different lease commencement date. Accordingly, P should consider the disclosure requirement in ASC 842-20-50-3(b) for leases that have not yet commenced. In addition, because each right of use is considered in the initial identification and separation of lease components, the fact that P obtains control of each right of use at different times does not result in a lease modification.

**13.4.2 Lessee Is Not Obligated or Committed to Use a Minimum Quantity**

Under ASC 842-10-55-18, if the lessee is not obligated or committed to the right to use a minimum quantity of assets, the lessee must account for the attainment of control of each additional right to use an underlying asset as a lease modification in accordance with ASC 842-10-25-8 through 25-18 (e.g., each additional right of use could be a lease modification accounted for as a separate contract in accordance with ASC 842-10-25-8). Because the lessee is not subject to a minimum commitment, the entity would not include the right to use any additional underlying assets in the initial separation of, and allocation to, the lease components in the contract. See Section 8.6 for additional information on accounting for lease modifications.

**Example 13-2**

Assume the same facts as in Example 13-1 above, except that under the master lease agreement, P is not obligated or committed to use a minimum quantity of equipment throughout the five-year term of the master lease agreement.

Because P is not obligated to use a minimum quantity of equipment, the entities (both C and P) should account for Ps obtaining control over the right to use each additional piece of equipment as a lease modification on the date on which control is obtained (e.g., each modification may be accounted for as a separate contract in accordance with ASC 842-10-25-8). In this example, the entities will account for the master lease agreement as follows:

- First lease commences on March 26, 20X1, when P obtains control of Equipment X.
- First modification on June 7, 20X2, when P obtains control of Equipment Y.
- Second modification on September 9, 20X3, when P obtains control of Equipment Z.

See Section 8.6 for additional information on accounting for lease modifications.
Chapter 14 — Presentation

14.1 Overview

14.2 Lessee
   14.2.1 Statement of Financial Position
   14.2.2 Statement of Comprehensive Income
   14.2.3 Statement of Cash Flows

14.3 Lessor
   14.3.1 Sales-Type and Direct Financing Leases
   14.3.2 Operating Leases

Scope → Identifying a lease → Separating lease and nonlease components

Key ingredients
(lease term, lease payments, discount rate)

Lessee accounting → Lessor accounting

Sale-and-leaseback accounting → Sublease accounting and other provisions

Presentation and disclosure
14.1 Overview

Concerns about the lease presentation requirements in ASC 840, particularly those for lessees, provided the impetus for the issuance of ASC 842. Specifically, in developing ASC 842, the Board decided to remove the classification disparity between operating leases and capital leases, bring all leases onto the balance sheet, and require lessees to recognize lease assets and lease liabilities in the statement of financial position. As indicated in the summary portion of ASU 2016-02, the primary objective of the new presentation requirements is to increase financial statement transparency and give users a more “complete and understandable picture of an entity’s leasing activities.”

Below is a more detailed discussion of ASC 842’s financial statement presentation requirements for both lessees and lessors.

14.2 Lessee

14.2.1 Statement of Financial Position

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.

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.

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.

A lessee must present in the statement of financial position (or disclose in the notes thereto) (1) finance lease ROU assets separately from operating lease ROU assets and (2) finance lease liabilities separately from operating lease liabilities. The rationale for separate presentation is that the lease classifications differ with respect to the subsequent-measurement patterns for their respective assets and, in the Board’s view, represent economically different transactions. In addition, finance lease liabilities may not be presented with operating liabilities because finance lease liabilities are the equivalent of debt and are generally treated as such in the case of an entity’s bankruptcy. ASC 842 does not specifically prescribe which financial statement line item is appropriate for presentation (e.g., separate presentation of finance-lease ROU assets in a PP&E financial statement line item).

Connecting the Dots — Balance Sheet Presentation Is Favorable for Debt Covenants

The separate presentation requirement for finance and operating leases may be viewed favorably by preparers because it may reduce an entity’s exposure to potential debt covenant violations that could have resulted if the entity was required to characterize all lease liabilities as debt. See Section 8.1.1 for more information.
While the standard does not require distinct presentation on the face of the statement of financial position, the assets and liabilities related to each lease classification must be presented separately (i.e., in either distinct or separate financial statement line items). A lessee that discloses the amounts in the notes must also disclose in which financial statement line items the amounts are included in the statement of financial position.

**Connecting the Dots — SEC Regulation S-X Requirements Related to Separate Presentation of Assets and Liabilities**

SEC Regulation S-X, Rule 5-02, requires registrants to separately present, in the balance sheet or a note thereto, (1) “other assets” that are in excess of 5 percent of total assets and (2) any item in excess of 5 percent of other current liabilities and any other liability in excess of 5 percent of total liabilities. Although these SEC Regulation S-X requirements do not appear to mandate any disclosures that are not already prescribed by ASC 842, companies should nonetheless consider the requirements in evaluating whether separate presentation on the face of the financial statements is warranted.

**14.2.1.1 Considerations Related to Classified Statement of Financial Position**

<table>
<thead>
<tr>
<th>ASC 842-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statement of Financial Position</strong></td>
</tr>
<tr>
<td>45-1 . . . 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.</td>
</tr>
</tbody>
</table>

**Q&A 14-1 Which an Entity That Presents a Classified Balance Sheet Is Required to Classify Its ROU Assets and Lease Liabilities as Current and Noncurrent**

**Question 1**

Is an entity that presents a classified balance sheet required to classify its ROU assets as current and noncurrent?

**Answer**

No. Entities typically exclude depreciated or amortized assets (e.g., PP&E and intangible assets, respectively) from current assets in accordance with ASC 210-10-45-4(f). Under ASC 842, ROU assets must be amortized and are therefore akin to other amortizable assets.

**Question 2**

Is an entity that presents a classified balance sheet required to classify its lease liabilities as current and noncurrent?

**Answer**

Yes. ASC 210-10-45-6 states, in part, that the “concept of current liabilities includes estimated or accrued amounts that are expected to be required to cover expenditures within the year for known obligations.” Therefore, an entity should classify the portion of its lease liabilities that is expected to be paid within the year (or the entity’s operating cycle) as a current liability.
As illustrated in the example below, the calculation of the current portion of the liability includes the portion of the lease payments that will be applied to the liability's principal over the next 12 months. This is consistent with the guidance in ASC 210-10-45-9, which states that current liabilities should include "[o]ther liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months."

**Example**

On December 31, 202X, Company X, a lessee, commenced a lease with a term of three years and an annual lease payment of $4,660 due on each anniversary of the commencement date. Company X uses a year (12 months) to classify other current assets and liabilities in its classified balance sheet in accordance with ASC 210. After discounting the lease payments at a discount rate of 8 percent, X determines that (1) its total lease liability is $12,009 and (2) $3,699 of the liability will be paid within one year from the balance sheet date. As of December 31, 202X, X classifies $3,699 as a current liability and the remaining $8,310 as a noncurrent liability when it presents its classified balance sheet.

The table below illustrates the calculation of the current liability in each year of the lease term by using an approach in which the current portion of the liability is equal to the payment amount to be applied to the liability's principal.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Balance</th>
<th>Interest Expense</th>
<th>Payment</th>
<th>Principal Payment</th>
<th>Ending Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>12,009</td>
<td>961*</td>
<td>(4,660)</td>
<td>(3,699)**</td>
<td>8,310</td>
</tr>
<tr>
<td>2</td>
<td>8,310</td>
<td>665</td>
<td>(4,660)</td>
<td>(3,995)</td>
<td>4,315</td>
</tr>
<tr>
<td>3</td>
<td>4,315</td>
<td>345</td>
<td>(4,660)</td>
<td>(4,315)</td>
<td>—</td>
</tr>
</tbody>
</table>

* Calculated as the lease liability balance of $12,009 multiplied by the discount rate of 8 percent.
** Represents the current portion of the liability. Calculated as the total payment ($4,660) less the interest ($961) and represents the reduction in the principal balance of the liability during the period.

We are aware that there are alternatives to the approach described above that an entity may apply in determining the current portion of the lease liability. We recommend that entities consult with their accounting advisers in evaluating the reasonableness of any alternative applied.

**14.2.2 Statement of Comprehensive Income**

**ASC 842-20**

**Statement of Comprehensive Income**

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.
14.2.2.1 **Finance Leases — Presentation of Interest Expense on the Lease Liability and Amortization Expense Related to the ROU Asset**

The requirements for finance leases in ASC 842-20-45-4(a) with respect to presentation of interest expense and amortization expense are consistent with the capital lease presentation requirements under ASC 840-10-45-3. These provisions of ASC 842 are in line with the FASB's view that a finance lease is economically similar to a financed asset purchase (i.e., the proceeds of a loan used to acquire an asset). Therefore, in a manner consistent with a financed purchase transaction, an entity would incur interest expense on its financing (loan) and would depreciate its asset acquired.

**Connecting the Dots — Variable Lease Payments in Finance Leases (or Sales-Type Leases and Direct Financing Leases)**

ASC 842 is silent on the appropriate classification of variable lease expense arising from finance leases. Many preparers have asked whether such expense should be recognized as amortization, interest expense, or lease expense (in a manner similar to recognition of an operating lease expense). Because of the variable and often contingent nature of such expense and its exclusion from the balance sheet ROU asset and liability, it does not involve the amortization of an asset or, similarly, the accrual of interest against a liability balance. Therefore, questions have arisen about how this expense should be recognized once the variability or contingency is resolved (or is deemed probable in accordance with ASC 842-20-55-1) and recognized as an expense.

Paragraph BC271 of ASU 2016-02 states:

> [T]he Board decided that cash flows from operating leases and variable lease payments that are not included in the lease liability should be classified as operating activities because the corresponding lease costs, if recognized in the statement of comprehensive income, will be presented in income from continuing operations. The previous sentence notwithstanding, Topic 842 states that lease payments capitalized as part of the cost of another asset (for example, inventory or a piece of property, plant or equipment) should be classified in the same manner as other payments for that asset. [Emphasis added]

Paragraph BC271 of ASU 2016-02 seems to indicate that, from the lessee's perspective, variable lease payments would be recognized in income from continuing operations in a manner similar to operating lease expense. (By analogy, this could also mean that variable lease payments from sales-type or direct financing leases should be recognized as a component of income from continuing operations, rather than as interest income.) Therefore, we believe that there is a basis to present variable lease expense as lease expense (i.e., instead of as amortization or interest).
However, we would accept presentation of variable lease expense in the statement of comprehensive income as either (1) interest expense or (2) a component of income from continuing operations (e.g., lease expense). (Similarly, we believe that lessors could present variable lease income related to payments that are not included in the initial measurement of a net investment in a sales-type or direct financing lease as either interest income or lease income.) Entities should disclose their presentation approach, if material.

14.2.2.2 Operating Leases — A Single Lease Expense

A lessee should evaluate its lease cost and, in a manner consistent with other types of expenses, should classify the single lease expense as cost of sales; selling, general, and administrative expenses; or another operating expense line item in the entity’s statement of comprehensive income.

Q&A 14-2 Presentation of Lease Expense for Operating Leases With Impaired ROU Assets

ASC 842-20-25-7 states:

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.

For an operating lease with an ROU asset impairment, an entity subsequently amortizes the ROU asset by using a finance lease model approach (i.e., the ROU asset is amortized on a straight-line basis, and incremental expense is recognized under the effective interest method). While the recognition pattern changes for operating leases after impairment (i.e., the finance lease exhibits a “front-loaded” expense profile because a higher liability corresponds to higher interest in earlier periods of the lease coupled with a straight-line amortization of the ROU asset), the character of the expense does not. See Section 8.4.4 for more information on how to record an operating lease impairment.

Question

After impairment, should an operating lessee separately present its expense incurred between interest expense and amortization of the ROU asset?

Answer

No. The expense must continue to be presented as a “single” lease expense and must be included in the operating lessee’s income from continuing operations in a manner consistent with its operating lease classification.
### 14.2.3 Statement of Cash Flows

**ASC 842-20**

<table>
<thead>
<tr>
<th>Statement of Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-5</strong> In the statement of cash flows, a lessee shall classify all of the following:</td>
</tr>
<tr>
<td>a. Repayments of the principal portion of the lease liability arising from finance leases within financing activities</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>d. Variable lease payments and short-term lease payments not included in the lease liability within operating activities.</td>
</tr>
</tbody>
</table>

Upon commencement of an operating lease, a lessee records an ROU asset and a lease liability. Such noncash activity should be disclosed (see Section 15.2.4.8). For operating leases, repayments of liabilities should be classified in operating activities. If any payments made for operating leases represent the costs of bringing another asset to the condition and location necessary for its intended use, such amounts should be classified as investing activities.

Upon commencement of a finance lease, a lessee records an ROU asset and lease liability. The noncash activities will be reflected in the noncash investing and financing disclosures (see Section 15.2.4.8). Such noncash activity should be included in the investing and financing activities sections of the statement of cash flows for the asset and liability, respectively. This is consistent with the guidance in ASC 230-10-50-4, which states:

> Examples of noncash investing and financing transactions are converting debt to equity; acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller; obtaining a right-of-use asset in exchange for a lease liability; obtaining a beneficial interest as consideration for transferring financial assets (excluding cash), including the transferor's trade receivables, in a securitization transaction; obtaining a building or investment asset by receiving a gift; and exchanging noncash assets or liabilities for other noncash assets or liabilities. [Emphasis added]

In addition to noncash disclosures associated with the initial recognition of a lease, a lessee should also consider noncash disclosure requirements based on other noncash changes (increases or decreases) to the lease balances, such as those resulting from lease modifications or reassessment events.

When the lessee makes lease payments under a finance lease, the lessee should reflect the principal portion of the payments as a cash outflow from a financing activity in the statement of cash flows. The portion of finance lease payment that reflects the interest payment should be classified as a cash outflow from an operating activity.
The example below illustrates the financial statement presentation for a finance lease and operating lease.

**Example 14-1**

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

This table highlights the differences in accounting for the lease as a finance lease and an operating lease:

<table>
<thead>
<tr>
<th>Year</th>
<th>Both Models</th>
<th>Finance Lease</th>
<th>Operating Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lease Liability</td>
<td>Interest Expense &lt;X&gt;</td>
<td>Amortization Expense &lt;Y&gt;</td>
</tr>
<tr>
<td>0</td>
<td>$ 38,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>31,038</td>
<td>3,038</td>
<td>12,666</td>
</tr>
<tr>
<td>2</td>
<td>18,520</td>
<td>2,481</td>
<td>12,667</td>
</tr>
<tr>
<td>3</td>
<td>—</td>
<td>1,481</td>
<td>12,667</td>
</tr>
<tr>
<td>Total</td>
<td>—</td>
<td>$ 7,000</td>
<td>$ 38,000</td>
</tr>
</tbody>
</table>

For the finance lease model, the interest expense calculated is a function of the lease liability balance and the discount rate (i.e., $38,000 multiplied by 8 percent in year 1). For the finance lease, the lessee includes amortization expense as a noncash add-back to the operating activities section of the statement of cash flows, which is calculated on a straight-line basis ($38,000 divided by 3). The principal portion of the cash payment is reflected in the financing section as principal paid. There is no need to separately add interest expense since it is already included in net income in the operating section. The supplemental section includes interest paid.

**Income Statement**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$ 203,283</td>
<td>$ 146,520</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expense</td>
<td>63,522</td>
<td>25,334</td>
</tr>
<tr>
<td>Amortization expense</td>
<td>12,666</td>
<td></td>
</tr>
<tr>
<td>Total expenses</td>
<td>76,188</td>
<td>51,463</td>
</tr>
<tr>
<td>Total operating income</td>
<td>127,095</td>
<td>171,854</td>
</tr>
<tr>
<td>Interest expense</td>
<td>3,038</td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$ 124,057</td>
<td>$ 135,184</td>
</tr>
</tbody>
</table>

**Balance Sheet**

<table>
<thead>
<tr>
<th>Assets</th>
<th>12/31/2010</th>
<th>12/31/2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 13,463</td>
<td>$ 146,520</td>
</tr>
<tr>
<td>ROU asset</td>
<td>$ 38,000</td>
<td>$ 25,334</td>
</tr>
<tr>
<td>Total assets</td>
<td>51,463</td>
<td>171,854</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td>2,336</td>
<td>5,632</td>
</tr>
<tr>
<td>Finance lease liability*</td>
<td>$ 38,000</td>
<td>$ 31,038</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>40,336</td>
<td>36,670</td>
</tr>
<tr>
<td>Equity</td>
<td>$ 11,127</td>
<td>$ 135,184</td>
</tr>
</tbody>
</table>

* For illustrative purposes, this amount has not been separated into current and noncurrent portions.
### Equity

<table>
<thead>
<tr>
<th>As of and Year Ended 12/31/2011</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning</td>
<td>$11,127</td>
</tr>
<tr>
<td>Income</td>
<td>124,057</td>
</tr>
<tr>
<td>Ending</td>
<td>$135,184</td>
</tr>
</tbody>
</table>

### Cash Flow Statement

<table>
<thead>
<tr>
<th>Year Ended 12/31/2011</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$124,057</td>
</tr>
<tr>
<td>Amortization expense</td>
<td>12,666</td>
</tr>
<tr>
<td>Change in operating liabilities</td>
<td>3,296</td>
</tr>
<tr>
<td>Operating</td>
<td>140,019</td>
</tr>
<tr>
<td>Investing</td>
<td>—</td>
</tr>
<tr>
<td>Principal paid</td>
<td>(6,962)</td>
</tr>
<tr>
<td>Financing</td>
<td>(6,962)</td>
</tr>
<tr>
<td>Change in cash flows</td>
<td>133,057</td>
</tr>
<tr>
<td>Beginning cash</td>
<td>13,463</td>
</tr>
<tr>
<td>Ending cash</td>
<td>146,520</td>
</tr>
<tr>
<td>Interest paid</td>
<td>$3,038</td>
</tr>
</tbody>
</table>

For the operating lease model, the lessee may include noncash lease expense as a noncash add-back to the operating section of the statement of cash flows ($15,000 – $3,038 = $11,962); this reflects the portion of the lease expense that amortized the ROU asset. While this presentation reflects a best practice, there may be other acceptable methods of presentation for the change in ROU assets; however, it would be inappropriate to present the change in ROU assets in amortization expense. Entities contemplating a different method of presentation are encouraged to discuss the method with their accounting advisers. The cash payment is reflected in the operating section as a change in operating liabilities. Because interest expense is not included in operating leases, there are no separate disclosures for this activity.

### Income Statement

<table>
<thead>
<tr>
<th>Year Ended 12/31/2011</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$203,283</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
</tr>
<tr>
<td>Operating expense</td>
<td>63,522</td>
</tr>
<tr>
<td>Lease expense</td>
<td>15,000</td>
</tr>
<tr>
<td>Total expenses</td>
<td>78,522</td>
</tr>
<tr>
<td>Total operating income</td>
<td>124,761</td>
</tr>
<tr>
<td>Interest expense</td>
<td>—</td>
</tr>
<tr>
<td>Net income</td>
<td>$124,761</td>
</tr>
</tbody>
</table>

### Balance Sheet

<table>
<thead>
<tr>
<th>12/31/2010</th>
<th>12/31/2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$13,463</td>
</tr>
<tr>
<td>ROU asset</td>
<td>38,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>51,463</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td>2,336</td>
</tr>
<tr>
<td>Operating lease liability*</td>
<td>38,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>40,336</td>
</tr>
<tr>
<td>Equity</td>
<td>$11,127</td>
</tr>
</tbody>
</table>

* For illustrative purposes, this amount has not been separated into current and noncurrent portions.
### Chapter 14 — Presentation

#### 14.3 Lessor

14.3.1 Sales-Type and Direct Financing Leases

14.3.1.1 Statement of Financial Position

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales-Type and Direct Financing Leases</strong></td>
</tr>
<tr>
<td><strong>Statement of Financial Position</strong></td>
</tr>
<tr>
<td><strong>45-1</strong> 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.</td>
</tr>
<tr>
<td><strong>45-2</strong> Lease assets shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet.</td>
</tr>
</tbody>
</table>

As noted above, “the aggregate of the lessor’s net investment in sales-type leases and direct financing leases” must be presented “separately from other assets in the statement of financial position.” In other words, these balances must be presented discretely in the statement of financial position and cannot be combined with other financial statement balances. The Q&A below addresses whether the amounts that comprise the net investment in the lease should be separated between current and noncurrent sections on a classified balance sheet.
**Q&A 14-3 Whether a Lessor That Presents a Classified Balance Sheet Is Required to Classify Its Net Investment in Leases as Current and Noncurrent**

**Question**

Is an entity that presents a classified balance sheet required to classify its net investments in leases as current and noncurrent?

**Answer**

Yes. While a lessee does not need to present its ROU assets as current and noncurrent, the same logic cannot be applied to a lessor’s net investment in the lease. The net investment in the lease is a financial asset that is within the scope of ASC 310; therefore, there is often a current balance, the amount that is reasonably expected to be realized in cash during the normal operating cycle of the business.

**14.3.1.2 Statement of Comprehensive Income**

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
</table>

**Statement of Comprehensive Income**

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.

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.

Any income from sales-type leases (selling profit or loss and interest income) or direct financing leases (interest income) must be included in the statement of comprehensive income. To the extent that the amounts are not presented separately, they should be disclosed in the notes to the financial statements. See the Connecting the Dots in Section 14.2.2.1 for a discussion that considers the presentation of income from variable lease payments.
Connecting the Dots — SEC Regulation S-X Requirements Related to Income Statement Presentation

SEC Regulation S-X, Rule 5-03, indicates the various line items that should appear on the face of the income statement. Specifically, a registrant should separately present any amounts that represent 10 percent of the sum of income derived from net sales of tangible products, operating revenues from public utilities or others, income from rentals, revenues from services, and other revenues. Although these SEC Regulation S-X requirements do not appear to mandate any disclosures that are not already prescribed by ASC 842, registrants should nonetheless consider the rule’s mandates in evaluating whether separate presentation on the face of the financial statements is warranted.

Connecting the Dots — Revenue Recognized

ASC 842-30-45-4(a) states that revenue recognized by a lessor that “uses leases as an alternative means of realizing value from the goods that it would otherwise sell” must be the lesser of (1) the “fair value of the underlying asset at the commencement date” or (2) the “sum of the lease receivable and any lease payments prepaid by the lessee.” The intent of this guidance is to ensure that a lessor reflects the substance of its transactions — as either a seller or financier of a good — regardless of whether the lease is a sales-type lease in form. It would be more appropriate for a seller of a good to present the gross sales proceeds and cost of the good sold, whereas a financier may only present profit and interest income.

Example 14-2

Case A
One of Loman Inc.’s traveling salespeople enters into an arrangement to lease props and other theater equipment to a customer, Miller Theater Company. Although Loman typically sells its equipment, Miller prefers to enter into a lease because the lease requires payment streams that are preferable to the full up-front selling price. Loman Inc. determines the lease is a sales-type lease. The fair value of the theater equipment is $10,000, and Loman’s cost is $8,000.

The appropriate income statement presentation of Loman Inc.’s sales-type lease at commencement is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of theater equipment</td>
<td>$ 10,000</td>
</tr>
<tr>
<td>Cost of theater equipment</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Selling profit on theater equipment</td>
<td>$ 2,000</td>
</tr>
</tbody>
</table>

Case B
Assume the same facts as in Case A except that Loman Inc. is a financial institution and provides financing to various customers to purchase equipment. In this case, Loman uses leasing as a means of providing financing to customers rather than selling its assets. The only amount presented in the financial statements at commencement would be selling profit of $2,000 (the net effect of the prior calculated balances — that is, the net impact of $10,000 less $8,000). (Note that with the changes to the lessor’s lease classification, it is possible for a financier to obtain sales-type lease classification — see Section 9.2.)
Q&A 14-4  Presentation of Sublease Income

The ASC master glossary defines a sublease as “[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.”

From a balance sheet perspective, subleases generally must be presented on a gross basis since they do not relieve the sublessor’s obligation under the head lease. However, ASC 842 does not directly address income statement presentation of subleases. While the amounts paid to the original, third-party lessor are generally presented in the income statement as a component of selling, general, and administrative expenses or as part of cost of goods sold, questions have arisen regarding how sublease income should be presented under ASC 842 — that is, whether it would be appropriate to recognize sublease income on a net basis (i.e., as an offset to the head lease expense) rather than on a gross basis.

Question
Is it acceptable under ASC 842 for an entity to offset sublease income against head lease expense in the income statement?

Answer
It depends. ASC 842 does not explicitly indicate whether it would be acceptable to net, for income statement presentation purposes, sublease income against the related head lease expense. Because subleases generally must be presented on the balance sheet on a gross basis under ASC 842, one might conclude that gross income statement presentation is required as well. However, we believe that net presentation of sublease activity in the income statement may be appropriate when the sublease activity is outside an entity’s normal business operations (and thus occurs infrequently) and when doing so would result in more meaningful financial reporting information for financial statement users. For example, in some instances, net presentation may better reflect the true cost of leasing the underlying asset or may avoid distortion of important financial statement metrics such as operating income (e.g., scenarios in which the recognition of the sublease income and head lease expense on a gross basis would understate total operating income because the sublease income would be recognized as a component of “other income/expense (net)”]. In such circumstances, net presentation within selling, general, and administrative expenses or cost of goods sold may be appropriate.

14.3.1.3  Statement of Cash Flows

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statement of Cash Flows</strong></td>
</tr>
<tr>
<td>45-5 In the statement of cash flows, a lessor shall classify cash receipts from leases within operating activities.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Pending Content (Transition Guidance: ASC 842-10-65-4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>45-5 In the statement of cash flows, a lessor shall classify cash receipts from leases within operating activities. However, if the lessor is within the scope of Topic 942 on financial services — depository and lending, it shall follow the guidance in paragraph 942-230-45-4 for the presentation of principal payments received from leases.</td>
</tr>
</tbody>
</table>
The guidance in ASC 842-30-45-5, as originally issued, was clear that cash receipts from sales-type leases or direct financing leases are included in operating activities in the statement of cash flows. However, the FASB staff received questions from stakeholders because the example in ASC 942-230-55-2 conflicted with the guidance in ASC 842-30-45-5, as originally issued. Specifically, the example in ASC 942 illustrates the direct method of cash flows and presents “principal payments received under leases” in cash flows from investing activities. (This example existed before, and was not consequentially amended by, the issuance of ASC 842.) Accordingly, in March 2019, the Board issued ASU 2019-01, which addresses this conflicting guidance by retaining the current guidance in ASC 942. Thus, depository and lending lessors (those entities within the scope of ASC 942) should continue to classify principal payments received from sales-type and direct financing leases within “investing activities.” See Section 17.3.1.7 for a detailed discussion of ASU 2019-01.

14.3.2 Operating Leases

14.3.2.1 Statement of Financial Position

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statement of Financial Position</strong></td>
</tr>
<tr>
<td><strong>45-6</strong> A lessor shall present the underlying asset subject to an operating lease in accordance with other Topics.</td>
</tr>
</tbody>
</table>

Because a lessor’s operating lease does not result in derecognition of the underlying asset, the lessor should present the underlying asset in accordance with other U.S. GAAP (e.g., ASC 360 on PP&E). Although there is no prescriptive guidance on presenting deferred rent balances (i.e., straight-line rent), an entity should present such balances in accordance with ASC 210.

14.3.2.2 Statement of Comprehensive Income

See ASC 842-30-45-3 for the discussion of the statement of comprehensive income in Section 14.3.1. The same guidance would apply to a lessor’s operating leases.

14.3.2.3 Statement of Cash Flows

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>45-7</strong> In the statement of cash flows, a lessor shall classify cash receipts from leases within operating activities.</td>
</tr>
</tbody>
</table>

Cash receipts from operating leases are included in operating activities in the statement of cash flows.
Chapter 15 — Disclosure

15.1 Background and Objective

15.2 Lessee Disclosure Requirements
   15.2.1 Information About the Nature of an Entity’s Leases (Including Subleases)
   15.2.2 Leases That Have Not Yet Commenced
   15.2.3 Significant Assumptions and Judgments
   15.2.4 Amounts Recognized in the Financial Statements
   15.2.5 Maturity Analysis of Liabilities
   15.2.6 Lease Transactions With Related Parties
   15.2.7 Practical-Expedient Disclosure Related to Short-Term Leases
   15.2.8 Practical-Expedient Disclosure Related to Not Separating Lease and Nonlease Components

15.3 Lessor Disclosure Requirements
   15.3.1 Information About the Nature of an Entity’s Leases
   15.3.2 Significant Assumptions and Judgments
   15.3.3 Lease Transactions With Related Parties
   15.3.4 Residual Assets and Risk Management
   15.3.5 Amounts Recognized in the Financial Statements
   15.3.6 Practical-Expedient Disclosure Related to Sales Taxes and Other Similar Taxes Collected From Lessees

15.4 Sale-and-Leaseback Transactions

15.5 Annual and Interim Disclosures
   15.5.1 Comparative Periods
   15.5.2 Interim Disclosures
15.1 Background and Objective

The disclosure objective of ASC 842 is to “enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases.” Accordingly, disclosures (both qualitative and quantitative) are intended to supplement the amounts recorded in the financial statements so that financial statement users can better understand the nature of an entity’s leasing activities from the standpoint of both lessees and lessors.

Although disclosure requirements were also a critical aspect of ASC 840, users believed that the information presented was often inadequate. ASC 842 therefore contains new and expanded disclosure requirements that are significantly more comprehensive than those in ASC 840. Accordingly, as with disclosures under the FASB’s new revenue recognition standard, disclosures about an entity’s leasing transactions are likely to increase under the new leasing requirements even though they may have decreased in many other areas of accounting (e.g., pensions, stock compensation, fair value, and income taxes) because of the Board’s recent focus on reducing disclosure overload (i.e., making disclosures more effective and coordinated and less redundant).

The Board has therefore emphasized that entities need to remain focused on the underlying disclosure objective so that they avoid obscurring useful information by providing extraneous detail or losing relevance by furnishing significantly aggregated information. Further, a “one-size-fits-all” approach would be inconsistent with the new disclosure objective; thus, to meet this objective, it is critical that an entity use significant judgment and evaluate the new requirements against its own leasing activities.

In 2019, the SEC did not issue a significant number of comment letters related to leasing transactions under ASC 842. During the 2019 AICPA Conference on Current SEC and PCAOB Developments, the staff in the SEC’s Division of Corporation Finance (the “Division”) discussed the new leasing standard. At the conference’s comment letter panel session, Chief of the Division’s Office of Real Estate and Construction Joel Parker indicated that the Division staff is still in the early stages of reviewing disclosures. While it is too soon to identify any trends or themes, Mr. Parker provided some disclosure reminders for registrants as they prepare their annual financial statements. Specifically, he reminded registrants to (1) consider the new standard’s changes to disclosure requirements, (2) avoid boilerplate disclosures that simply restate the requirements of ASC 842, and (3) tailor disclosures to specific lease arrangements and provide disclosures about the assumptions that were used in applying the standard to those arrangements.

As regulators review disclosures and issue comments, entities should evaluate their peers’ filings and look for opportunities to improve existing disclosures. We encourage such continual improvement and remind preparers to focus on the disclosure objective stated above.

Connecting the Dots — System and Implementation Challenges

Entities should be proactive in developing the disclosures required by the standard because of the substantive system and implementation challenges that may arise when entities (1) gather the information necessary for drafting the required disclosures and (2) implement controls to review related disclosures and underlying data.
Q&A 15-1 Omission of Disclosures

Question
When would an entity be permitted to exclude from its financial statements and notes a specific disclosure that is otherwise required under ASC 842?

Answer
Throughout ASC 842, the FASB consistently uses the word “shall” to indicate that an entity would generally be required to provide a specific disclosure. However, in paragraph BC276 of ASU 2016-02, the FASB acknowledges that an entity needs to consider both relevance and materiality when determining which disclosures to provide:

The Board also rejected including an explicit statement that the disclosure requirements are not required in all circumstances. That is because it is implicit to the overall disclosure objective that the level of detail in the disclosures should equate to the significance of an entity’s leasing activity (for example, if leasing is a significant part of an entity’s business activities, the disclosures would be more comprehensive than for an entity whose leasing activities are less significant to its business activities).

For example, a lessee would most likely not discuss judgments and assumptions used to allocate consideration in a contract between lease and nonlease components if there are no nonlease components or if management concludes that the quantitative and qualitative impact of the disclosure requirement is immaterial. However, as with other materiality assessments, entities should carefully consider whether the omission of a required disclosure represents an error. Entities are encouraged to consult with their financial advisers when making such determinations.

Further, while the disclosures specified in ASC 842 are generally viewed as mandatory, how an entity complies with the disclosure requirements under ASC 842 may vary significantly. An entity should assess which disclosures need to be provided for each reporting period since a disclosure deemed irrelevant or immaterial in previous reporting periods may subsequently become material (e.g., as a result of increases in the monetary values to be disclosed or changes in qualitative factors).

This chapter is divided into the following overall subsections:

• 15.2 Lessee Disclosure Requirements.
• 15.3 Lessor Disclosure Requirements.
• 15.4 Sale-and-Leaseback Transactions.
• 15.5 Annual and Interim Disclosures.
15.2 Lessee Disclosure Requirements

ASC 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).

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.

In addition to considering the above disclosure requirements for lessees, an entity that is both a lessee and lessor or engages in sale-and-leaseback transactions will need to review the lessor and sale-and-leaseback requirements separately (see Sections 15.3 and 15.4, respectively). Further, as noted in ASC 842-20-50-2, a lessee should consider the appropriate level of disclosure aggregation or disaggregation so that it avoids including “a large amount of insignificant detail or . . . aggregating items that have different characteristics.”

Illustrative Example — Disclosure Disaggregation

The following are examples of ways a lessee may choose to disaggregate its lessee disclosures:

- Real estate leases and equipment leases
  - Business segment or unit in which leased asset is used
  - Class (or type) of underlying asset
    - Consumer products and industrial products segments
  - Lease payment terms
    - Leases with significant variable payments and leases with fixed payment terms
  - Geographical region in which lease was entered into or in which the leased asset will be used
    - Leases in Americas region and leases in Eurasia region

Leases for 3 to 5 years, 6 to 9 years, and 10 or more years

Lease term

Leases in Americas region and leases in Eurasia region
The lessee disclosure requirements can be further subdivided into the following topics:

- Information about the nature of an entity’s leases (including subleases) (Section 15.2.1).
  - General description of leases (Section 15.2.1.1).
  - Basis and terms and conditions on which variable lease payments are determined (Section 15.2.1.2).
  - Terms and conditions of options to extend or terminate leases (Section 15.2.1.3).
  - Residual value guarantees (Section 15.2.1.4).
  - Restrictions or covenants imposed by leases (Section 15.2.1.5).

- Leases that have not yet commenced (Section 15.2.2).

- Significant assumptions and judgments (Section 15.2.3).
  - Whether a contract contains a lease (Section 15.2.3.1).
  - Allocation of consideration in a contract (Section 15.2.3.2).
  - Discount rate (Section 15.2.3.3).

- Amounts recognized in the financial statements (Section 15.2.4).
  - Finance lease cost (Section 15.2.4.1).
  - Operating lease cost (Section 15.2.4.2).
  - Short-term lease cost (Section 15.2.4.3).
  - Variable lease cost (Section 15.2.4.4).
  - Sublease income (Section 15.2.4.5).
  - Net gain or loss from sale-and-leaseback transactions (Section 15.2.4.6).
  - Cash paid for amounts included in measurement of lease liabilities (Section 15.2.4.7).
  - Supplemental noncash information (Section 15.2.4.8).
  - Weighted-average remaining lease term (Section 15.2.4.9).
  - Weighted-average discount rate (Section 15.2.4.10).

- Maturity analysis of liabilities (Section 15.2.5).

- Lease transactions with related parties (Section 15.2.6).

- Practical-expedient disclosure related to short-term leases (Section 15.2.7).

- Practical-expedient disclosure related to not separating lease and nonlease components (Section 15.2.8).

- Electing transition practical expedients:
  - Hindsight practical expedient (Section 16.5.1).
  - Practical expedient package (Section 16.5.2).

- Election not to restate comparative periods in the period of adoption (Section 16.1.1).
15.2.1 Information About the Nature of an Entity’s Leases (Including Subleases)

**ASC 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.

The information that a lessee discloses about the nature of its leases should be consistent with the disclosure objective of ASC 842 and generally is qualitative (e.g., the extent to which terms or conditions exist and a description of those terms or conditions). As noted in ASC 842-20-50-3, a lessee should also consider providing such disclosures for subleases when appropriate.

Below is a discussion of, and examples illustrating, each of the requirements in (1)–(5) of ASC 842-20-50-3(a) above.

15.2.1.1 General Description of Leases

**ASC 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.

ASC 842 does not explicitly define the phrase “general description of leases.” This disclosure requirement is intentionally broad, and a lessee should consider the level of detail it needs to provide to satisfy the disclosure objective as well as how much emphasis to place on this and other disclosure requirements. The lessee should also consider whether its existing disclosures meet this requirement, since ASC 840 did not include a disclosure objective (though it did contain the “general description” disclosure requirement).
Illustrative Example — General Description of an Entity’s Leases

Classes of underlying assets:
- Entity A leases real estate for a lease term of 10 years.
- Entity B leases equipment for terms between 12 months and 3 years.
- Entity C leases weaponry on a seasonal basis.

Use of leased asset:
- Entity A leases its corporate headquarters.
- Entity B leases equipment for use in managing inventory (e.g., forklifts).
- Entity C leases specialized glass equipment for use during the winter season.

Use of leasing:
- Entity A leases the corporate headquarters to limit exposure to risks related to ownership such as fluctuations in real estate prices.
- Entity B leases certain forklifts on a short-term basis in response to seasonal fluctuations in its business. Entity B only leases from large, reputable equipment finance companies.
- Entity C leases specialized glass equipment to retain its position in the marketplace against competitors. Because the glass is so specialized, there are restrictions against ownership of the glass; thus, C may only lease these assets.

Are there differences in leasing between asset classes (e.g., equipment vs. real estate)?
What types or classes of assets are leased?
What are the terms of the entity’s leases?
How does the entity use assets in its business?
Are leased assets specialized?
Why does the entity lease assets?
Who are the counterparties to an entity’s leases?
### 15.2.1.2 Basis and Terms and Conditions on Which Variable Lease Payments Are Determined

<table>
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<th>ASC 842-20</th>
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<tr>
<td><strong>50-3</strong> A lessee shall disclose all of the following:</td>
</tr>
<tr>
<td>1. Information about the nature of its leases, including: . . .</td>
</tr>
<tr>
<td>2. The basis and terms and conditions on which variable lease payments are determined. . .</td>
</tr>
</tbody>
</table>

As discussed in Section 6.3, only some variable lease payments (those based on an index or rate) are included in the initial and subsequent measurement of a lessee’s lease liability and ROU asset. Because variable lease costs are treated in different ways, the determination of what type of variability exists within a lease contract and whether that variability is included in, or excluded from, the recognized lease liability is critical to understanding lease costs and to achieving the disclosure objective (i.e., to understanding the timing and uncertainty of the entity’s cash flows). Therefore, the terms and conditions that create, and expose the entity to, that variability provide the user with information about amounts that are not recorded in the balance sheet because variable lease payments not based on an index or rate are not included in the measurement of the ROU asset or lease liability.

Although it is not expressly required to do so, it may be helpful for an entity to describe the sources of the variability in two separate groups: (1) amounts included in the lease liability and (2) variability that is excluded. In addition, an entity must explain the types of variability that exists in its contracts, and this explanation should include a discussion of key terms and conditions. For example, an entity may encounter variability because a retail store location’s rent is determined on the basis of a percentage of its store’s sales. From that simple description, a user may understand the direct relationship between the sales and the rent increases. Sometimes, however, the variability may be more complex, in which case an entity may need to provide additional explanation and align key financial metrics.
### Illustrative Example — Basis and Terms and Conditions on Which Variable Lease Payments Are Determined

Variable lease payments that are based on an index or rate:

- A majority of leases are subject to annual changes in the CPI. While lease liabilities are not remeasured as a result of changes to the CPI, changes to the CPI are treated as variable lease payments and recognized in the period in which the obligation for those payments was incurred. A 100-basis-point increase in CPI would have resulted in $6.8 million in additional lease costs.

Variable lease payments not based on an index or rate:

- The company is obligated to pay the lessor 2 percent of its retail store’s sales. Such amounts are not included in the measurement of the lease liability but will be recognized as variable lease expense when they are incurred. After $2 million of retail store sales, the payment amount is 1 percent of the retail store’s sales.
- All of the payments made to lease the solar facility are variable. The company pays a stated rate per megawatt produced by the solar facility and is required to purchase 100 percent of the output from the facility, which can produce up to 10 megawatts.

### 15.2.1.3 Terms and Conditions of Options to Extend or Terminate Leases

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<tbody>
<tr>
<td>50-3 A lessee shall disclose all of the following:</td>
</tr>
<tr>
<td>a. Information about the nature of its leases, including: . . .</td>
</tr>
<tr>
<td>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. . . .</td>
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</table>

The requirement to disclose terms and conditions related to options to extend or terminate leases should increase the transparency of the lessee’s rights and obligations. This requirement is in line with the disclosure objective because it allows users to more easily understand the future cash flows expected to be incurred (i.e., extension) or eliminated (i.e., termination) if the entity elects these options. The extent of such disclosures may depend on how integral a lease is to a business.
Illustrative Example — Terms and Conditions of Options to Extend or Terminate Leases

A company has an option to extend the lease term of its corporate headquarters; the noncancelable lease period began in 2022 and ends in 2032, with one 5-year renewal period. During the first quarter of 2029, the exercise of the renewal option became reasonably certain; therefore, the payments associated with the renewal are now included in the measurement of the lease liability and ROU asset. The exercise of the renewal option became reasonably certain when the company installed a new data room at the corporate headquarters. The useful life of this room will extend through 2037.

The lease of the company's 3-D printer may be terminated in two years for a termination penalty of $2 million. As of the balance sheet date, the company is reasonably certain that it will not exercise the termination option; however, the company continues to explore alternative technologies for manufacturing its inventory.

15.2.1.4 Residual Value Guarantees

ASC 842-20

50-3 A lessee shall disclose all of the following:
   a. Information about the nature of its leases, including: . . .
      4. The existence and terms and conditions of residual value guarantees provided by the lessee. . .

The ASC master glossary defines a residual value guarantee as “[a] guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount.” As further discussed in Section 6.7, with respect to such a guarantee, a lessee is only required to include the amounts whose payment is probable in the measurement of the lease liability and ROU asset.
Therefore, as outlined above, a lessee must explain the existence and terms and conditions of any residual value guarantees associated with its leases (e.g., the full amount that a lessee has guaranteed under its leases). Providing such information is consistent with the disclosure objective since the lessee’s future cash outflows may be affected if an asset’s value at the end of the lease term is less than the residual value that the lessee has guaranteed for the lessor. To the extent that amounts have been deemed probable and have therefore been included in the lease liability, it may be appropriate for an entity to explain its determination of such amounts — in particular, the circumstances that may subsequently change the amount included in the liability or future amounts that will be owed to the lessor.

**Illustrative Example — Residual Value Guarantees**

Entity P has provided a residual value guarantee for the lease of a vehicle fleet. No amounts related to this residual value guarantee have been deemed probable, but if the value of the vehicle fleet is zero at the end of the fleet’s lease term, P would be required to pay $10 million.

Entity G has leased an aircraft for its executive team and has provided a residual value guarantee of $3.3 million to the aircraft owner. The amount that it is probable G will owe under the residual value guarantee is $1.6 million; therefore, this amount is included in the measurement of the lease liability and ROU asset.

**15.2.1.5 Restrictions or Covenants Imposed by Leases**

**ASC 842-20**

50-3 A lessee shall disclose all of the following:

a. Information about the nature of its leases, including: . . .

   5. The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations. . . .
This requirement is similar to the requirement in ASC 840-10-50-2(c), under which a lessee must disclose “[r]estrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing.” Therefore, an entity would typically have already been disclosing this information for existing leases. Nevertheless, an entity should consider the extent to which such information is in line with ASC 842’s disclosure objective. In addition, while the existing requirements in ASC 840 focus on the cash flows directly related to the lessee’s use of the underlying asset (i.e., the cash flows associated with the expected rental payments for that use), the requirement in ASC 842 is a bit broader and an entity may want to consider whether the lease imposes other restrictions or covenants that constrain the entity’s cash flows for other purposes (e.g., restricting the payment of dividends, restricting the use of additional leases or other debt financing).

**Illustrative Example — Restrictions or Covenants Imposed by Leases**

Entity B entered into a master lease with a third-party automotive supplier. The master lease indicates that B cannot enter into any other lease contracts with other automotive suppliers. As a result, B is restricted from finding more favorable pricing during the term of the master lease.

If B’s lease liabilities are in excess of $350 million, its ability to draw from its credit facility is reduced by $100 million and it is further restricted from issuing dividends to its shareholders.

**15.2.2 Leases That Have Not Yet Commenced**

**ASC 842-20**

**50-3** A lessee shall disclose all of the following: . . .

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. . . .
In complying with the requirement to disclose “[i]nformation about leases that have not yet commenced but that create significant rights and obligations for the lessee,” an entity is providing users with information that will affect the entity’s future cash flows as a result of leasing activities that would not yet appear on the balance sheet, in particular as a lease liability. The requirements specifically highlight disclosures related to two common circumstances: (1) a forward-starting lease and (2) a future lessee’s involvement in the “construction or design” of an asset that it will lease upon completion of construction at some future date (e.g., a build-to-suit arrangement).

A forward-starting lease is a lease whose inception precedes the time when the asset is made available for use by the customer (i.e., lease commencement). As discussed in Section 3.3, a forward-starting lease may result from an arrangement that includes a front-loaded substitution right such that when that substitution right expires, the customer and the supplier will have an identified asset that they can use to assess whether the contract is or contains a lease. Note that a lease amendment (that is accounted for as a modification) that extends the term but involves the same asset is not a forward-starting lease while a lease amendment that grants an additional right of use in the future (e.g., by adding a new floor to an existing lease of office space) would be considered a forward-starting lease.

As discussed in Chapter 11, there are specific recognition and measurement requirements that apply when a future lessee is involved in the construction or design of an asset that it will lease in the future. As a result of those requirements, the future lessee may need to recognize the asset during the construction period and then assess the arrangement in accordance with the sale-and-leaseback requirements outlined in Chapter 10.

### Illustrative Example — Leases That Have Not Yet Commenced

A company entered into an agreement in September 2018 to lease a retail space in New York City as its flagship location. The lessor and its agents are currently building this retail space. The lease is expected to commence in late 2019 when construction of the asset is completed.

The company has entered into a contract under which Harry Inc., a third party, will manufacture 100 percent of the steering wheels to be placed in the company’s vehicles for sale; the contract with Lloyd Inc. to produce the steering wheels will be discontinued. The contract contains a lease, since part of the consideration in the contract is related to the manufacturing facility, as a result of which the company has substantially all of the economic benefits from use and has the right to direct HAFWP the manufacturing facility is being used. The terms of the contract will begin in the third quarter of 2022 when the contract with Lloyd Inc. is terminated.
15.2.3 Significant Assumptions and Judgments

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<tr>
<td><strong>50-3</strong> A lessee shall disclose all of the following: . . .</td>
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<tr>
<td>c. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:</td>
</tr>
<tr>
<td>1. The determination of whether a contract contains a lease (as described in paragraphs 842-10-15-2 through 15-27)</td>
</tr>
<tr>
<td>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)</td>
</tr>
<tr>
<td>3. The determination of the discount rate for the lease (as described in paragraphs 842-20-30-2 through 30-4).</td>
</tr>
</tbody>
</table>

The requirement for an entity to disclose the significant assumptions and judgments it used in applying ASC 842 in itself involves judgment. That is, the three types of information about significant assumptions and judgments listed above in ASC 842-20-50-3 (and discussed below) may not always be applicable and, in some cases, another significant assumption or judgment may be critical and material to an entity's financial statements.

15.2.3.1 Whether a Contract Contains a Lease

A lessee should consider disclosing information about the significant assumptions and judgments used to determine whether a contract is or contains a lease. (See Chapter 3 for more information.) Specifically, a customer must consider whether (1) explicitly or implicitly identified assets have been deployed in the contract and (2) the customer obtains substantially all of the economic benefits from the use of that underlying asset and directs HAF WP the asset is used during the term of the contract. The standard indicates that, when preparing such disclosures, the lessee should consider the discussion in ASC 842-10-15-2 through 15-27 regarding the definition of a lease. For example, we believe that if a customer considers its involvement in the design of the asset when determining whether a contract contains a lease, significant judgment may be required and disclosure may be warranted.
Illustrative Example — Whether a Contract Contains a Lease

A company has entered into a service contract with a third party to store its inventory. In assessing whether that contract is or contains a lease, the company determined that a warehouse is implicitly identified in Palos Park, Illinois. The warehouse owner does not have alternative warehouses within a 100-mile radius to store the company's inventory; in addition, any substitution rights stated in the contract are not substantive.

When evaluating the economic benefits from the warehouse's use, the company identified a local not-for-profit entity that intermittently uses the warehouse for storage; however, such use involves less than 5 percent of the total square footage of the warehouse. Contractually, the company has the right to use all of the square footage of the warehouse and such usage represents 100 percent of the economic benefit that can be derived from the warehouse.

The company has the right to enter and exit the warehouse facility and to move its inventory at will. The company has determined that it has the right to direct HAFWP the asset is being used.

The service contract with the third party contains a lease of the warehouse.

15.2.3.2 Allocation of Consideration in a Contract

A lessee should consider disclosing information about the significant assumptions and judgments used to determine its allocation of consideration in a contract or contracts. (See Chapter 4 for more information.) Specifically, the stand-alone prices used to allocate consideration may be estimated and subject to significant fluctuations over time. For example, such estimates may be significantly lower or higher than another entity's estimates or the estimates may change in future periods and be incorporated into new leases. (Keep in mind that while estimates made to allocate consideration in a lease in the current period may differ from those made in prior periods for different leases, a lessee is not required to revisit its estimates made in prior periods for different leases.) An entity should consider describing the method used to determine stand-alone prices and how those estimates may involve less or greater judgment for various lease types (e.g., leases based on geography or an asset such as real estate/equipment whose value may fluctuate depending on economic factors).

ASC 842 indicates that, when preparing such disclosures, a lessee should consider the discussion in ASC 842-10-15-28 through 15-32 regarding allocation of consideration in a contract.
Illustrative Example — Allocation of Consideration in a Contract

Separate Components in a Contract

Company G entered into a contract to lease a bulldozer, a truck, and a crane to build parking garages throughout the U.S. Virgin Islands. While the assets are being leased together for a similar purpose, the machines are not highly dependent on or interrelated with each other. The machines are not, in effect, inputs into a single combined item; therefore, each machine is a separate lease component in the contract.

The lessor also provides certain maintenance services, a nonlease component, associated with the leased assets and the payment for such services is included in the payments provided to the lessor.

The company has not elected the practical expedient under which the lease component would not be separated from the nonlease components. The company obtains stand-alone prices for each of the lease and nonlease components from our supplier (i.e., the cost to lease the asset without maintenance services and the cost to obtain maintenance services for a nonleased asset) and allocates the total transaction price to the lease component and nonlease components on a relative stand-alone price basis.

How did the company allocate the consideration in the contract to lease and nonlease components?

15.2.3.3 Discount Rate

A lessee should consider disclosing information about the significant assumptions and judgments used to determine its discount rate(s). For example, a lessee may need to disclose information regarding its determination of the incremental borrowing rate, such as collateral assumptions, the term used, and the economic environment in which the lease is denominated. To the extent that a portfolio approach is used to determine discount rates, an entity should consider disclosing information about the composition of the portfolios. (See Chapter 7 for more information about discount rates.)
**Connecting the Dots — Discount Rate**

While it is too early to identify trends in SEC comments, we believe that the SEC staff will continue to focus on discount rate disclosures. As previously noted, the staff encourages registrants to avoid boilerplate disclosures that simply restate the requirements of ASC 842. For example, when such disclosures indicate that a registrant used the implicit rate “when available,” the SEC may request the registrant to provide additional information about when it used the implicit rate.

For more information about SEC comment letter trends related to the disclosure requirements in ASC 842, see Deloitte’s *A Roadmap to SEC Comment Letter Considerations, Including Industry Insights*.

### 15.2.4 Amounts Recognized in the Financial Statements

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<tr>
<td><strong>50-4</strong> 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:</td>
</tr>
<tr>
<td>- a. Finance lease cost, segregated between the amortization of the right-of-use assets and interest on the lease liabilities.</td>
</tr>
<tr>
<td>- b. Operating lease cost determined in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7.</td>
</tr>
<tr>
<td>- 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.</td>
</tr>
<tr>
<td>- d. Variable lease cost determined in accordance with paragraphs 842-20-25-5(b) and 842-20-25-6(b).</td>
</tr>
<tr>
<td>- e. Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense.</td>
</tr>
<tr>
<td>- f. Net gain or loss recognized from sale and leaseback transactions in accordance with paragraph 842-40-25-4.</td>
</tr>
<tr>
<td>- g. Amounts segregated between those for finance and operating leases for the following items:</td>
</tr>
<tr>
<td>- 1. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows</td>
</tr>
<tr>
<td>- 2. Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets</td>
</tr>
<tr>
<td>- 3. Weighted-average remaining lease term</td>
</tr>
<tr>
<td>- 4. Weighted-average discount rate.</td>
</tr>
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| **50-5** See paragraphs 842-20-55-11 through 55-12 for implementation guidance on preparing the weighted-average remaining lease term and the weighted-average discount rate disclosures. See Example 6 (paragraphs 842-20-55-52 through 55-53) for an illustration of the lessee quantitative disclosure requirements in paragraph 842-20-50-4. |

While the disclosure requirements discussed in Section 15.2.3 are largely qualitative, those addressed in this section are mostly quantitative. When preparing such disclosures, a lessee will need to gather certain quantitative information about amounts (1) recognized in the financial statements and (2) derived from the underlying leases recognized in the financial statements. Such amounts should include those that are recognized in profit or loss during the period and capitalized as part of the cost of another asset in accordance with other U.S. GAAP (e.g., a cost that is capitalized into inventory and that will be recognized as a cost of sales when the inventory is subsequently sold to a customer).
Given the different ways such costs are treated (e.g., inclusion in and exclusion from recognition on the balance sheet), the FASB found it appropriate to disaggregate lease costs to increase the transparency of the cash flows expected from leasing. Further, the Board provides the following example from ASC 842-20-55-53 to illustrate the disclosure requirements from ASC 842-20-50-4:

**ASC 842-20**

*Illustration of Lessee Quantitative Disclosure Requirements*

**55-52** Example 6 illustrates how a lessee may meet the quantitative disclosure requirements in paragraph 842-20-50-4.

**Example 6 — Lessee Quantitative Disclosure Requirements in Paragraph 842-20-50-4**

**55-53** The following Example illustrates how a lessee may meet the quantitative disclosure requirements in paragraph 842-20-50-4.

<table>
<thead>
<tr>
<th>Year Ending December 31,</th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease cost</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance lease cost</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of right-of-use assets</td>
<td>$ XXX</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Interest on lease liabilities</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Operating lease cost</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Short-term lease cost</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Variable lease cost</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Sublease income</td>
<td>(XXX)</td>
<td>(XXX)</td>
</tr>
<tr>
<td>Total lease cost</td>
<td>$ $XXX</td>
<td>$ $XXX</td>
</tr>
</tbody>
</table>

**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 XX% XX%
- Weighted-average discount rate — operating leases XX% XX%
15.2.4.1 Finance Lease Cost

ASC 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.

The finance lease cost disclosed represents the entire amount recognized for finance leases that are recognized on the balance sheet (i.e., excluding variable lease payments presented as interest expense or a component of income from continuing operations). In providing this disclosure, the lessee must disaggregate the total finance lease cost to indicate the amount recorded for the amortization of the ROU asset and the amount recognized as interest. The lessee should also disclose the financial statement line item in which these amounts are included if they are not presented separately on the face of the financial statements. Note that as discussed in Section 14.2.2.1, we would accept presentation of variable lease payments in the statement of comprehensive income as either (1) interest expense or (2) a component of income from continuing operations (e.g., lease expense). Lessees should disclose their presentation accordingly.

15.2.4.2 Operating Lease Cost

ASC 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:
   b. Operating lease cost determined in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7.

The operating lease cost disclosed represents the entire amount recognized for operating leases that are recognized on the balance sheet (i.e., excluding variable lease expense). This cost is determined in accordance with ASC 842-20-25-6(a) and ASC 842-20-25-7, which state, in part:

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.

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.
The entire amount recognized as a “single lease cost” is the expense recognized for the operating lease during the period. Note that while the expense recognition pattern for an operating lease differs from that for a finance lease model (i.e., “interest” expense plus straight-line expense of the ROU asset), such “single lease cost” is not disaggregated into its underlying component parts (i.e., amortization of the ROU asset and the change in the lease liability) for presentation purposes.

**Connecting the Dots — Operating Lease Cost When ROU Asset Is Impaired**

As discussed in Section 8.4.4, in accordance with ASC 842-20-25-7, after an impairment is recognized on an ROU asset for a lessee's operating lease, the “straight-line” lease expense is no longer maintained as the ROU asset is subsequently amortized on a straight-line basis (unless another systematic basis is more representative of the pattern of use). Despite “breaking” the straight-line lease pattern, the operating lease expense is still presented as a “single lease cost” and would be included in the above quantitative disclosure of operating lease cost rather than being broken into its two component parts for disclosure as a finance lease cost.

### 15.2.4.3 Short-Term Lease Cost

<table>
<thead>
<tr>
<th>ASC 842-20</th>
</tr>
</thead>
</table>
| **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: . . .  
  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. . . . |

While lessees may elect not to recognize short-term leases on the balance sheet (i.e., leases with a lease term of 12 months or less), lessees are required to disclose short-term lease cost determined under ASC 842-20-25-2. However, expenses related to leases with a lease term of one month or less are excluded from this requirement.

**Q&A 15-2 Excluding Leases With a Term of One Month or Less From Short-Term Lease Expense Disclosure**

Although we expect that most entities will find respite in the “one month or less” exclusion, entities may sometimes find it more burdensome to extract leases with a term of one month or less and may prefer to disclose expenses related to all short-term leases.

**Question**

Is it acceptable for a lessee to include expenses related to leases with a term of one month or less in its short-term lease expense disclosure?
Answer

Yes. We believe that an entity may elect to include all expenses related to leases with a term of one month or less (or all short-term lease expenses by class of underlying asset) in the short-term lease expense disclosure (despite the explicit exclusions). We understand that the one month or less exclusion was intended to provide relief and therefore believe that it would not be inconsistent with the disclosure principles to disclose all of the short-term lease expenses (including expenses related to leases with a term of one month or less) if doing so would be less burdensome. Entities should consider disclosing their policy if leases with a term of one month or less are included in their short-term lease expense disclosures and the effect is material.

15.2.4.4 Variable Lease Cost

<table>
<thead>
<tr>
<th>ASC 842-20</th>
</tr>
</thead>
</table>
| 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: . . .
| d. Variable lease cost determined in accordance with paragraphs 842-20-25-5(b) and 842-20-25-6(b). . . |

The variable lease cost disclosure should include the costs discussed in ASC 842-20-25-5(b) and ASC 842-20-25-6(b) — that is, variable lease payments that are not included in the measurement of the lease liability. Such payments may include amounts that are entirely variable and therefore never would have been included in the measurement of the lease liability, or they may represent the difference between (1) the variable amount based on an index or rate and therefore reflected in the lease liability and (2) what is actually incurred. The disclosure requirements do not stipulate that variable lease cost related to finance leases must be disclosed separately from that for operating leases; however, in some instances, entities may find it helpful to perform such disaggregation. In addition, an entity may have short-term lease costs that are also considered variable lease costs. In these circumstances, we believe that it would be acceptable for an entity to include such costs in either the short-term lease cost disclosure or the variable lease cost disclosure. An entity should apply the selected approach consistently between reporting periods and should disclose the approach taken, if material.

Connecting the Dots — Variable Lease Cost

If an entity discloses that it elected to use the practical expedient of not separating lease and nonlease components for real estate leases and also discloses that it has triple net leases (i.e., leases in which the lessee pays a single fixed payment for rent but the lessee's share of property taxes, insurance, and CAM is generally variable), the entity would be expected to disclose the variable lease cost related to such triple net leases. This is because the property taxes, insurance, and CAM are all deemed to be part of the lease component.
15.2.4.5 Sublease Income

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: . . .

e. Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense. . . .

A lessee should disclose any sublease income it has received on a gross basis separately from its operating and finance lease expenses. That is, cash inflows received as a sublessor must be disclosed, on a gross basis, separately from cash outflows the entity incurs with respect to that same asset that it leases as a lessee in a head lease. See Q&A 14-4 for discussion of whether it would be appropriate to net head lease expense with sublease income in the income statement.

15.2.4.6 Net Gain or Loss From Sale-and-Leaseback Transactions

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: . . .

f. Net gain or loss recognized from sale and leaseback transactions in accordance with paragraph 842-40-25-4 . . .

To the extent applicable, a seller-lessee should disclose any recognized net gains or losses associated with any sale-and-leaseback transactions for assets previously owned (or recognized as a result of the lessee's involvement in the asset's construction, as described in Chapter 11) and sold by the lessee.

15.2.4.7 Cash Paid for Amounts Included in Measurement of Lease Liabilities

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: . . .

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. . . .

A lessee should separately disclose its cash paid for finance and operating lease liabilities during the reporting period. In some cases, these amounts will be separately presented in the statement of cash flows and such presentation may be sufficient to meet the disclosure requirement. Nonetheless, an entity should consider separate disclosure, especially if such amounts are not separately presented in the statement of cash flows in their own activity line items.
15.2.4.8 Supplemental Noncash Information

<table>
<thead>
<tr>
<th>ASC 842-20</th>
</tr>
</thead>
</table>
| **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: . . .
| g. Amounts segregated between those for finance and operating leases for the following items: . . .
| 2. Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets . . . |

A lessee records an ROU asset upon entering into operating and finance leases. At lease commencement, the lessee would account for the lease transaction (other than any lease payments made at lease commencement) as a noncash investing and financing transaction, as discussed in ASC 230-10-50-4. The standard requires separate disclosure of the supplemental noncash information related to this activity. Amounts for noncash activities related to operating leases should be disclosed separately from those for finance leases.

In addition to noncash disclosures associated with the initial recognition of a lease, a lessee should also consider noncash disclosure requirements based on other noncash changes (increases or decreases) to the lease balances, such as those resulting from lease modifications or reassessment events.

Q&A 15-3 Noncash Disclosures Provided by a Lessee Regarding Changes in ROU Assets

In addition to ASC 842-20-50-4(g)(2), other areas of U.S. GAAP include requirements related to providing noncash disclosures. For example, ASC 230-10-50-3 states that “[i]nformation about all investing and financing activities of an entity during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period shall be disclosed.” Further, in paragraph 70 of the Basis for Conclusions of Statement 95, the FASB contemplated disclosure requirements related to situations in which “transactions result in no cash inflows or outflows in the period in which they occur but generally have a significant effect on the prospective cash flows of a company.”

**Question**
What other events (apart from entering into a new lease) trigger the requirement for a lessee to provide noncash disclosures?

**Answer**
ASC 842 explicitly stipulates that any lessee that has entered into a new lease must provide noncash disclosures related to the ROU assets obtained. We believe that the word “obtaining,” as used in ASC 842-20-50-4(g)(2), should be interpreted as including all noncash increases (debits) to an ROU asset. In addition, events that affect a recognized asset and liability as well as prospective cash flows, including noncash decreases to an ROU asset (credits), should be disclosed as a noncash transaction in light of the guidance in ASC 230-10-50-3 and the Basis for Conclusions of FASB Statement 95 (discussed above).
Accordingly, the requirement to disclose a noncash transaction would be triggered in the following circumstances:

- Any lease modification that (1) grants the lessee an additional ROU asset or (2) removes an ROU asset (i.e., physical increases or decreases related to a lessee’s right to use the underlying leased assets). The modification does not need to be accounted for as a separate contract.
- Any other modification or reassessment event that results in increases or decreases (debits or credits) to the ROU asset.

**15.2.4.9 Weighted-Average Remaining Lease Term**

ASC 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: . . .

- Amounts segregated between those for finance and operating leases for the following items: . . .
  3. Weighted-average remaining lease term . . .

**Weighted-Average Remaining Lease Term and Weighted-Average Discount Rate Disclosures**

55-11 The lessee should calculate the weighted-average remaining lease term on the basis of the remaining lease term and the lease liability balance for each lease as of the reporting date.

A lessee must disclose — separately for both its operating leases and its finance leases — the weighted-average remaining lease term. Below is an example illustrating how to calculate the weighted-average lease term as of the reporting date. In this example, the reporting date is December 31, 2032, and the entity has six leases outstanding: three operating leases and three finance leases.

<table>
<thead>
<tr>
<th>Leased Asset</th>
<th>Operating Lease Liability as of 12/31/2032</th>
<th>Percentage</th>
<th>Months Remaining on the Lease</th>
<th>Weighted Average (Percentage × Months Remaining)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease L</td>
<td>11,051,984</td>
<td>39%</td>
<td>32</td>
<td>12.45</td>
</tr>
<tr>
<td>Lease B</td>
<td>10,161,963</td>
<td>36%</td>
<td>54</td>
<td>19.31</td>
</tr>
<tr>
<td>Lease S</td>
<td>7,198,709</td>
<td>25%</td>
<td>29</td>
<td>7.35</td>
</tr>
<tr>
<td></td>
<td>28,412,656</td>
<td></td>
<td>115</td>
<td>39.11</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.
### Table

<table>
<thead>
<tr>
<th>Leased Asset</th>
<th>Finance Lease Liability as of 12/31/2032</th>
<th>Percentage</th>
<th>Months Remaining on the Lease</th>
<th>Weighted Average (Percentage × Months Remaining)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease G</td>
<td>23,623,734</td>
<td>10%</td>
<td>62</td>
<td>6.05</td>
</tr>
<tr>
<td>Lease N</td>
<td>198,306,083</td>
<td>82%</td>
<td>53</td>
<td>43.42</td>
</tr>
<tr>
<td>Lease J</td>
<td>20,124,190</td>
<td>8%</td>
<td>55</td>
<td>4.57</td>
</tr>
<tr>
<td></td>
<td>242,054,007</td>
<td></td>
<td>170</td>
<td>54.04</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.

As calculated above, in this example, the weighted-average lease term for the operating lease liabilities is approximately 3 years (or approximately 39 months), and the weighted-average lease term for the finance lease liabilities is approximately 4.5 years (or approximately 54 months).

### 15.2.4.10 Weighted-Average Discount Rate

A lessee must disclose — separately for both its operating leases and its finance leases — the weighted-average discount rate. Below is an example illustrating how to calculate the weighted-average discount rate as of the reporting date (in the example below, the reporting date is December 31, 2026).
### Operating Leases

<table>
<thead>
<tr>
<th>Discount rate at commencement</th>
<th>Lease A</th>
<th>Lease B</th>
<th>Lease C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2022</td>
<td>5.2%</td>
<td>5.6%</td>
<td>9.6%</td>
<td></td>
</tr>
<tr>
<td>2023</td>
<td>35,230</td>
<td>2,000</td>
<td>11,023,603</td>
<td></td>
</tr>
<tr>
<td>2024</td>
<td>35,230</td>
<td>3,000</td>
<td>11,244,075</td>
<td></td>
</tr>
<tr>
<td>2025</td>
<td>35,230</td>
<td>23,923</td>
<td>11,468,957</td>
<td></td>
</tr>
<tr>
<td>2026</td>
<td>35,230</td>
<td>4,000</td>
<td>11,698,336</td>
<td></td>
</tr>
<tr>
<td>2027</td>
<td>35,230</td>
<td>6,000</td>
<td>11,932,302</td>
<td></td>
</tr>
<tr>
<td>2028</td>
<td>35,230</td>
<td>7,000</td>
<td>12,170,948</td>
<td></td>
</tr>
<tr>
<td>2029</td>
<td>35,230</td>
<td>8,000</td>
<td>12,414,367</td>
<td></td>
</tr>
<tr>
<td>2030</td>
<td>24,404</td>
<td>9,000</td>
<td>12,662,655</td>
<td></td>
</tr>
<tr>
<td>2031</td>
<td>23,926</td>
<td>10,000</td>
<td>12,915,908</td>
<td></td>
</tr>
<tr>
<td>2032</td>
<td>24,405</td>
<td></td>
<td>805,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Remaining balance of lease payments as of the reporting date</th>
<th>105,690</th>
<th>144,986</th>
<th>40,000</th>
<th>290,676</th>
<th>62,096,181</th>
<th>4,830,000</th>
<th>66,926,181</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>36%</td>
<td>50%</td>
<td>14%</td>
<td></td>
<td>93%</td>
<td>7%</td>
<td></td>
</tr>
</tbody>
</table>

| Weighted average discount rate | 1.9% | 2.8% | 1.3% | 6% | 5.3% | 0.4% | 5.7% |

Note that certain amounts in the table are subject to rounding differences.

### Finance Leases

<table>
<thead>
<tr>
<th>Discount rate at commencement</th>
<th>Lease D</th>
<th>Lease E</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2022</td>
<td>5.7%</td>
<td>5.4%</td>
<td></td>
</tr>
<tr>
<td>2023</td>
<td>11,023,603</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2024</td>
<td>11,244,075</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2025</td>
<td>11,468,957</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2026</td>
<td>11,698,336</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2027</td>
<td>11,932,302</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2028</td>
<td>12,170,948</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2029</td>
<td>12,414,367</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2030</td>
<td>12,662,655</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2031</td>
<td>12,915,908</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2032</td>
<td>805,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Remaining balance of lease payments as of the reporting date</th>
<th>105,690</th>
<th>144,986</th>
<th>40,000</th>
<th>290,676</th>
<th>62,096,181</th>
<th>4,830,000</th>
<th>66,926,181</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>36%</td>
<td>50%</td>
<td>14%</td>
<td></td>
<td>93%</td>
<td>7%</td>
<td></td>
</tr>
</tbody>
</table>

### 15.2.5 Maturity Analysis of Liabilities

#### ASC 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.

A lessee must disclose a maturity analysis on an undiscounted basis, aggregating all of its finance lease liabilities separately from its aggregated operating lease liabilities. Paragraph BC287 of ASU 2016-02 provides further details regarding the disclosure requirements in ASC 842-20-50-6 and states, in part:

Topic 842 requires that a lessee disclose a maturity analysis of the contractual lease payments included in its lease liabilities at the reporting date to assist users of financial statements in understanding and evaluating the nature and extent of liquidity risks. A lessee should disclose, at a minimum, the amounts due on an annual basis for each of the first five years after the reporting date, plus a lump sum for the remaining years. Those maturity analyses are similar to the maturity analyses that were required in previous GAAP.
In the below example, as of the reporting date, the entity has five leases — three operating and two finance — and has presented a maturity table summarizing those lease payments. The total amount of lease payments, on an undiscounted basis, is reconciled to the lease liability in the statement of financial position (discounted cash flows).

<table>
<thead>
<tr>
<th>Lease</th>
<th>Lease A</th>
<th>Lease B</th>
<th>Lease C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2027</td>
<td>35,230</td>
<td>23,924</td>
<td>6,000</td>
<td>65,154</td>
</tr>
<tr>
<td>2028</td>
<td>35,230</td>
<td>24,402</td>
<td>7,000</td>
<td>66,632</td>
</tr>
<tr>
<td>2029</td>
<td>35,230</td>
<td>23,925</td>
<td>8,000</td>
<td>67,155</td>
</tr>
<tr>
<td>2030</td>
<td>24,404</td>
<td>9,000</td>
<td>33,404</td>
<td></td>
</tr>
<tr>
<td>2031</td>
<td>23,926</td>
<td>10,000</td>
<td>33,926</td>
<td></td>
</tr>
<tr>
<td>2032</td>
<td>24,405</td>
<td></td>
<td>24,405</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Lease</th>
<th>Lease D</th>
<th>Lease E</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2027</td>
<td>11,932,302</td>
<td>805,000</td>
<td>12,737,302</td>
</tr>
<tr>
<td>2028</td>
<td>12,170,948</td>
<td>805,000</td>
<td>12,975,948</td>
</tr>
<tr>
<td>2029</td>
<td>12,414,367</td>
<td>805,000</td>
<td>13,219,367</td>
</tr>
<tr>
<td>2030</td>
<td>12,662,655</td>
<td>805,000</td>
<td>13,467,655</td>
</tr>
<tr>
<td>2031</td>
<td>12,915,908</td>
<td>805,000</td>
<td>13,720,908</td>
</tr>
<tr>
<td>2032</td>
<td>805,000</td>
<td></td>
<td>805,000</td>
</tr>
</tbody>
</table>

### Maturity Analysis for Liabilities

<table>
<thead>
<tr>
<th></th>
<th>One Year</th>
<th>Two Years</th>
<th>Three Years</th>
<th>Four Years</th>
<th>Five Years</th>
<th>Beyond Five Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating lease payments</td>
<td>65,154</td>
<td>66,632</td>
<td>67,155</td>
<td>33,404</td>
<td>33,926</td>
<td>24,405</td>
</tr>
<tr>
<td>Finance lease payments</td>
<td>12,737,302</td>
<td>12,975,948</td>
<td>13,219,367</td>
<td>13,467,655</td>
<td>13,720,908</td>
<td>805,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Lease</th>
<th>Lease A</th>
<th>Lease B</th>
<th>Lease C</th>
<th>Total Undiscounted Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>2027</td>
<td>35,230</td>
<td>23,924</td>
<td>6,000</td>
<td>65,154</td>
</tr>
<tr>
<td>2028</td>
<td>35,230</td>
<td>24,402</td>
<td>7,000</td>
<td>66,632</td>
</tr>
<tr>
<td>2029</td>
<td>35,230</td>
<td>23,925</td>
<td>8,000</td>
<td>67,155</td>
</tr>
<tr>
<td>2030</td>
<td>24,404</td>
<td>9,000</td>
<td></td>
<td>33,404</td>
</tr>
<tr>
<td>2031</td>
<td>23,926</td>
<td>10,000</td>
<td></td>
<td>33,926</td>
</tr>
<tr>
<td>2032</td>
<td>24,405</td>
<td></td>
<td></td>
<td>24,405</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Lease</th>
<th>Lease D</th>
<th>Lease E</th>
</tr>
</thead>
<tbody>
<tr>
<td>2027</td>
<td>11,932,302</td>
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</tr>
<tr>
<td>2028</td>
<td>12,170,948</td>
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<tr>
<td>2029</td>
<td>12,414,367</td>
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<tr>
<td>2030</td>
<td>12,662,655</td>
<td>805,000</td>
</tr>
<tr>
<td>2031</td>
<td>12,915,908</td>
<td>805,000</td>
</tr>
<tr>
<td>2032</td>
<td>805,000</td>
<td></td>
</tr>
</tbody>
</table>

**Present values**

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>95,582</td>
<td>120,299</td>
<td>29,939</td>
<td>245,820</td>
<td></td>
</tr>
<tr>
<td>52,628,486</td>
<td>4,034,180</td>
<td>56,662,667</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Short-term lease liabilities**

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>33,489</td>
<td>22,655</td>
<td>5,474</td>
<td>61,614</td>
<td></td>
</tr>
<tr>
<td>11,288,838</td>
<td>763,757</td>
<td>12,052,595</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Long-term lease liabilities**

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>62,093</td>
<td>97,644</td>
<td>24,465</td>
<td>184,201</td>
<td></td>
</tr>
<tr>
<td>41,339,648</td>
<td>3,270,423</td>
<td>44,610,071</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Total lease liabilities**

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>95,582</td>
<td>120,299</td>
<td>29,939</td>
<td>245,820</td>
<td></td>
</tr>
<tr>
<td>52,628,486</td>
<td>4,034,180</td>
<td>56,662,667</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Difference between undiscounted cash flows and discounted cash flows**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>44,856</td>
<td>10,263,513</td>
</tr>
</tbody>
</table>

Note that certain amounts in the table are subject to rounding differences.
SEC registrants should also consider the requirement to include lease obligations in the tabular disclosure of contractual obligations in MD&A. (See Section 18.8 for more information.)

15.2.6 Lease Transactions With Related Parties

**ASC 842-20**

| 50-7 | A lessee shall disclose lease transactions between related parties in accordance with paragraphs 850-10-50-1 through 50-6. |

Lease transactions between related parties should be disclosed in accordance with the guidance in ASC 850. In accordance with ASC 850, a lessee should consider disclosing the nature of the related-party lease, the related-party relationship, and the terms of the lease that are affected by the relationship.

15.2.7 Practical-Expedient Disclosure Related to Short-Term Leases

**ASC 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. |

When a lessee elects the short-term lease recognition exemption by class of underlying asset (which results in off-balance-sheet accounting for the lease), it should disclose that it has done so. While a lessee may continue to apply a short-term lease exemption, if its activities in the reporting period do not give financial statement users a reasonable reflection of upcoming liabilities, the lessee should disclose that fact and adequately disclose the amount of its short-term lease commitments.

15.2.8 Practical-Expedient Disclosure Related to Not Separating Lease and Nonlease Components

**ASC 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. |

When a lessee elects the practical expedient under which it does not need to separate lease components from nonlease components, it should disclose this fact as well as the “class or classes of underlying assets” for which it has made the election. (See further discussion of this practical expedient in Section 4.3.3.1.)
### 15.3 Lessor Disclosure Requirements

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-1</strong> 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 lessor shall disclose qualitative and quantitative information about all of the following:</td>
</tr>
<tr>
<td>a. Its leases (as described in paragraphs 842-30-50-3(a), 842-30-50-4, and 842-30-50-7)</td>
</tr>
<tr>
<td>b. The significant judgments made in applying the requirements in this Topic to those leases (as described in paragraph 842-30-50-3(b))</td>
</tr>
<tr>
<td>c. The amounts recognized in the financial statements relating to those leases (as described in paragraphs 842-30-50-5 through 50-6 and 842-30-50-8 through 50-13).</td>
</tr>
<tr>
<td><strong>50-2</strong> A lessor 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 lessor 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.</td>
</tr>
<tr>
<td><strong>50-8</strong> 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.</td>
</tr>
<tr>
<td><strong>50-11</strong> 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.</td>
</tr>
</tbody>
</table>

The disclosure objective for lessors is the same as that for lessees (i.e., “to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases”). However, a lessor should consider the different, lessor-related information that a user of its financial statements may be concerned about. Paragraph BC16 of ASU 2016-02 indicates that part of the reason the FASB increased the lessor disclosure requirements was because disclosures under ASC 840 were insufficient:

Some users of financial statements also criticized previous GAAP applicable to lessors because that guidance did not provide adequate information about a lessor's exposure to credit risk (arising from a lease) and exposure to asset risk (arising from the lessor's retained interest in the underlying asset), particularly for those leases of assets that were previously classified as operating leases.
**Illustrative Example — Disclosure Disaggregation**

The following are examples of ways a lessor may choose to disaggregate its lessor disclosures:

- Real estate leases and equipment leases
  - Business segment or unit in which leased asset is used
  - Class (or type) of underlying asset
  - Consumer products and industrial products segments

- Leases for 3 to 5 years, 6 to 9 years, and 10 or more years
  - Lease payment terms
  - Lease term
  - Leases with significant variable payments and leases with fixed payment terms

- Leases in Americas region and leases in Eurasia region
  - Geographical region in which lease was entered into or in which the leased asset will be used

Another reason ASC 842 requires more disclosures for lessors is that the Board views a lessor’s activities as similar to other revenue-generating activities, and the lack of disclosure regarding revenue was a key issue that the Board addressed in its project on revenue from contracts with customers.

The lessor disclosure requirements are further subdivided into the following topics:

- Information about the nature of an entity’s leases (Section 15.3.1).
  - General description of leases (Section 15.3.1.1).
  - Basis and terms and conditions on which variable lease payments are determined (Section 15.3.1.2).
  - Terms and conditions of options to extend or terminate leases (Section 15.3.1.3).
  - Existence of terms and conditions for a lessee to purchase a leased asset (Section 15.3.1.4).
- Significant assumptions and judgments (Section 15.3.2).
  - Whether a contract contains a lease (Section 15.3.2.1).
  - Allocation of consideration in a contract (Section 15.3.2.2).
  - Amount lessor expects to derive from underlying asset after the end of the lease term (Section 15.3.2.3).
  - Practical-expedient disclosure related to not separating lease and nonlease components (Section 15.3.2.4).
- Lease transactions with related parties (Section 15.3.3).
• Residual assets and risk management (Section 15.3.4).
• Amounts recognized in the financial statements (Section 15.3.5).
  ○ Sales-type leases and direct financing leases (Section 15.3.5.1).
    ▪ Tabular disclosures (Section 15.3.5.1.1).
    ▪ Components of net investments in leases (Section 15.3.5.1.2).
    ▪ Significant changes in the balance of unguaranteed residual assets and deferred selling profit (Section 15.3.5.1.3).
    ▪ Maturity analysis of lease receivables (Section 15.3.5.1.4).
  ○ Operating leases (Section 15.3.5.2).
    ▪ Tabular disclosures (Section 15.3.5.2.1).
    ▪ Maturity analysis of lease payments (Section 15.3.5.2.2).
    ▪ Separate ASC 360 disclosures (Section 15.3.5.2.3).

Q&A 15-4 Presentation of Lease Revenue and Tenant Reimbursements in the Financial Statements

As discussed in Section 4.4.1.1, in a typical gross lease of real estate, the lessee pays a single fixed payment that covers rent, property taxes, insurance, and CAM. The portion of the single fixed payment attributable to property taxes, insurance, and CAM has historically been presented by real estate lessors as “tenant reimbursements,” a separate revenue line item in a lessor’s income statement. Under ASC 842, CAM is considered a nonlease component (see Section 4.3.1) whereas reimbursements for property taxes and insurance are noncomponents (see Section 4.3.2). Nonlease components are separated from lease components and are generally accounted for in accordance with ASC 606 unless the lessor qualifies for and elects the practical expedient related to combining the components (see Section 4.3.3.2). Furthermore, as discussed in Section 4.3.2, consideration in the contract is not allocated to noncomponents because they do not transfer a good or service to the lessee. Consideration for noncomponents is considered part of the overall consideration in the contract, which is allocated to lease and nonlease components on a relative stand-alone selling price basis.

Question
Is a lessor allowed to present lease revenue and tenant reimbursements in separate financial statement line items under ASC 842?

Answer
No. If a lessor elects the practical expedient in ASU 2018-11 (discussed in Section 4.3.3.2) and therefore combines lease and associated nonlease components (provided that certain criteria are met), the lessor should present a single rental revenue line item (as long as the lease component is predominant1) that includes the combined lease and nonlease components. However, if a lessor does not qualify for or elect the practical expedient, it should present the lease and nonlease components separately. The resulting separate presentation typically will not be aligned with the historical presentation when the Comparatives Under 840 Option is elected.

1 See Section 4.3.3.2.2 for further discussion of how an entity determines which component is predominant when applying the lessor practical expedient to combine lease and nonlease components.
Example

Lessor and Lessee enter into a five-year lease of a floor in an office building. The contract stipulates that Lessee is required to reimburse Lessor for the costs related to the asset, including the real estate taxes and Lessor's performance of CAM at the building. The lease commences on March 1, 2016. Lessor's ASC 842 adoption date will be January 1, 2019, and it will elect the transition relief under ASU 2018-11 (i.e., the Comparatives Under 840 Option — see Section 16.1.1) and thus will not be recasting prior periods.

Lessee's total payments for 2016–2018 are as follows:

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2017</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent</td>
<td>$ 46,000</td>
<td>$ 45,000</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Property taxes</td>
<td>3,000</td>
<td>3,000</td>
<td>2,500</td>
</tr>
<tr>
<td>CAM</td>
<td>6,000</td>
<td>6,000</td>
<td>3,500</td>
</tr>
</tbody>
</table>

**Presentation Under ASC 840 for Year Ended December 31, 2018**

Many real estate lessors have historically presented the revenue components for this type of lease agreement in two separate revenue line items in the income statement. The two separate line items are usually titled “Rental Revenue” and “Tenant Reimbursement Revenue.”

<table>
<thead>
<tr>
<th></th>
<th>Year Ended December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2018</td>
</tr>
<tr>
<td>Rental revenue</td>
<td>$ 46,000</td>
</tr>
<tr>
<td>Tenant reimbursement revenue</td>
<td>9,000</td>
</tr>
<tr>
<td>Total revenue</td>
<td>$ 55,000</td>
</tr>
</tbody>
</table>

**Sample Presentation Under ASC 842 for Year Ended December 31, 2019**

If Lessor elects the practical expedient related to not separating lease and nonlease components (provided that the lease meets the criteria under ASU 2018-11), rental revenue (the lease component) and CAM (the nonlease component(s)) should be presented in a single line item in the financial statements (i.e., rental revenues), beginning in the year of adoption.
Example (continued)

The following is a sample presentation if Lessor elects the practical expedient under ASU 2018-11 (in this example, it is assumed that 2019 gross lease payments are the same as those for 2018):

<table>
<thead>
<tr>
<th>Year Ended December 31</th>
<th>2019</th>
<th>2018</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental revenue</td>
<td>$55,000</td>
<td>$46,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Tenant reimbursement revenue</td>
<td>—</td>
<td>9,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Total revenue</td>
<td>$55,000</td>
<td>$55,000</td>
<td>$54,000</td>
</tr>
</tbody>
</table>

If Lessor does not elect the practical expedient, lease and nonlease components would be presented separately in the income statement. Lease components are accounted for under ASC 842, while nonlease components are accounted for in accordance with other U.S. GAAP (typically ASC 606). Assume that the stand-alone selling prices for the lease of the underlying asset and maintenance services are $50,000 and $8,000, respectively. The property taxes paid by Lessee are a noncomponent, and no consideration would be allocated to the noncomponents. The total consideration would be allocated between the lease component and the nonlease component on the basis of the stand-alone selling price.2

The table below illustrates a sample presentation if Lessor does not elect the practical expedient under ASU 2018-11.

<table>
<thead>
<tr>
<th>Year Ended December 31</th>
<th>2019</th>
<th>2018</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental revenue</td>
<td>$47,410</td>
<td>$46,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Tenant reimbursement revenue</td>
<td>—</td>
<td>9,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Service revenue</td>
<td>7,590</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total revenue</td>
<td>$55,000</td>
<td>$55,000</td>
<td>$54,000</td>
</tr>
</tbody>
</table>

Note that while we believe that the income statement presentation of “tenant reimbursements” will change from historical practice (as described above), we understand that many real estate lessors will want to continue providing this information going forward given the performance metrics used by analysts that cover the sector. Lessors that wish to disclose such information in the financial statement footnotes should work with their auditors to develop appropriate disclosures and, in doing so, should take into consideration the rules related to non-GAAP measures.

---

2 The allocation of the total consideration in this example is calculated as follows (see Section 4.4 for further details on allocating consideration in a contract):

<table>
<thead>
<tr>
<th>Component</th>
<th>Stand-Alone Selling Price</th>
<th>Percentage of Total Stand-Alone Selling Price</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease of underlying asset</td>
<td>$50,000</td>
<td>86.2%</td>
<td>$47,410</td>
</tr>
<tr>
<td>Maintenance</td>
<td>$8,000</td>
<td>13.8%</td>
<td>$7,590</td>
</tr>
<tr>
<td>Total</td>
<td>$58,000</td>
<td>100.0%</td>
<td>$55,000</td>
</tr>
</tbody>
</table>
15.3.1 Information About the Nature of an Entity’s Leases

A lessor shall disclose both of the following:

1. 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.

A lessor should disclose information about its leases in a manner consistent with the disclosure objective described above. Generally, disclosures provided under this requirement are more qualitative.

15.3.1.1 General Description of Leases

The considerations related to a lessor’s disclosure of a general description of its leases are similar to those for lessees. See Section 15.2.1.1 for more information.

Illustrative Example — General Description of an Entity’s Leases

Types of underlying assets:
- Entity A is a lessor of retail real estate.
- Entity B is a lessor of construction equipment.

Lessor strategy:
- Entity A leases real estate to lessees to generate a positive cash flow derived from rental income.
- Entity B uses leasing as an alternative to selling equipment to customers.

Types of customers:
- Entity A leases to high-fashion clothing designers.
- Entity B leases to mid- to high-rise building construction companies in the Midwest.

Lease terms:
- Entity A’s lease terms are between three and five years.
- Entity B’s lease terms are typically six months.
15.3.1.2  Basis and Terms and Conditions on Which Variable Lease Payments Are Determined

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-3 A lessor shall disclose both of the following:</td>
</tr>
<tr>
<td>a. Information about the nature of its leases, including: . . .</td>
</tr>
<tr>
<td>2. The basis and terms and conditions on which variable lease payments are determined . . .</td>
</tr>
</tbody>
</table>

As discussed in Section 6.3, only some variable lease payments (those based on an index or rate) are included in the initial and subsequent measurement of any (1) recognized net investment in the lease for sales-type or direct financing leases or (2) lease receivables for operating leases. Because variable lease payments are treated in different ways, the determination of what type of variability exists in a lease contract and whether that variability is included or excluded from amounts recognized on the balance sheet is critical to understanding lease income and achieving the disclosure objective (i.e., information about the timing and uncertainty of the entity's cash flows). Therefore, the terms and conditions related to variability provide the user with information about amounts that are not recorded on the balance sheet because variable lease payments not based on an index or rate are not included in recorded balance sheet amounts and could be considered more volatile forms of revenue and potential future cash inflows.

Therefore, although it is not expressly required to do so, it may be helpful for an entity to describe the sources of the variability in two separate groups: (1) the amounts included in the net investment in the lease and (2) the variability that is excluded. In addition, an entity must explain the types of variability within its contracts, and that explanation must include a discussion of key terms and conditions. For example, an entity may receive variable lease payments because a lessee's rental payment is determined on the basis of a percentage of its store's sales. Because of its volatility, users view this variability differently from how they view a fixed rental payment; the more transparent the source of that volatility, the better a user can understand the nature, timing, and uncertainty of the entity's future cash flows. Sometimes, however, the variability in future lease payments may be more complex, in which case a lessor may need to provide additional information.
Illustrative Example — Basis and Terms and Conditions on Which Variable Lease Payments Are Determined

Variable lease payments that are based on an index or rate:

- A majority of the company's leases are subject to annual changes in the CPI. Although increases in the CPI are not estimated as part of the company's measurement of straight-line rent revenue, to the extent that the actual CPI is greater or less than the CPI at lease commencement, there could be changes to realized income or loss.

Customer usage:

- The company's lessees lease the warehouses for shipping of consumer goods sold online.

Variable lease payments not based on an index or rate:

- All of the payments made to lease the solar facility are variable. Because all lease payments are variable and the lease term extends over the major part of the economic life of the solar facility, the company is unable to record any net investment in the lease; therefore, the company has recognized a loss upon derecognition of the asset. The company is required to sell 100 percent of the output from the facility, which has a nameplate capacity of 15 MW.

15.3.1.3 Terms and Conditions of Options to Extend or Terminate Leases

ASC 842-30

50-3 A lessor shall disclose both of the following:

a. Information about the nature of its leases, including: . . .

3. The existence and terms and conditions of options to extend or terminate the lease . . .

Disclosures about terms and conditions related to options to extend or terminate leases should allow a user to assess the rights of the entity's customers in the contracts. Such information may be helpful for users who want to understand situations in which lessors have contractually agreed to lease payments that may not be at market terms in the future (i.e., fixed-price renewal options on real estate).
Illustrative Example — Terms and Conditions of Options to Extend or Terminate Leases

The company's retail properties have fixed-price renewal options, and the lessee may be able to exercise its renewal options at an amount less than the fair value of the rent at such time.

What rights do the lessees have to effectively limit the cash flows from their assets?

15.3.1.4 Existence of Terms and Conditions for a Lessee to Purchase a Leased Asset

ASC 842-30

50-3 A lessor shall disclose both of the following:

a. Information about the nature of its leases, including: . . .
   4. The existence and terms and conditions of options for a lessee to purchase the underlying asset. . . .

Regardless of whether it is reasonably certain that a lessee will exercise a right to purchase an underlying asset, a lessor should disclose the existence of such terms and conditions. Such disclosure allows a user to understand when there may be an effective cap on the cash flows realizable in the contract (e.g., if the purchase option is a fixed price purchase option).

15.3.2 Significant Assumptions and Judgments

ASC 842-30

50-3 A lessor shall disclose both of the following: . . .

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), unless a lessor elects the practical expedient in paragraph 842-10-15-42A and all nonlease components in the contract qualify for that practical expedient
   3. The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term.
An entity that elects the practical expedient in paragraph 842-10-15-42A on not separating nonlease components from associated lease components (including an entity that accounts for the combined component entirely in Topic 606 on revenue from contracts with customers) shall disclose the following, by class of underlying asset:

a. Its accounting policy election and the class or classes of underlying assets for which it has elected to apply the practical expedient
b. The nature of:
   1. The lease components and nonlease components combined as a result of applying the practical expedient
   2. The nonlease components, if any, that are accounted for separately from the combined component because they do not qualify for the practical expedient
c. The Topic the entity applies to the combined component (this Topic or Topic 606).

The considerations related to a lessor's disclosures about significant assumptions and judgments are similar to those for lessees. For more information, see Section 15.2.3.

15.3.2.1 Whether a Contract Contains a Lease

A lessor shall disclose both of the following: . . .

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) . . .

The lessor's considerations related to disclosures about significant judgments used to determine whether a contract contains a lease are similar to those for lessees. For more information, see Section 15.2.3.1.
Illustrative Example — Whether a Contract Contains a Lease

A company has entered into a service contract with a customer to store its inventory. In assessing whether that contract is or contains a lease, the company determined that a warehouse is implicitly identified in Palos Park, Illinois. The company does not have alternative warehouses within a 100-mile radius to store the customer’s inventory; in addition, any substitution rights stated in the contract are not substantive.

A local not-for-profit entity intermittently uses the warehouse for storage; however, such use involves less than 5 percent of the total square footage of the warehouse. Contractually, the customer has the right to use all of the square footage of the warehouse and such usage represents 100 percent of the economic benefit that can be derived from the warehouse.

The customer has the right to enter and exit the warehouse facility and to move its inventory at will. The company has determined that the customer has the right to direct HAFWP the asset is being used.

The service contract with the customer contains a lease of the warehouse.

15.3.2.2 Allocation of Consideration in a Contract

ASC 842-30

50-3 A lessor shall disclose both of the following: . . .

b. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following: . . .

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), unless a lessor elects the practical expedient in paragraph 842-10-15-42A and all nonlease components in the contract qualify for that practical expedient . . .

The lessor’s considerations related to disclosures about significant judgments used to determine the allocation of consideration in a contract are similar to those for lessees. For more information, see Section 15.2.3.2.
Chapter 15 — Disclosure

Illustrative Example — Allocation of Consideration in a Contract

Company G entered into a contract to lease to a customer a bulldozer, a truck, and a crane to build parking garages throughout the U.S. Virgin Islands. While the assets are being leased together for a similar purpose, the machines are not highly dependent on or interrelated with each other. The machines are not, in effect, inputs into a single combined item; therefore, each machine is a separate lease component in the contract.

The company provides certain maintenance services (a nonlease component) associated with the leased assets, and the payment for such services is included in the payments provided to the company.

The company considers the separate stand-alone selling prices for the lease and nonlease components (i.e., the price the company would charge to lease the assets and provide the services separately) and allocates the total transaction price to the lease and nonlease components on a relative stand-alone selling price basis. The lease component is accounted for in accordance with ASC 842, and the nonlease component is accounted for in accordance with ASC 606.

Note that in July 2018, the FASB issued ASU 2018-11, which contains a new practical expedient under which lessors can elect, by class of underlying asset, not to separate lease and nonlease components, provided that the associated nonlease component(s) otherwise would be accounted for under the revenue guidance in ASC 606 and both of the following conditions are met:

- **Criterion A** — The timing and pattern of transfer for the lease component are the same as those for the nonlease components associated with that lease component.
- **Criterion B** — The lease component, if accounted for separately, would be classified as an operating lease.

The ASU also clarifies that the presence of a nonlease component that is ineligible for the practical expedient does not preclude a lessor from electing the expedient for the lease component and nonlease component(s) that meet the criteria. Rather, the lessor would account for the nonlease components that do not qualify for the practical expedient separately from the combined lease and nonlease components that do qualify.
See Section 4.3.3.2 for further details about the practical expedient related to a lessor’s separation of lease and nonlease components. In addition, see Section 15.3.2.4 below for the disclosure requirements, and Section 16.4.6 for the transition requirements, related to ASU 2018-11.

15.3.2.3 Amount Lessor Expects to Derive From the Underlying Asset After the End of the Lease Term

ASC 842-30

50-3 A lessor shall disclose both of the following: . . .

b. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following: . . .

3. The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term.

An entity considers various inputs when evaluating the amount it expects to derive from its leased assets at the end of the lease terms, including the following.

- The remaining useful life.
- Expected market conditions:
  - Fair value of lease payments.
  - Expected fair values of underlying assets.
- Expected deployment of underlying asset in business (e.g., re-lease or sell).

The estimated amount of the residual asset directly affects the gain (in a sales-type lease) or loss (in either a sales-type or a direct financing lease) the entity recognizes upon commencement of the lease. Therefore, this estimate and any related assumptions should be disclosed because they are critical to a user’s understanding of the amount of the gain or loss recognized and potential future cash flows.

15.3.2.4 Practical-Expedient Disclosure Related to Not Separating Lease and Nonlease Components

ASC 842-30

50-3A An entity that elects the practical expedient in paragraph 842-10-15-42A on not separating nonlease components from associated lease components (including an entity that accounts for the combined component entirely in Topic 606 on revenue from contracts with customers) shall disclose the following, by class of underlying asset:

a. Its accounting policy election and the class or classes of underlying assets for which it has elected to apply the practical expedient
b. The nature of:
   1. The lease components and nonlease components combined as a result of applying the practical expedient
   2. The nonlease components, if any, that are accounted for separately from the combined component because they do not qualify for the practical expedient
   c. The Topic the entity applies to the combined component (this Topic or Topic 606).
When a lessor elects the practical expedient to combine lease and nonlease components in a contract, it is required to provide certain disclosures. Such disclosures include (1) the lessor's election to combine lease components with associated nonlease components, (2) the class(es) of underlying asset(s) for which the election was made, (3) the nature of the items that are being combined, (4) any nonlease components that were not eligible for the practical expedient, and (5) which standard applies to the combined component (i.e., ASC 842 or ASC 606). (See Section 4.3.3.2 for further discussion of this practical expedient.)

15.3.3 Lease Transactions With Related Parties

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-4 A lessor shall disclose any lease transactions between related parties (see Topic 850 on related party disclosures).</td>
</tr>
</tbody>
</table>

Lessors should disclose lease transactions between related parties in a manner consistent with the guidance in ASC 850. In accordance with ASC 850, a lessor should consider disclosing the nature of the related-party lease, the related-party relationship, and the terms of the lease that are affected by the relationship.

15.3.4 Residual Assets and Risk Management

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>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:</td>
</tr>
<tr>
<td>a. Its risk management strategy for residual assets</td>
</tr>
<tr>
<td>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))</td>
</tr>
<tr>
<td>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).</td>
</tr>
</tbody>
</table>

Paragraph BC331 of ASU 2016-02 describes the FASB's rationale for including the above disclosure requirements related to residual assets in ASC 842-30-50-7:

While users generally said that the lessor accounting model in previous GAAP provided them with the financial information they needed, many users indicated that they needed more information about the lessor's residual assets and exposure to residual asset risk. The latter (exposure to residual asset risk) is addressed by the lessor disclosure requirements discussed in paragraphs BC339 and BC340. Regarding the former (information about the lessor's residual assets), the Board noted that users will benefit from the disclosure of a lessor's unguaranteed residual assets separate from the lessor's lease receivable. That is, because, although linked, those assets (that is the unguaranteed residual asset and the lease receivable) have different natures, risks, and liquidity. Separate disclosure of those assets will improve the transparency of information provided to users of financial statements about a lessor's exposure to credit risk (relating to the lease receivable, which includes any guaranteed portion of the underlying assets' estimated residual value) and asset risk (relating to the unguaranteed residual asset).
Further, paragraph BC340 of ASU 2016-02 states the following regarding the Board’s reasoning behind changing the previous U.S. GAAP guidance on this topic:

A primary concern of users on the disclosure requirements in previous GAAP is the lack of transparency about how the lessor manages its exposure to residual value risk. While users generally said that the lessor accounting model in previous GAAP provided them with the financial information they needed, many users indicated that additional information was needed about the lessor’s residual assets and exposure to residual risk. Uncertainty about the residual value of the underlying asset at the end of the lease is a lessor’s primary risk, particularly for a lessor of equipment and vehicles. This is because a decline in the market value of leased equipment and vehicles at a rate greater than the rate the lessor projected (on the basis of its policy on residual value measurement) would adversely affect the profitability of the lease. Residual value realization at the end of the lease term might be affected by several factors (for example, rapid technological or economic obsolescence, unusual wear and tear, excess use, or manufacturer’s warranties). Consequently, the Board decided that a lessor should disclose how it manages its residual value risk to enable users to assess the uncertainty of cash flows arising from a lessor’s leases and from its leased assets. The Board considered that producing residual risk disclosures will carry an incremental cost to preparers, but it decided to require the disclosures on the basis that this is an area in which users have consistently requested additional information and told the Board that the financial reporting for lessors in previous GAAP was inadequate for their information needs in many cases.

Connecting the Dots — Disclosures About Residual Asset Risk May Not Be as Applicable to Lessors of Real Estate

Residual value risk might not be a primary risk for many lessors of property (i.e., land or buildings in this context) because of the long-lived nature of those assets as well as the propensity for such assets to hold their value or, in many cases, to appreciate. In such cases, a lessor may consider providing more limited narrative disclosures.

15.3.5 Amounts Recognized in the Financial Statements

15.3.5.1 Sales-Type Leases and Direct Financing Leases

15.3.5.1.1 Tabular Disclosures

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-5 A lessor shall disclose lease income recognized in each annual and interim reporting period, in a tabular format, to include the following:</td>
</tr>
<tr>
<td>a. For sales-type leases and direct financing leases:</td>
</tr>
<tr>
<td>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)</td>
</tr>
<tr>
<td>2. Interest income either in aggregate or separated by components of the net investment in the lease. . . .</td>
</tr>
</tbody>
</table>

The table below outlines information that an entity would need to disclose for sales-type or direct financing leases to comply with the requirements in ASC 842-30-50-5 above.
## Lessor Uses Leasing to “Sell” PP&E It Would Otherwise Sell

<table>
<thead>
<tr>
<th></th>
<th>Sales-Type Lease</th>
<th>Direct Financing Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling profit</td>
<td>Gross selling price, cost of leased property, selling profit</td>
<td>Not applicable — no selling profit is recognized at lease commencement for direct financing leases</td>
</tr>
<tr>
<td>at lease commencement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling loss</td>
<td><strong>Gross selling price, cost of leased property, selling loss</strong></td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>Disclose interest income either in aggregate or separated by components of the net investment in the lease. That is, disclose interest income related to (1) the interest earned on the lease receivable and (2) the accretion of the unguaranteed residual value of the asset.</td>
<td>Disclose interest income either in the aggregate or separated by components of the net investment in the lease. That is, disclose interest income related to (1) the interest earned on the lease receivable, (2) the accretion of the unguaranteed residual value of the asset, and (3) any deferred selling profit included in the net investment balance.</td>
</tr>
</tbody>
</table>

## Lessor Uses Leasing to Provide Financing to Lessees

<table>
<thead>
<tr>
<th></th>
<th>Sales-Type Lease</th>
<th>Direct Financing Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling profit</td>
<td>Selling profit</td>
<td>Not applicable — no selling profit is recognized at lease commencement for direct financing leases</td>
</tr>
<tr>
<td>at lease commencement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling loss</td>
<td>Selling loss</td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>Disclose interest income either in aggregate or separated by components of the net investment in the lease. That is, disclose interest income related to (1) the interest earned on the lease receivable and (2) the accretion of the unguaranteed residual value of the asset.</td>
<td>Disclose interest income either in the aggregate or separated by components of the net investment in the lease. That is, disclose interest income related to (1) the interest earned on the lease receivable, (2) the accretion of the unguaranteed residual value of the asset, and (3) any deferred selling profit included in the net investment balance.</td>
</tr>
</tbody>
</table>
Example 15-1

Disclosures Related to Sales-Type Lease
The following disclosures are based on the calculations in Section 9.3.7:

Lessor uses leasing to “sell” PP&E it would otherwise sell

- Sales-type lease selling price $62,000
- Cost of underlying asset $(54,000)
- Operating profit (loss) $8,000

- Interest income on the lease receivable $1,097
- Interest income related to the accretion on the unguaranteed residual value $2,303
- Initial direct costs incurred $(2,000)

Lessor uses leasing as a means of providing financing

- Selling profit $8,000

- Interest income on the lease receivable $1,097
- Interest income related to the accretion on the unguaranteed residual value $2,303
- Initial direct costs incurred $(2,000)

Example 15-2

Disclosures Related to Direct Financing Lease
The following disclosures are based on the calculations in Section 9.3.8:

- Interest income on the lease receivable $2,726
- Interest income related to the accretion on the unguaranteed residual asset $248
- Interest income on deferred profit $1,651

15.3.5.1.2 Components of Net Investments in Leases

ASC 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).
The following is an example of a disclosure an entity might provide to comply with the above requirement in ASC 842-30-50-6 regarding disclosure of components of net investments in leases:

<table>
<thead>
<tr>
<th>Net investment in the lease — lease payment receivable:</th>
<th>$ XXX,XXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net investment in the lease — unguaranteed residual assets:</td>
<td>$ X,XXX</td>
</tr>
<tr>
<td>Net investment in the lease — deferred selling profits (direct financing lease only):</td>
<td>$ XXX</td>
</tr>
</tbody>
</table>

Changing Lanes — ASC 842 Amends Disclosure Requirements Pertaining to the Components of Net Investments in Leases

Under ASC 840-30-50-4, all of the following components of the net investment in sales-type or direct financing leases were disclosed: (1) future minimum lease payments to be received (with certain separate deductions), (2) unguaranteed residual values accruing to the lessor's benefit, (3) initial direct costs (for direct financing leases only), and (4) unearned income. Unearned income in a sales-type lease was initially measured as the difference between the gross investment in the lease and the sum of the present values of the two components of the gross investment. Unearned income in a direct financing lease was initially measured as the difference between the gross investment in the lease and the cost or carrying amount of the underlying asset. Accordingly, under ASC 840, disclosures about the components of the net investment in a sales-type or a direct financing lease needed to include the gross amount of the components, with an unearned income adjustment to arrive at a total that corresponded to the balance sheet amount. On the other hand, ASC 842 requires that the carrying amount of the components of the net investment be disclosed. That is, each individual component should be presented at a discounted value.

15.3.5.1.3 Significant Changes in the Balance of Unguaranteed Residual Assets and Deferred Selling Profit

ASC 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.

Significant changes in the “balance of [a lessor’s] unguaranteed residual assets and deferred selling profit on direct financing leases” must be disclosed and could arise from fluctuations in the residual asset value governed by technological or other market influences, termination or completion of the lease, or impairment of the underlying asset.

15.3.5.1.4 Maturity Analysis of Lease Receivables

ASC 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).
The below example\(^3\) includes a maturity analysis of lease receivables as well as a reconciliation to the total amount of receivables recognized in the statement of financial position.

<table>
<thead>
<tr>
<th>Maturity Period</th>
<th>Cash Flows</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>One year</td>
<td>$9,500</td>
<td></td>
</tr>
<tr>
<td>Two years</td>
<td>9,500</td>
<td></td>
</tr>
<tr>
<td>Three years</td>
<td>9,500</td>
<td></td>
</tr>
<tr>
<td>Four years</td>
<td>9,500</td>
<td></td>
</tr>
<tr>
<td>Five years</td>
<td>9,500</td>
<td></td>
</tr>
<tr>
<td>Thereafter</td>
<td>9,500</td>
<td></td>
</tr>
<tr>
<td>Total undiscounted cash flows</td>
<td>$57,000</td>
<td></td>
</tr>
</tbody>
</table>

Present value of lease payments (recognized as lease receivables) 48,770* 

Difference between undiscounted cash flows and discounted cash flows 8,230*

* Amount comprises a current and long-term portion of lease receivables of $8,739 and $40,031, respectively, which is presented in the lessor’s statement of financial position.

15.3.5.2 Operating Leases

A lessor should treat assets subject to operating leases as a major class of depreciable assets. Specifically, paragraph BC341 of ASU 2016-02 states, in part:

[A] lessor should provide the required property, plant, and equipment disclosures for assets subject to operating leases separately from owned assets held and used by the lessor. In the Board’s view, leased assets often are subject to different risks than owned assets that are held and used (for example, the decrease in the value of the underlying asset in a lease could be due to several factors that are not within the control of the lessor), and, therefore, users will benefit from lessors segregating their disclosures related to assets subject to operating leases from disclosures related to other owned property, plant, and equipment.

15.3.5.2.1 Tabular Disclosures

<table>
<thead>
<tr>
<th>ASC 842-30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-5</strong> A lessor shall disclose lease income recognized in each annual and interim reporting period, in a tabular format, to include the following: . . .</td>
</tr>
<tr>
<td>b. For operating leases, lease income relating to lease payments. . .</td>
</tr>
</tbody>
</table>

In interim and annual reporting periods, a lessor should disclose, within its tabular disclosure of lease income, lease income related to lease payments from operating leases.

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\(^3\) Assume that the lessor has one lease with a remaining lease term of six years and annual lease payments of $9,500.
15.3.5.2.2 Maturity Analysis of Lease Payments

**ASC 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.

With respect to the requirement in ASC 842-30-50-12 for a lessor to disclose a maturity analysis of operating lease payments, a reconciliation of the cash flows to the receivable balance is not required because a receivable similar to that recorded under a direct financing or sales-type lease is not recorded under an operating lease. (See Section 15.3.5.1.4.)

15.3.5.2.3 Separate ASC 360 Disclosures

**ASC 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.

To comply with the disclosure requirement above, an entity will need to consider the disclosure requirements in ASC 360-10-50, including those related to items such as depreciation, balances of major classes of assets, and impairment considerations.

15.3.5.3 Variable Lease Income

**ASC 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: . . .

c. Lease income relating to variable lease payments not included in the measurement of the lease receivable.

In interim and annual reporting periods, a lessor should disclose, within its tabular disclosure of lease income, lease income related to variable lease payments. This amount should include variable lease income associated with all lease classifications, but it should exclude any lease income already disclosed within the sales-type lease, direct-financing lease, or operating lease disclosures (i.e., it should exclude lease income related to payments included in the measurement of the lease receivable or in the calculation of straight-line operating lease income).

15.3.6 Practical-Expedient Disclosure Related to Sales Taxes and Other Similar Taxes Collected From Lessees

**ASC 842-30**

50-14 A lessor that makes the accounting policy election in paragraph 842-10-15-39A shall disclose its accounting policy election and comply with the disclosure requirements in paragraphs 235-10-50-1 through 50-6.
When a lessor elects, as an accounting policy, to exclude from revenue and expenses sales taxes and other similar taxes assessed by a governmental authority and collected by the lessor from a lessee, it should disclose that it has done so. See Section 17.3.1.5 for detailed discussion of ASU 2018-20, including transition requirements.

### 15.4 Sale-and-Leaseback Transactions

<table>
<thead>
<tr>
<th>ASC 842-40</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-1 If a seller-lessee or a buyer-lessee 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-lessee.</td>
</tr>
<tr>
<td>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:</td>
</tr>
<tr>
<td>a. The main terms and conditions of that transaction</td>
</tr>
<tr>
<td>b. Any gains or losses arising from the transaction separately from gains or losses on disposal of other assets.</td>
</tr>
</tbody>
</table>

An entity that enters into a sale-and-leaseback transaction must provide disclosures in addition to those outlined in Sections 15.2 and 15.3 for lessees and lessors, respectively. In addition, a seller-lessee must disclose the terms and conditions of the sale-and-leaseback transaction and present the gains and losses resulting from the transaction separately from those arising from other asset disposals.

### 15.5 Annual and Interim Disclosures

This section outlines the comparative period disclosure requirements (i.e., for the comparative annual periods presented in an entity’s financial statements) and interim disclosure requirements under ASC 842.

#### 15.5.1 Comparative Periods

Some of the disclosure requirements outlined in the sections above start with the phrase “for each period presented in the financial statements, a lessee shall disclose.” These statements typically accompany quantitative requirements such as those in ASC 842-20-50-4 (lessee amounts recognized in the balance sheet). Therefore, these quantitative disclosures should be presented comparatively with respect to the prior annual periods presented. Other requirements, such as the qualitative requirements, do not necessarily lend themselves to separate disclosures for the comparative balance sheet dates presented and therefore may be discussed only as of the reporting date (rather than on a comparative basis).

#### 15.5.2 Interim Disclosures

Interim disclosure requirements are outlined in ASC 270. Generally, ASC 270 requires that entities report significant changes in financial position (see ASC 270-10-50-4) and changes in accounting principles and estimates (see ASC 270-10-45-12 through 45-16), along with other information that helps users understand the interim financial reporting results compared with those for its most recent annual period.
In addition, ASC 270 requires lessors to provide the following disclosure on both an interim and annual basis:

<table>
<thead>
<tr>
<th><strong>ASC 270-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-6A</strong> A lessor shall disclose a table of all lease-related income items in its interim financial statements (see paragraph 842-30-50-5 for lease-related income items).</td>
</tr>
</tbody>
</table>

Other than this one explicit requirement for lessors, no disclosures are prescribed for lessees and lessors on an interim basis. The aforementioned lease-related income items required for lessors are detailed in ASC 842-30-50-5 and further discussed in Section 15.3.5.1.1.

**Connecting the Dots — Interim Disclosures**

While there are no explicit interim requirements (in the year after adoption), an entity may elect to provide interim lease disclosures in a manner consistent with how it provides disclosures in its annual financial statements if the entity's leasing activities are significant or if there are significant changes in its leasing activities on an interim basis. Further, we believe that providing the required annual lease disclosures for each interim period could alleviate a significant amount of work at year-end. That is, it will most likely take entities significant time to compile the amount of information required, and discussed throughout this chapter, if it is accumulated at year-end for a full year of activity. Therefore, entities that have controls and processes in place to accumulate this information throughout the year may find it less burdensome to prepare their annual disclosures.

For more information about what annual disclosures an entity needs to provide in its first quarterly filing after adoption, see Section 16.11.
Chapter 16 — Effective Date and Transition

16.1 Overview
   16.1.1 Entities Permitted to Elect Not to Restate Comparative Periods in the Period of Adoption
   16.1.2 Adoption Timelines

16.2 Considerations Related to Applying Transition Guidance

16.3 Lessee
   16.3.1 Lease Previously Classified as an Operating Lease Under ASC 840
   16.3.2 Lease Previously Classified as a Capital Lease Under ASC 840

16.4 Lessor
   16.4.1 Lease Classified as an Operating Lease Under Both ASC 840 and ASC 842
   16.4.2 Lease Is a Direct Financing Lease or a Sales-Type Lease Under ASC 842 (Operating Lease Under ASC 840)
   16.4.3 Lease Classified as a Direct Financing Lease or a Sales-Type Lease Under ASC 840 (and Is Still Classified as a Direct Financing Lease or a Sales-Type Lease Under ASC 842)
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16.7 Separation and Allocation of Consideration to Components in a Contract in Transition
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   16.7.2 Lessor Practical Expedient

16.8 Build-to-Suit Transition

16.9 Transition for Sale-and-Leaseback Transactions

16.10 Amounts Previously Recognized From Business Combinations

16.11 Transition Disclosures
16.1 Overview

ASC 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 (with an exception for those entities that have not yet issued their financial statements or made financial statements available for issuance as described in the following sentence), 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. 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 that has not yet issued financial statements or made financial statements available for issuance as of June 3, 2020, shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2019, 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, 2021, and interim periods within fiscal years beginning after December 15, 2022. Earlier application is permitted. . . .

In November 2019, the FASB issued ASU 2019-10, which (1) provides a framework for staggering the effective dates of future major accounting standards and (2) amends the effective dates of certain major new accounting standards to give implementation relief to certain types of entities. In June 2020, the FASB issued ASU 2020-05, which further amends the effective dates to give implementation relief to certain types of entities in response to the coronavirus disease 2019 (“COVID-19”) pandemic. ASU 2020-05 amends the effective dates of ASU 2016-02 as follows:

<table>
<thead>
<tr>
<th>Public Companies¹</th>
<th>Public NFPs²</th>
<th>All Other Entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>As originally issued (ASU 2016-02)</td>
<td>Fiscal years beginning after December 15, 2018, and interim periods therein</td>
<td>Fiscal years beginning after December 15, 2018, and interim periods therein</td>
</tr>
<tr>
<td>As amended by ASU 2019-10</td>
<td>No changes</td>
<td>No changes</td>
</tr>
<tr>
<td>As amended by ASU 2020-05</td>
<td>No changes</td>
<td>Fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2020</td>
</tr>
<tr>
<td></td>
<td>Fiscal years beginning after December 15, 2019, and interim periods therein</td>
<td>Fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022</td>
</tr>
</tbody>
</table>

¹ Public companies are PBEs, as well as certain non-for-profit entities and employee benefit plans as described above in ASC 842-10-65-1(a).
² The deferral in ASU 2020-05 applies to public NFPs that have not issued financial statements or made financial statements available for issuance as of June 3, 2020. Public NFPs that have issued financial statements or have made financial statements available for issuance before that date must comply with the effective dates prescribed for public companies above.
Connecting the Dots — Impact of Early Adoption

While an entity may believe that there are certain benefits of early adoption (e.g., the ability to derecognize assets and liabilities that resulted from deemed ownership under existing build-to-suit accounting guidance), it should carefully consider the implications of doing so. For example, the entity will need to ensure that it has systems, processes, and controls in place to appropriately implement ASU 2016-02 (see Appendix D for more information). Further, it is not unusual for interpretations of a new standard to evolve during the implementation period, which could cause an entity to account for lease transactions differently from its peers and thus could increase the risk of regulatory scrutiny.

Bridging the GAAP — Comparison With IFRS 16

The effective date of IFRS 16 is similar to the effective date of ASU 2016-02 for PBEs. However, the IASB decided that an entity would only be allowed to early adopt IFRS 16 if it has also adopted IFRS 15 (the IASB’s revenue standard). The IASB decided to limit early adoption of IFRS 16 because, as noted in paragraph BC272 of IFRS 16, “some of the requirements in IFRS 16 depend on an entity also applying the requirements of IFRS 15 (and not the Standards that were superseded by IFRS 15).”

Q&A 16-1A Early Adoption of ASC 842 in an Interim Period Other Than the First Interim Period in a Fiscal Year

ASC 842 does not address whether an entity is permitted to early adopt ASU 2016-02 in an interim period other than the first interim period in a fiscal year, nor does it specifically prohibit early adoption in any interim period in a fiscal year.

Question

Can a PBE early adopt ASC 842 in an interim period other than the first interim period in a fiscal year and, if so, what are the reporting implications?

Answer

We believe that a PBE may elect to early adopt ASC 842 in an interim period other than the first interim period in a fiscal year (e.g., as of October 1, 2018, the start of a calendar-year-end entity’s fourth quarter). If elected, the early adoption should be reflected as of the beginning of the annual period in accordance with ASC 842-10-65-1(a), which indicates that ASC 842 is effective for PBEs in interim periods within the annual period of adoption.

Further, we believe that, in the absence of any specific reference in an ASU’s transition requirements to prospective adoption in an interim period, preparers should apply the guidance in ASC 250-10-45-14, which states:

A change in accounting principle made in an interim period shall be reported by retrospective application in accordance with paragraphs 250-10-45-5 through 45-8. However, the impracticability exception in paragraph 250-10-45-9 may not be applied to prechange interim periods of the fiscal year in which the change is made. When retrospective application to prechange interim periods is impracticable, the desired change may only be made as of the beginning of a subsequent fiscal year.

Therefore, a calendar-year-end entity’s early adoption of ASC 842 in the second, third, or fourth quarter of 2018 should be reflected as if the entity had adopted ASC 842 on January 1, 2018. Accordingly, application of ASC 842 for the entire fiscal year is required in such circumstances. As a result, in accordance with SEC Regulation S-K, Item 302(a), the selected quarterly financial data presented in the year-end 2018 Form 10-K must reflect the adoption
of ASC 842. Further, when the entity subsequently presents 2018 comparative periods in the interim financial statements for the first, second, or third quarter of 2019, the 2018 comparative financial statements should reflect the application of ASC 842.

This answer is further supported by the discussion in Section 18.7 regarding the application of ASC 842 to interim periods in the year of adoption for emerging growth companies (EGCs).

**ASC 842-10**

65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

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 application date, as determined by the transition method that the entity elects. An entity shall apply the pending content that links to this paragraph using one of the following two methods:

1. Retrospectively to each prior reporting period presented in the financial statements with the cumulative effect of initially applying the pending content that links to this paragraph recognized at the beginning of the earliest comparative period presented, subject to the guidance in (d) through (gg). Under this transition method, the application date shall be the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease.

2. Retrospectively at the beginning of the period of adoption through a cumulative-effect adjustment, subject to the guidance in (d) through (gg). Under this transition method, the application date shall be the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.

d. An entity shall adjust equity and, if the entity elects the transition method in (c)(1), 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 (e) through (gg).

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 for an entity that applies the pending content that links to this paragraph in accordance with (c)(1) . . .

An entity adopts ASC 842 by using a modified retrospective transition approach. Under this approach, the standard is effectively implemented either (1) as of the earliest period presented and through the comparative periods in the entity’s financial statements or (2) as of the effective date of ASC 842, with a cumulative-effect adjustment to equity (see Section 16.1.1). The modified nature of this transition approach is intended to maximize comparability while reducing the complexity of transition compared with the full retrospective approach, under which financial statements would be prepared as if ASC 842 was always effective.

ASC 842 provides for certain practical expedients in transition. Depending on the expedients elected, certain aspects of ASC 842 will not be implemented until the standard’s effective date, regardless of whether an entity elects to recast comparative periods under ASC 842. The practical expedients are intended to reduce the cost and complexity of adoption while maintaining financial statement comparability after adoption.
Connecting the Dots — Modified Retrospective Transition Under ASC 842 Differs From That Under ASC 606

An entity that elects the modified retrospective transition option in ASC 606 is permitted to apply ASC 606 only to the current-year financial statements (i.e., the financial statements for the year in which ASC 606 is first implemented). Such an entity will record a cumulative-effect adjustment to the opening balance of retained earnings in the year in which it first adopts ASC 606. By contrast, an entity that uses the modified retrospective transition approach under ASC 842 may record an adjustment as of the beginning of either the earliest year presented or the first year of adoption.

16.1.1 Entities Permitted to Elect Not to Restate Comparative Periods in the Period of Adoption

In July 2018, the FASB issued ASU 2018-11, which amended certain aspects of ASC 842 to provide relief from the costs of implementing the new leasing standard. ASU 2018-11 allows an entity to elect not to recast its comparative periods in the period of adoption when transitioning to ASC 842 (the “Comparatives Under 840 Option”). Effectively, an entity would be permitted to change its date of initial application to the beginning of the period of adoption of ASC 842 (e.g., January 1, 2019, for a calendar-year-end PBE or January 1, 2022, for a calendar-year-end non-PBE). In doing so, the entity would:

- Apply ASC 840 in the comparative periods.
- Provide the disclosures required by ASC 840 for all periods that continue to be presented in accordance with ASC 840.
- Recognize the effects of applying ASC 842 as a cumulative-effect adjustment to retained earnings as of the effective date (e.g., January 1, 2019, for a calendar-year-end PBE or January 1, 2022, for a calendar-year-end non-PBE); under the Comparatives Under 840 Option, this date would represent the date of initial application.

The entity would not:

- Restate comparative periods for the effects of applying ASC 842.
- Provide the disclosures required by ASC 842 for the comparative periods.
- Change how the transition requirements apply, only when the transition requirements apply.

Therefore, an entity that elects the Comparatives Under 840 Option under ASU 2018-11 may find transition (as well as navigating the complicated concepts in this chapter) easier.

Connecting the Dots — Implementation Challenges Remain When the Comparatives Under 840 Option Is Used

Although the Comparatives Under 840 Option does not change how an entity applies the transition requirements, the lease-related balances recorded as of the effective date may still differ from the balances that would be remaining as of that date if comparative periods had been restated for the effects of applying ASC 842.

The Board expects that the new transition election will relieve entities from the cost burdens that are associated with restating comparative periods for the effects of applying ASC 842. However, many entities will still need to enhance their lease-related IT systems as a result of ASC 842’s data requirements. In addition, ASC 842’s requirements related to judgments and estimations have not changed, and new processes and internal controls will still need to be

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3 In accordance with ASU 2020-05.
instituted accordingly. Therefore, we do not think that entities should slow their implementation efforts because of the issuance of ASU 2018-11.

Throughout this chapter, we use the phrase “date of initial application” to mean either of the following:

- The beginning of the earliest comparative period presented — if the entity does not elect the Comparatives Under 840 Option.
- The date on which the entity adopts ASC 842 — if the entity elects the Comparatives Under 840 Option.

See Section 16.11 for additional discussion of the transition disclosures related to ASU 2018-11 and Section 17.3.1.4.1 for further discussion of this additional transition method.

### 16.1.2 Adoption Timelines

**PBE With a Calendar Year-End**

Assumes no early adoption (and no election of the Comparatives Under 840 Option)

<table>
<thead>
<tr>
<th>Beginning of earliest comparative period to be presented</th>
<th>ASC 842 effective date</th>
<th>First quarterly reporting date</th>
<th>First annual reporting date</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 2017</td>
<td>January 1, 2019</td>
<td>March 31, 2019</td>
<td>December 31, 2019</td>
</tr>
</tbody>
</table>

**Non-PBE With a Calendar Year-End**

Assumes no early adoption (and no election of the Comparatives Under 840 Option)

<table>
<thead>
<tr>
<th>Beginning of earliest comparative period to be presented</th>
<th>ASC 842 effective date</th>
<th>First quarterly reporting date, if required</th>
<th>First annual reporting date</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 2019</td>
<td>January 1, 2022</td>
<td>December 31, 2022</td>
<td>March 31, 2023</td>
</tr>
</tbody>
</table>

The above charts indicate the transition timelines for calendar-year-end PBEs and non-PBEs, respectively. Differences in assets and liabilities as of the earliest comparative period are recognized as a cumulative-effect adjustment in equity at such time. Lessors apply the modified retrospective transition approach similarly to how lessees apply it.
Connecting the Dots — Meaning of “Earliest Comparative Period Presented”

PBEs that present three years of income statements and statements of cash flows must prepare the balance-sheet effect of the adoption of ASC 842 as of January 1, 2017, even though they generally provide only two years of balance sheets in their financial statements. That is, PBEs need the balance sheet so that they can (1) prepare the income statement in the earliest year presented and a statement of cash flow reconciliation and (2) properly roll forward the balance sheet.

Connecting the Dots — Modified Retrospective Transition Method Required

Because the FASB wanted to limit the number of potential transition methods that an entity could apply, full retrospective transition is not permitted; rather, the modified retrospective transition method is required. However, as discussed later in this chapter, the level of modification depends on the extent to which an entity elects optional practical expedients (see Section 16.5).

Connecting the Dots — “Earliest Period Presented” for a Non-PBE’s Stand-Alone Financial Statements

While PBEs are subject to the SEC’s public-company reporting requirements, other entities may prepare single or multi-year comparative financial statements in accordance with their own reporting requirements. An entity that does not elect the Comparatives Under 840 Option must apply the modified retrospective transition approach to the earliest period presented in its financial statements. If a non-PBE is consolidated by a PBE, the PBE will technically have an “earliest period presented” that is different from (earlier than) the period in which the non-PBE will prepare financial statements for its users. Nonetheless, we believe that in the PBE’s consolidated financial statements, the PBE is required to determine its subsidiary’s lease balance as of the PBE’s earliest period presented. We do not believe that the FASB intended for the lease balances to be calculated as of multiple dates (one for the parent and one for the subsidiary) in the PBE’s consolidated financial statements.

Example 16-1

Roses Inc., a PBE that does not elect the Comparatives Under 840 Option, prepares its 2019 financial statements for which the earliest comparative period begins on January 1, 2017. One of its consolidated subsidiaries, Free LLC, prepares separate financial statements for which the earliest comparative period begins on January 1, 2018. Roses is required to determine its lease balances as of January 1, 2017, which include lease balances that roll up from Free. Further, it would be acceptable for Free to use the January 1, 2017, lease balances and roll forward the balances to January 1, 2018, for transition and disclosure purposes.

16.2 Considerations Related to Applying Transition Guidance

ASC 842 requires all entities to apply the modified retrospective approach. The determination of lease balances under this approach is generally based on the remaining lease payments and discount rate as of the date of initial application. Under the full retrospective approach (which is not permitted), by contrast, lease balances would be determined as of lease commencement and rolled forward. In addition, an entity may elect various transition-related accounting policies under ASC 842, which could affect its comparability to other entities.
Specifically, ASC 842 offers relief from implementing the transition provisions by permitting an entity (lessee or lessor) to elect not to reassess:

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

An entity that elects this transition relief (i.e., the “practical expedient package”) is required to adopt all three relief provisions and is prohibited from applying the relief on a lease-by-lease basis. In addition, the entity must disclose that it has elected the practical expedient package. Separately, the entity is also allowed to use hindsight in evaluating the lease term (e.g., renewal, termination, and purchase options for existing leases) and impairment of the ROU asset. As a result, when preparing for transition, entities must consider the following transition and accounting policy elections:

### Transition Elections (Entity-Wide for All Leases)

<table>
<thead>
<tr>
<th>Practical expedient package (Section 16.5.2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Lease identification (Section 16.5.2.1)</td>
</tr>
<tr>
<td>- Lease classification (Section 16.5.2.2)</td>
</tr>
<tr>
<td>- Initial direct costs (Section 16.5.2.3)</td>
</tr>
<tr>
<td>Hindsight (Section 16.5.1)</td>
</tr>
<tr>
<td>Land easement practical expedient for transition (Section 2.4)</td>
</tr>
</tbody>
</table>

### Accounting Policy Elections

- Separation of consideration in the contract between lease and nonlease components by class of underlying asset (Chapter 4).
- Portfolio approach (Chapters 8 and 9).
- Short-term lease exemption by class of underlying asset (Chapter 8).
- Other materiality-influenced judgments.
- Discount rate (nonpublic entities only) (Chapter 7).
- Sales taxes and other similar taxes collected from lessees (Chapter 4).

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**Connecting the Dots — Considerations Related to Selecting Expedients and Accounting Policies**

As companies prepare to implement ASU 2016-02 and assess its impact, the appropriateness to their organization of policies related to practical expedients may continue to evolve. For example, although the practical expedient package may be an efficient manner of adopting the standard, an entity that elects this package may miss the opportunity to reassess whether a lease under ASC 840 would be outside the scope of ASC 842. In addition, some may find the income statement presentation of a finance lease to be more favorable than that of an operating lease and therefore may wish to assess lease classification under ASC 842. We recommend that companies work with various stakeholders at their organizations (e.g., accounting, finance, real estate, and IT professionals, as well as the audit committee) to determine the impact and costs/benefits of the above elections for each stakeholder. Further, companies should consider discussing the impact of the elections with their professional advisers.

**Connecting the Dots — Hindsight Expedient May Increase Complexity**

While the hindsight practical expedient only applies to lease term and impairment considerations (see Section 16.5.1), we believe that the expedient could make adoption more complex given that both of these matters affect other aspects of lease accounting.
16.3 Lessee

The transition approach for lessees — except for reporting entities that elect, as an accounting policy, to exclude short-term leases\(^4\) (see Section 5.2.4.3) — is to recognize all lease obligations and ROU assets on the balance sheet. For leases previously classified as operating under ASC 840, this represents a significant change because ASC 840 required that only capital leases be included on the balance sheet. For leases previously classified as a capital lease, the finance lease transition generally carries forward the previous capital lease balances, subject to the application of the practical expedients described in Section 16.5.

16.3.1 Lease Previously Classified as an Operating Lease Under ASC 840

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>65-1</strong> The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .</td>
</tr>
<tr>
<td>k. A lessee shall initially recognize a right-of-use asset and a lease liability at the application date as determined in (c).</td>
</tr>
<tr>
<td>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 application date as determined in (c):</td>
</tr>
<tr>
<td>1. The remaining minimum rental payments (as defined under Topic 840).</td>
</tr>
<tr>
<td>2. Any amounts probable of being owed by the lessee under a residual value guarantee. . . .</td>
</tr>
<tr>
<td>p. If a lessee does not elect the practical expedients described in (f), any unamortized initial direct costs that do not meet the definition of initial direct costs in this Topic shall be written off as an adjustment to equity unless the entity elects the transition method in (c)(1) and the costs were incurred after the beginning of the earliest period presented, in which case those costs shall be written off as an adjustment to earnings in the period the costs were incurred.</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

Leases previously classified as an operating lease under ASC 840 could be accounted for as either an operating lease or a finance lease under ASC 842. The classification under ASC 842 depends on whether an entity elects the practical expedient package (see Section 16.5.2.2). If so, the entity does not reassess the ASC 840 classification (i.e., the classification is carried forward when the entity adopts ASC 842). However, if the practical expedient package is not elected, the lease must be assessed under the ASC 842 classification criteria. Because there are only minor differences between the lease classification criteria under ASC 840 and those under ASC 842, the lease classification conclusion often will remain unchanged even if the practical expedient package is not elected.

\(^4\) We do not believe that the short-term lease exemption applies to leases that, upon transition, have a remaining term of 12 months or less if the original term was greater than 12 months. The ASC master glossary defines a short-term lease 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.” While a lease may have a remaining lease term of less than 12 months at transition, it would not meet the definition of a short-term lease if the lease term as of the original commencement date would have been greater than 12 months.
The two transition scenarios for an operating lease under ASC 840 are as follows:

<table>
<thead>
<tr>
<th>ASC 840 Classification</th>
<th>ASC 842 Classification</th>
<th>Roadmap Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating</td>
<td>Operating</td>
<td>16.3.1.1</td>
</tr>
<tr>
<td>Operating</td>
<td>Finance</td>
<td>16.3.1.2</td>
</tr>
</tbody>
</table>

As discussed further below, transition in both of these scenarios is the same with respect to (1) the timing of recognizing the ROU asset and lease liability, (2) the initial measurement of the lease liability, (3) unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842, and (4) modifications on or after the effective date of ASC 842. Sections 16.3.1.1 and 16.3.1.2 discuss these two scenarios and highlight how the accounting differs between the two with regard to the initial measurement of the ROU asset.

**Timing of Recognition**

In both scenarios, a lessee recognizes the ROU asset and lease liability at the later of the date of initial application or the commencement date of the lease.

**Initial Measurement of the Lease Liability**

The lease liability is measured in the same manner regardless of whether lease classification has changed. In both scenarios, the lease liability should represent the present value of the sum of:

- The remaining minimum rental payments (as defined under ASC 840).
- Any amounts that it is probable the lessee will owe under a residual value guarantee (see Section 6.7 for guidance on how to measure these amounts).

These amounts are measured at their present value by using a discount rate established at the later of (1) the date of initial application or (2) the commencement date of the lease. See Chapter 7 for more information on the identification of the appropriate discount rate.

**Q&A 16-1 Identifying Minimum Rental Payments**

In the transition to ASC 842, the lease obligation for an operating lease is typically measured by using the remaining minimum rental payments, as described in ASC 840.

**Question**

What is included in minimum rental payments?

**Answer**

Although ASC 840 does not define the term “minimum rental payments,” ASC 840-20-50-2 indicates that lessees must disclose future minimum rental payments as of the balance sheet date for operating leases that meet certain conditions:

For operating leases having initial or remaining noncancelable lease terms in excess of one year, the lessee shall disclose both of the following:

- a. Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years

- b. The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented. [Emphasis added]
The FASB has confirmed that the intent of requiring, in transition, lessees to measure operating leases by using the ASC 840 minimum rental payments is to ease the burden of determining the lease liability in transition. That is, in referencing the above disclosure under ASC 840, a lessee should be able to determine the gross amounts due under the lease and discount those required payments to determine the initial lease liability under ASC 842. This is consistent with paragraph BC390 of ASU 2016-02, which states that the application of the term “minimum rental payments” should be similar to that under prior guidance.

We have noted diversity in practice related to two aspects of the disclosure of future minimum rental payments under ASC 840:

1. **Lease payments that depend on an index or rate** — Some entities have included the most current rate as of the balance sheet date when disclosing future minimum rental payments, whereas other entities have included the rate in effect at the inception of the lease. ASC 840-10-25-4 and 25-5 define what does or does not constitute a minimum lease payment (as opposed to a minimum “rental” payment):

   **25-4** This guidance addresses what constitutes minimum lease payments under the minimum-lease-payments criterion in paragraph 840-10-25-1(d) from the perspective of the lessee and the lessor. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. . . . However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at lease inception; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and thus affect the determination of income as accruable.

   **25-5** For a lessee, minimum lease payments comprise the payments that the lessee is obligated to make or can be required to make in connection with the leased property, excluding both of the following:

   a. **Contingent rentals**

   b. Any guarantee by the lessee of the lessor’s debt and the lessee’s obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property. [Emphasis added]

At the 2018 AICPA Conference on Current SEC and PCAOB Developments (the “2018 AICPA Conference”), the SEC staff indicated that either historical approach is acceptable and that an entity may, depending on the facts and circumstances, deviate from its historical policy when measuring its leases as of the date of initial application. See Q&A 16-2 for further discussion of lease payments that fluctuate on the basis of a variable index or rate in the context of transition of a company’s operating leases under ASC 840 to the new leasing guidance under ASC 842.

2. **Executory costs (i.e., insurance, property taxes, and CAM)** — Some entities have concluded that executory costs are part of minimum rental payments under ASC 840 and other entities have not. A technical inquiry with the FASB staff has confirmed that either interpretation is acceptable under ASC 840. See Q&A 16-2A for additional information regarding the inclusion or exclusion of executory costs in the determination of a lessee’s lease liability for existing operating leases in transition, including considerations for entities that wish to change their historical approach under ASC 840.
Q&A 16-2  Operating Lease Payments That Fluctuate on the Basis of a Variable Rate or Index — Transition Considerations

In transitioning its operating leases under ASC 840 to the new leasing guidance under ASC 842, a lessee must measure its lease liabilities as of the date of initial application by using the remaining minimum rental payments, as defined in ASC 840. Like ASC 842, ASC 840 contains guidance designed to address variable payments that depend on an index or rate, including how an entity should view these payment mechanisms when determining minimum rental payments for classification and measurement purposes. While ASC 842 is clear on the treatment of variable lease payments that depend on an index or rate, we are aware of diversity in practice related to how such payments have been treated under ASC 840, particularly with respect to the disclosure of future operating lease payments required by ASC 840-20-50-2(a) (commonly referred to as the “lease commitments table”). While ASC 840 appears clear on the treatment of such payments for classification and initial measurement purposes (if applicable), it is less clear on how the lease commitments table should be constructed in the required footnote disclosures. For classification and initial measurement purposes, ASC 840 requires lessees to compute the minimum rental payments on the basis of the index or rate existing at lease inception. However, ASC 840 does not discuss how to determine future lease payments for disclosure purposes, and some entities have used updated index/rate information for this purpose under the belief that the disclosure is primarily a liquidity disclosure and therefore should reflect updated information about an entity’s obligations as of each balance sheet date. Other entities have continued to present future lease payments for disclosure purposes by using the index or rate existing at lease inception.

Question 1

In making the transition to ASC 842, what date should a lessee in an operating lease use to determine the rate or index that it should employ to determine the lease payments that are included in the calculation of the lessee’s lease liability under ASC 842?

Answer

It depends. ASC 842-10-65-1(l) addresses the transition for operating leases and states, in part:

[A] lessee shall measure the lease liability at the present value of the sum of the following, using a discount rate for the lease . . . established at the application date . . .

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.

As discussed in paragraph BC390 of ASU 2016-02, the FASB intended for a lessee to effectively “run off” leases existing under ASC 840 upon adopting ASC 842 (i.e., the lessee should use its minimum rental payment table disclosed under ASC 840 as the basis for initially measuring its operating lease liabilities under ASC 842). However, the transition guidance in ASC 842-10-65 is silent on the index or rate that should be used to determine lease payments in transition, other than via the reference to minimum rental payments under ASC 840, which, as described above, has been interpreted differently in practice for purposes other than classification and initial measurement. For this reason, stakeholders have expressed two potential alternatives:

- **Alternative 1** — Use the index or rate that was employed to calculate the lessee’s minimum lease payments as of lease inception.
- **Alternative 2** — Use the index or rate existing as of the date of initial application of ASC 842.
At the 2018 AICPA Conference, the SEC staff stated that it would be acceptable for a lessee to use the same approach for initial application as it has historically used for disclosure purposes under ASC 840. In other words, if a lessee used the inception rate for its ASC 840 disclosure, it would be acceptable for the lessee to apply Alternative 1 upon adopting ASC 842. Likewise, if a lessee used an updated index or rate for its ASC 840 disclosure, it would be acceptable for the lessee to apply Alternative 2 upon adopting ASC 842. The SEC staff indicated that it considers the definition of minimum rental payments in ASC 840 — for purposes other than classification and initial measurement — to be ambiguous and that it is therefore acceptable either to use the original index/rate or to update the index/rate for ASC 840 disclosure purposes. The SEC staff also indicated that it views the historical approach related to developing the ASC 840 disclosure as a policy election and therefore would generally expect an entity to apply its chosen approach consistently when making the transition to ASC 842. However, an entity may be able to change its historical approach on the basis of various factors, including the materiality of the historical policy to the overall financial statements, the direction of the change (e.g., changing from inception rate to initial application rate or vice versa), and the basis for making the change. The following are considerations related to each of these factors:

- **Materiality** — An entity should first assess the significance of its policy (the use of the inception rate as opposed to an updated rate) in the context of the overall financial statements. We generally believe that an entity can change its historical approach to the extent that the policy is immaterial to the overall financial statements.

- **Direction of the change** — We believe that an entity can change from using an updated rate to using the inception rate when determining its lease liabilities upon adopting ASC 842. A change in this direction is consistent with formal feedback received from the FASB staff regarding the requirements of ASC 840, and many entities have relied on such feedback as part of their implementation processes. Such a change is also more consistent with a literal read of the definition of minimum lease payments in ASC 840. Therefore, we do not believe that an entity would be required to apply the accounting guidance in ASC 250-10 when making such a change. However, we also believe that, under certain circumstances, a company can change from using the inception rate to using an updated rate when determining its lease liabilities upon adopting ASC 842. An entity wishing to do so may be subject to the preferability requirements in ASC 250-10, as discussed in the next bullet.

- **Basis for the change** — If an entity that has historically used the inception rate for its ASC 840 disclosure wishes to change the rate (i.e., wishes to use the rate as of the date of initial application) to determine its lease liabilities upon adopting ASC 842, it may be able to do so if the change is appropriate on the basis of the guidance in ASC 250-10 on accounting changes. In other words, if the historical approach represents a material policy and the entity wants to change its historical treatment, it would be subject to the preferability requirements in ASC 250-10-45-2(b). In this regard, the SEC staff stated in its prepared remarks at the 2018 AICPA Conference that “it would be reasonable for a registrant to consider as part of its Topic 250 analysis, if the lease obligation that results from using current index or rate values represents a better measurement of the registrant’s current lease obligations.” Therefore, we believe that the SEC staff would generally view the use of an updated index/rate as preferable.
The following table summarizes our understanding of the SEC staff’s and FASB staff’s views on whether it is acceptable for an entity to change its historical disclosure approach upon transition to ASC 842 when calculating its initial lease liability under ASC 842:

<table>
<thead>
<tr>
<th>Historical ASC 840 Disclosure Approach</th>
<th>ASC 842 Transition Approach</th>
<th>Views on Acceptability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inception rate</td>
<td>Inception rate</td>
<td>SEC staff views as acceptable</td>
</tr>
<tr>
<td>Updated rate</td>
<td>Updated rate</td>
<td>SEC staff views as acceptable</td>
</tr>
<tr>
<td>Inception rate</td>
<td>Updated rate</td>
<td>Assess preferability — SEC staff</td>
</tr>
<tr>
<td>Updated rate</td>
<td>Inception rate</td>
<td>FASB staff views as acceptable</td>
</tr>
</tbody>
</table>

**Question 2**

If an entity changes its accounting policy from using the rate at lease inception to using an updated rate when calculating its lease liability upon adopting ASC 842, must that change be reflected retrospectively in accordance with ASC 250?

**Answer**

It depends. If the use of an inception rate (as opposed to an updated rate) represents a material accounting policy, the change to an updated rate would need to be preferable and retrospective application would be required in accordance with ASC 250. However, if the policy is not deemed material to the overall financial statements, an entity could make the change without establishing preferability and would likewise not be required to reflect the change in prior periods.

As discussed in **Question 1**, on the basis of prepared remarks by the SEC staff at the 2018 AICPA Conference, we understand that it would generally be preferable to use an updated rate since the use of such a rate results in better information regarding a lessee’s future commitments upon adoption of the new guidance.

**Question 3**

The discussion above refers to the appropriate rate for an entity to use in making the transition from ASC 840 to ASC 842 for operating lease liabilities. Does an entity’s decision to change its approach (i.e., use a different rate for adoption) affect its recognition of lease liabilities in transition for capital/finance leases?

**Answer**

It depends. We generally believe that the analysis in **Questions 1 and 2** is limited to an entity’s operating lease portfolio and would not affect the measurement of capital/finance lease liabilities in transition. An exception to this rule could arise for entities that do not elect the “practical expedient package” and that have capital leases under ASC 840 that become operating leases under ASC 842.

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6 A preferability determination is required under ASC 250 if an entity that is making the transition from ASC 840 to ASC 842 wishes to change from using an inception rate to using an updated rate to calculate its lease liability, provided that the historical policy has a material impact on the financial statements.

7 While an entity is not required to reflect the change in historical periods in this circumstance, we believe that an entity is permitted to do so since the change would increase comparability.
When the practical expedient package is elected or when classification of a capital lease otherwise remains unchanged upon adoption of ASC 842, we would not expect a change related to the measurement of operating leases to affect the measurement of capital/finance leases. We do not believe that a policy choice (inception rate vs. updated rate) existed for capital leases under ASC 840. ASC 840 is clear on the initial measurement of capital lease liabilities and does not require (or allow) remeasurement for changes in an index/rate. Since the initial measurement of capital lease liabilities is clear and footnote disclosures of total outstanding capital lease liabilities under ASC 840 are tied directly to the balance sheet, there is no ambiguity in the index/rate used to meet the disclosure requirements for capital leases under ASC 840. Furthermore, the transition guidance in ASC 842 for capital/finance leases indicates that they should be recognized at the carrying amount of the lease asset and capital lease liability immediately before adoption (i.e., the balances are simply carried forward).

When the practical expedient package is not elected and the classification of a lease changes from capital to operating, the lessee is required to derecognize the previous capital lease recorded under ASC 840 and record the new operating lease under ASC 842 by measuring an operating lease liability and ROU asset. We believe that, in such circumstances, an entity should measure its lease liability in a manner consistent with its other operating lease liabilities recognized upon transition. In doing so, the entity should consider a change in the index/rate used to measure these liabilities in transition, if applicable.

### Q&A 16-2A Approaches to Accounting for Executory Costs for Operating Leases in Transition

Under ASC 840, executory costs include three primary components: (1) property taxes, (2) insurance, and (3) maintenance (e.g., CAM). Since ASC 840 does not distinguish between these three components, a historically acceptable approach has been to fully include executory costs in (or fully exclude them from) disclosures about remaining rental payments provided under ASC 840. However, under ASC 842, maintenance is considered a nonlease component while property taxes and insurance are considered neither a lease component nor a nonlease component; instead, the consideration attributable to property taxes and insurance is allocated to the components in the arrangement.

As described above and further discussed in Q&A 16-1, it was acceptable under ASC 840 for executory costs to be included in or excluded from the disclosure of minimum rental payments for operating leases. Further, the FASB has generally indicated that a lessee (1) would use its ASC 840 disclosure to determine the lease payments when calculating the lease liability upon adopting ASC 842 and (2) would “run off” the balance. In addition, at the 2018 AICPA Conference, the SEC staff stated that it “did not object to registrants consistently applying their historical accounting policy regarding the composition of minimum rental payments when concluding whether executory costs should be included in remaining minimum rental payments for purposes of establishing the lease liability in transition.”

However, given the differences in how these costs are treated under ASC 842, questions have arisen about whether it would be acceptable for an entity, upon adopting ASC 842, to treat executory costs differently when calculating the lease liability in transition than it has historically treated the costs for disclosure purposes (e.g., changing from including executory costs in, to excluding them from, the determination of lease payments).

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8 Paragraph BC390 of ASU 2016-02 states that the “practical effect of the modified retrospective transition method, particularly when combined with the practical expedients that are offered, is that an entity will **run off those leases existing at the beginning of the earliest comparative period presented** in accordance with previous GAAP” (emphasis added).
Question 1

Is it acceptable for an entity’s treatment of executory costs to differ from historical practice when the entity is initially measuring the lease liability as part of its transition from ASC 840 to ASC 842?

Answer

It depends. On the basis of remarks made by the SEC staff at the 2018 AICPA Conference, if an entity’s policy on executory costs has a material impact on the entity’s financial statements, a change in whether executory costs are included in minimum rental payments meets the definition of an “accounting change” and would be subject to the preferability requirements in ASC 250-10-45-2(b). ASC 250-10-20 defines a “change in accounting principle,” in part, as a “change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply.” Thus, a lessee’s change in the treatment of executory costs as of the effective date of ASC 842 represents a change from its historical policy under ASC 840.

In assessing preferability, an entity must conduct a well-reasoned analysis and should consider, among other factors, the prospective accounting policy of the lessee under ASC 842, including an entity’s election to combine lease and nonlease components. We believe that an entity may elect the practical expedient for either (1) both the existing lease population and new or modified leases or (2) only new or modified leases. For example, if a lessee plans to elect the practical expedient to account for the nonlease components in a contract as part of the single lease component to which they are related under ASC 842 for new or modified leases only (i.e., the entity is not choosing to elect the practical expedient to combine lease and nonlease components for existing leases), this election would generally be a factor supporting the preferability of changing from excluding executory costs from minimum rental payments under ASC 840 to including them under ASC 842 for the existing lease population (see Question 3). We also understand that a change from including executory costs to excluding such costs would be viewed negatively by the SEC staff, and would generally not be preferable, if the change is made solely to reduce the lease liability at transition.

Further, we believe that when an entity makes the transition from ASC 840 to ASC 842 and elects both (1) to change its historical practice related to accounting for executory costs on the basis of the preferability requirement in ASC 250 and (2) the Comparatives Under 840 Option, the change must be applied retrospectively. The change in this historical practice is an elective accounting policy change made on the basis of ASC 250 and is not required by ASC 842. Therefore, the historical financial statement disclosures (i.e., the future minimum rental payments required by ASC 840-20-50-2(a), commonly referred to as the “lease commitments table”) that will be presented when an entity adopts ASC 842 by using the Comparatives Under 840 Option should take into account the accounting change made in accordance with ASC 250.

In summary, when making the transition to ASC 842, a lessee may be allowed to change the approach it has historically used under ASC 840 to include or exclude executory costs. If the existing approach under ASC 840 has a material impact on the financial statements, a change would need to be made on the basis that it is preferable. On the other hand, if an entity’s historical approach related to executory costs does not have a material impact on the financial statements, the entity may change its historical approach under ASC 840 and would not be required to assess preferability. In developing the transition requirements, the FASB expected that a lessee could “run off” its existing minimum rental payments. Therefore, in making the
transition to ASC 842, a lessee should consider the following principles in determining its approach related to executory costs:

- It was acceptable for an entity to either include executory costs in, or exclude them from, a disclosure of minimum rental payments; therefore, diversity in practice has arisen. Either historical approach would have never affected measurement of operating leases (because of off-balance-sheet treatment under ASC 840), and the historical policy may have never been material to the financial statement disclosures.

- If the inclusion (exclusion) of executory costs does not have a material impact on the financial statements, a lessee may change its treatment of executory costs before or upon adopting ASC 842 without assessing preferability and would likewise not be required to reflect the ASC 840 policy change in prior periods, since those periods would continue to be presented under ASC 840 if the entity is electing the Comparatives Under 840 Option. If a lessee has explicitly disclosed in its financial statements its approach for including (excluding) executory costs under ASC 840, such disclosure may be an indication that the policy is material.

- As discussed above, a choice between two acceptable methods of presenting disclosure information is an accounting principle for which a change in method must be preferable under ASC 250-10-45-11 through 45-13 if an entity's policy on executory costs has a material impact on its financial statements. This change must be retrospectively applied to all periods presented under ASC 840. Practically, the only impact of retrospective application should be a revision of the lease commitments table disclosure for the year ended immediately before the date of initial application. This historical table must be included again in the financial statements (quarterly and annual) in the year of adoption if the Comparatives Under 840 Option is elected.

**Question 2**

When making the transition from ASC 840 to ASC 842, how should an entity treat executory costs if the entity elects, as a practical expedient, to combine lease and nonlease components for existing leases at transition?

**Answer**

A lessee may elect, as an accounting policy for each underlying asset class, not to separate lease and nonlease components (including executory costs) on the effective date. We believe that a lessee may elect such a policy for both the existing lease population and new or modified leases, since the lessee may prefer comparability and consistent application for all leases regardless of whether they commenced before the effective date.

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10 While not required to reflect the change in the historical periods in this circumstance, we believe that an entity is permitted to do so since the change would increase comparability.

11 Depending on an entity's election (made by underlying asset class) to combine lease and nonlease components, all or a portion of an entity's leases may be affected by this election. In contrast, an entity's ASC 840 policy choice for including or excluding executory costs is an entity-wide election. Accordingly, inconsistencies between ASC 840 and ASC 842 may arise in such circumstances.
Chapter 16 — Effective Date and Transition

The guidance on the practical expedient under which a lessee may elect not to separate lease and nonlease components is silent on the treatment of noncomponents in a contract (i.e., executory costs such as property taxes and insurance). Specifically, ASC 842-10-15-37 only discusses lease and nonlease components, stating the following:

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.

When the practical expedient is elected, any portion of the consideration in the contract that would otherwise be allocated to the nonlease components is instead accounted for as part of the related lease component for classification, recognition, and measurement purposes. In addition, any payments related to noncomponents would be accounted for as part of the related lease component (i.e., the associated payments would not be allocated between the lease and nonlease components since they are all treated as a single lease component). Therefore, an entity electing the practical expedient would do so for both the nonlease components and noncomponents of the contract (e.g., executory costs). An entity that elects this accounting policy for existing leases would therefore account for all executory costs as part of its lease payments, regardless of whether the entity had included or excluded executory costs when determining the minimum rental payments (i.e., the “lease commitments table”) under ASC 840.

As discussed in Question 1, the SEC staff indicated in prepared remarks at the 2018 AICPA Conference that a change in whether executory costs are included in minimum rental payments meets the definition of a “change in accounting principle,” and would be subject to the preferability requirements in ASC 250-10-45-2(b), if an entity's policy on executory costs has a material impact on its financial statements. However, we do not believe that the same requirement would apply when an entity elects the practical expedient to combine lease and nonlease components, including noncomponents of a contract (e.g., executory costs), for existing leases at transition. The question raised to the SEC staff that it discussed at the 2018 AICPA Conference involved a registrant's ability to change its treatment of executory costs but was not premised on the election of the practical expedient. We believe that an entity can elect to apply the practical expedient in transition to all existing leases, regardless of the entity’s prior treatment of executory costs, without being subject to the preferability requirement in ASC 250-10-45-2(b).

**Question 3**

When making the transition from ASC 840 to ASC 842, how should an entity treat executory costs if the entity elects, as a practical expedient, to combine lease and nonlease components for new or modified leases only?

**Answer**

As discussed in Question 2, a lessee may elect, as an accounting policy for each underlying asset class, not to separate lease and nonlease components (including executory costs) on the effective date. We believe that the lessee may elect such a policy for either (1) both the existing lease population and new or modified leases or (2) only new or modified leases. With respect to new or modified leases, this election only applies to those that commence or are modified on or after the effective date of ASC 842. When this election is made for new or modified leases only, a lessee that has historically excluded executory costs from its minimum rental payment disclosures under ASC 840 may be able to change to including executory costs under ASC 842 for the existing lease population, as described below.
As discussed in Question 1, the SEC staff indicated in prepared remarks at the 2018 AICPA Conference that a change in whether executory costs are included in “minimum rental payments” meets the definition of a “change in accounting principle,” and would be subject to the preferability requirements in ASC 250-10-45-2(b), if an entity’s policy on executory costs has a material impact on its financial statements. We believe that this requirement would apply when an entity does not elect the practical expedient to combine lease and nonlease components, including noncomponents of a contract (e.g., executory costs), for the existing lease population at transition (i.e., the entity elects the practical expedient for new or modified leases only) but wishes to change from excluding executory costs under ASC 840 to including executory costs when determining the opening lease liability under ASC 842. See Question 4 below for considerations that may be relevant to the evaluation of preferability. As discussed in Question 2, if the entity had elected to apply the practical expedient in transition to all existing leases, a change regarding the entity’s prior treatment of executory costs would not be subject to the preferability requirement in ASC 250-10-45-2(b).

**Question 4**

In what situations is it appropriate for an entity to change its ASC 840 disclosure approach for executory costs for existing leases at transition?

**Answer**

We do not believe that it would be appropriate (depending on the materiality of the impact under ASC 840) for a lessee to change its ASC 840 disclosure approach for executory costs, as discussed in Question 1, in a manner that reduces comparability to its ASC 842 accounting, including the impact of the lessee’s election to include or exclude nonlease components.

We expect that one of the scenarios below will apply to an entity that wishes to change its disclosure approach for executory costs in transition. We further expand on whether we believe it may be appropriate for an entity to change its ASC 840 disclosure approach for existing leases at transition, depending on the scenario.

- **Scenario 1** — An entity historically excluded executory costs from its minimum rental payment disclosures under ASC 840 but intends to elect the practical expedient related to combining lease and nonlease components for new or modified leases only (see Question 3). The entity may prefer to change from excluding executory costs under ASC 840 to including them under ASC 842 for the existing lease population. Such an entity will be subject to the preferability determination discussed in Question 1 if the inclusion/exclusion of executory costs under ASC 840 has a material impact on the financial statements.

- **Scenario 2** — An entity historically excluded executory costs from its minimum rental payment disclosures under ASC 840 and intends to elect the practical expedient to combine lease and nonlease components for both existing and new or modified leases. The entity will then include nonlease components under ASC 842 in the calculation of the lease liability for the existing lease population at transition. Such an entity will not be subject to the preferability determination, as discussed in Question 2, when the entity elects the practical expedient to combine lease and nonlease components, including noncomponents of a contract (e.g., executory costs), for existing leases at transition.
• Scenario 3 — An entity historically included executory costs in its minimum rental payment disclosures under ASC 840 and does not intend to elect the practical expedient to combine lease and nonlease components for new or existing leases. The entity wishes to exclude executory costs for existing leases when initially calculating its lease liability upon adopting ASC 842. Such an entity will be subject to the preferability determination discussed in Question 1 if the inclusion/exclusion of executory costs under ASC 840 has a material impact on the financial statements. An entity in this scenario should also contemplate the makeup of the executory costs under ASC 840 as follows:
  
  ◦ Scenario 3A — The entity's executory costs under ASC 840 predominantly consist of maintenance costs, which are considered a nonlease component under ASC 842. In this situation, changing from including executory costs under ASC 840 to excluding executory costs in the transition to ASC 842 generally enhances comparability between existing and new or modified leases.
  
  ◦ Scenario 3B — The entity's executory costs under ASC 840 predominantly consist of property taxes and insurance (i.e., noncomponents under ASC 842). In this situation, changing from including executory costs under ASC 840 to excluding executory costs in the transition to ASC 842 generally does not enhance comparability between existing and new or modified leases.

Achieving perfect comparability between ASC 840 and ASC 842 may be difficult (unless all lease and nonlease components are combined for new and existing leases) because “executory costs” is an ASC 840 concept and the components of executory costs are characterized differently under ASC 842, as described above. In the above scenarios, the entity's treatment of costs for property taxes, insurance, and maintenance upon adoption of ASC 842 changes from the historical treatment under ASC 840. We believe that such a change should enhance comparability between ASC 840 and ASC 842, as illustrated in Scenarios 1, 2, and 3A above. Scenario 3B will not enhance comparability since property taxes and insurance (i.e., noncomponents) are greater than maintenance. Therefore, when assessing preferability, lessees should carefully consider the significance of property taxes and insurance compared with that of maintenance.

As indicated above, we do not believe that it would be appropriate for an entity to change its ASC 840 disclosure approach in a manner that reduces comparability to its ASC 842 election to include or exclude nonlease components. Consider the following additional scenario in which comparability is not enhanced:

• Scenario 4 — An entity historically included executory costs in its minimum rental payment disclosures under ASC 840 and intends to elect the practical expedient to combine lease and nonlease components for new or modified leases. The entity wishes to change its treatment to exclude executory costs when initially calculating its lease liability upon adopting ASC 842 for the existing lease population. An entity electing to do so would be subject to the preferability determination, as discussed in Question 1, if the inclusion/exclusion of executory costs under ASC 840 has a material impact on the financial statements. However, we believe that it would be inappropriate for such an entity to change its treatment of executory costs for existing leases upon adoption of ASC 842, since doing so would reduce comparability between ASC 840 and ASC 842.
The table below summarizes whether (1) the scenarios above enhance comparability between the disclosure approach under ASC 840 and the measurement approach under ASC 842; (2) an entity in these scenarios is required to determine preferability under ASC 250 to change its historical approach of accounting for costs related to property taxes, insurance, and maintenance; and (3) the change in treatment of such costs is appropriate.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Enhances Comparability?</th>
<th>Preferability Determination Required Under ASC 250? (^{12})</th>
<th>Change in Treatment of Executory Costs Appropriate? (^{13})</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scenario 1</td>
<td>Yes</td>
<td>Yes</td>
<td>Generally yes, subject to a well-reasoned preferability analysis</td>
</tr>
<tr>
<td>Scenario 2</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Scenario 3A</td>
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<td>Yes</td>
<td>Generally yes, subject to a well-reasoned preferability analysis</td>
</tr>
<tr>
<td>Scenario 3B</td>
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<td>Generally no</td>
</tr>
<tr>
<td>Scenario 4</td>
<td>No</td>
<td>Yes</td>
<td>Generally no</td>
</tr>
</tbody>
</table>

Because executory costs are characterized differently under ASC 840 than they are under ASC 842, the following are generally true:

- The lease liability in a gross lease of real estate that excludes executory costs under ASC 840, and for which the lessee elects to separate nonlease components, will be **lower** if the lease commences before the effective date of ASC 842 than it will if the lease commences on or after the effective date of ASC 842. The reason for the lower liability in this case is that property taxes and insurance would be excluded under ASC 840 but would be allocated primarily (or totally) to the lease component under ASC 842.

- Conversely, the lease liability in a gross lease of real estate that includes executory costs under ASC 840, and for which the lessee elects to separate nonlease components, will be **higher** if the lease commences before the effective date of ASC 842 than it will if the lease commences on or after the effective date of ASC 842. The reason for the higher liability in this case is that maintenance would be included under ASC 840 but would represent a nonlease component under ASC 842.

- The chosen approach for including or excluding executory costs under ASC 840 in a triple net lease should not have a significant impact, because the executory costs are typically variable (and reimbursed, or paid directly, by the lessee) and therefore are not included in the minimum rental payments.

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\(^{12}\) The preferability determination is required under ASC 250 if an entity wishes to treat executory costs differently than historical practice when making the transition from ASC 840 to ASC 842 and the inclusion (exclusion) of executory costs has a material impact on the financial statements (see Question 1).

\(^{13}\) An entity should perform a well-reasoned preferability analysis to determine whether a change in executory costs is appropriate (see Question 1). The fact that the change enhances comparability between ASC 840 and ASC 842 is not solely determinative of whether a change in policy is preferable. Other factors to consider in a preferability analysis include, but are not limited to, whether the change in policy is consistent with guidance under ASC 842, the composition of costs associated with expected leasing activity after adoption, comparability with relevant peer companies, and whether the change results in relevant measurement of the liability upon adoption of ASC 842.
Q&A 16-2B Determining the Lease Term at Transition

On January 1, 2010, Company W enters into a lease that includes a noncancelable period of 10 years with two, five-year renewal options. At lease inception, the lease term is determined to be 10 years. In 2016, W completes significant leasehold improvements and, as a result, it is reasonably certain that W will exercise the first five-year renewal option. Under ASC 840, the installation of leasehold improvements does not trigger a reassessment of the lease term. Company W has elected the Comparatives Under 840 Option (see Section 16.1.1), and its ASC 842 adoption date is January 1, 2019; however, W has not elected the “use-of-hindsight” practical expedient.

**Question**

How should W determine the lease term at transition?

**Answer**

Because W did not elect the use-of-hindsight practical expedient, it would be inappropriate for W to reconsider the remaining lease term at transition. Although the addition of leasehold improvements would be a reassessment event under ASC 842-10, the renewal options should not be reassessed since the event occurred before the ASC 842 adoption date. Rather, W would determine the ROU asset and lease liability on the basis of the remaining minimum rental payments for the remaining term, as was determined under ASC 840 (i.e., the lease term at transition would be the one year that is remaining in the original lease term).

This conclusion is supported by the fact that the FASB’s overall objective with transition is to allow lessees to run off their existing leases by using the assumptions that were in place under ASC 840. For this reason, the “remaining minimum rental payments” under ASC 840 are used to initially measure the lease liability in transition (the amounts that are included in the lease commitments table). This is consistent with the discussion in paragraph BC390 of ASU 2016-02, which states:

> Entities will, in effect, “run off” existing leases, as described, unless the lease is either modified (and that modification is not accounted for as a separate contract) or, for lessees only, the lease liability is remeasured in accordance with the subsequent measurement guidance in Subtopic 842-30 on or after the effective date. To ensure that the financial statements provide relevant and reliable financial information, lessees and lessors should apply the subsequent measurement guidance in Topic 842 beginning on the effective date. For lessees, this includes the subsequent measurement guidance in Subtopic 842-30 on lease term and purchase option reassessments and assessing impairment of right-of-use assets. [Emphasis added]

Paragraph BC390 of ASU 2016-02 highlights that transition is designed to allow entities to “run off” their legacy leases unless there is (1) a modification or (2) a liability remeasurement event on or after the effective date of ASC 842. We believe that this conclusion would also apply to the determination of lease term. Therefore, it does not appear appropriate to revise the lease term to reflect events or changes in facts and circumstances that occurred before the application date of ASC 842. On the other hand, if an entity elects the use-of-hindsight practical expedient, the lease term (and assessment of impairment) should be evaluated by using facts and circumstances up to the effective date of the standard. (See Section 16.5.1 for discussion of the use-of-hindsight practical expedient.) We do not believe that the determination of lease term, as discussed above, would be affected by whether the entity elected the practical

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14 ASC 842-20, not ASC 842-30, contains the subsequent-measurement guidance for lessees; we believe that this is a typographical error.

15 See footnote 11.
expedient package. (See Section 16.5.2 for more information about the practical expedient package.) For example, if the practical expedient package is not elected, an entity is required to reassess, upon transition, (1) lease classification, (2) whether a contract is or contains a lease, and (3) initial direct costs. In performing this reassessment, an entity would not reevaluate the lease term unless it elects the use-of-hindsight practical expedient. Likewise, if an entity elects the practical expedient package, the lease term would not be reassessed unless the use-of-hindsight practical expedient is elected.

Connecting the Dots — Hindsight Impact Related to Lease Term and Liability Measurement (Lease Classified as an Operating Lease Under ASC 840)

The measurement of the lease liability is affected by the identification of the lease term. If a lessee elects the hindsight practical expedient, any changes to expectations regarding renewals during the comparative period should be reflected in the measurement of the lease liability as of the date of initial application or at lease commencement, if later. (See Section 16.5.1 for more information on the hindsight practical expedient.) Further, an entity must identify the amounts that it is probable will be owed under a residual value guarantee as of the later of the date of initial application or the lease commencement date. This amount should be measured on the basis of the facts and circumstances as of that date, which should include the impact of any change in lease term.

Q&A 16-2C Transition for Leasehold Improvements With Amortization Period Greater Than Remaining Lease Term

In some cases under ASC 840, leasehold improvements installed significantly after lease inception or acquired in a business combination can have an amortization period greater than the remaining lease term. As a result, questions have arisen about whether the amortization period for such leasehold improvements existing as of the date of initial application of ASC 842, when that period is greater than the remaining lease term, should be retained or whether it should be updated to align with the “lease term,” as defined under ASC 842.

ASC 840-10-35-6 states:

Leasehold improvements in operating leases that are placed in service significantly after and not contemplated at or near the beginning of the lease term shall be amortized over the shorter of the following terms:

a. The useful life of the assets
b. A term that includes required lease periods and renewals that are deemed to be reasonably assured (as used in the context of the definition of lease term) at the date the leasehold improvements are purchased. [Emphasis added]

In addition, ASC 840-10-35-9 states:

Paragraph 805-20-35-6 requires that leasehold improvements acquired in a business combination or an acquisition by a not-for-profit entity be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured (as used in the definition of [the] lease term) at the date of acquisition. [Emphasis added]
The above guidance suggests that the period for amortization of certain leasehold improvements under ASC 840 could differ from the “lease term” used for lease classification and disclosure of remaining rental payments. That is, notwithstanding the requirement to determine the appropriate amortization period for leasehold improvements (1) placed in service significantly after the beginning of the lease term or (2) acquired in a business combination, ASC 840 does not permit lessees to reassess the lease term related to accounting for the lease itself.

Upon the adoption of ASC 842, the above guidance is superseded.

**Example**

Company X, a public company with a calendar-year-end, acquires 100 store leases as part of a business combination transaction on January 1, 2018. The acquiree’s remaining lease term immediately before the transaction is three years, which represents the remaining noncancelable term of the lease and excludes one lease renewal option of five years (exercise of the option was originally determined not to be reasonably assured as of lease inception). However, upon acquiring the store leases in a business combination, X determines that the exercise of the five-year renewal option is reasonably assured. The lease does not transfer ownership of the leased stores to X at the end of the lease term, and X does not have the option of purchasing the stores. The leases are classified as operating leases under ASC 840.

In accordance with ASC 840-10-25-27, X did not revisit the lease term and classification of the store leases acquired in the business combination. Therefore, X considers the remaining lease term of the 100 store leases to be three years (i.e., X continues to exclude the five-year renewal option from the lease term, even though exercise of the renewal option is now reasonably assured).

Each of the stores also includes certain leasehold improvements that have a useful life of 10 years. In determining the amortization period of the leasehold improvements, X concludes that the renewal is reasonably assured. In accordance with ASC 840-10-35-9, X determines that the amortization period for the acquired leasehold improvements should be eight years, because this period represents the lesser of (1) the useful life of the improvements (10 years) or (2) eight years (i.e., the remaining noncancelable lease term of three years plus the five-year renewal option whose exercise is deemed reasonably assured as of the acquisition date).

On January 1, 2019, X adopts ASC 842 by using the “Comparatives Under 840 Option” transition method (i.e., elects not to restate comparative periods under ASC 842). Company X elects the “package of three” practical expedients in ASC 842-10-65-1(f) and therefore does not reassess the lease classification of its existing leases, including the 100 store leases acquired on January 1, 2018. However, X does not elect the hindsight practical expedient in ASC 842-10-65-1(g) related to reassessing the lease term.

**Question**

Upon adopting ASC 842, over what period should X amortize the leasehold improvements related to the 100 store leases previously acquired in the business combination?

**Answer**

ASC 842-20-35-12 states:

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.
Further, ASC 842-20-35-13 states:

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.

Under ASC 842 (after transition), any leasehold improvements installed after commencement or purchased in a business combination would be reassessed in conjunction with a reassessment of the lease term used for measuring the lease. That is, there will be no disconnect between the “lease term” for measuring the lease and the amortization period for leasehold improvements arising after the initial application of ASC 842, because both are reassessed. However, since lease term is not reassessed under ASC 840, it is less clear whether the previous amortization periods should be conformed to the remaining lease term used for measuring the lease liability in transition. The following two approaches have emerged:

- **Approach A** — Under this approach, X should retain the amortization period in place at the time of adoption. We do not believe that the FASB intended to shorten the amortization period of leasehold improvements in situations in which a lessee elects not to apply hindsight in determining the lease term upon adopting ASC 842. Further, use of the amortization period already in place at the time of adoption better reflects the economics of the arrangement and the fact that the leasehold improvements will continue to be used for a period longer than the remaining lease term under ASC 842; therefore, under this approach, it is acceptable to use the longer amortization period of seven years.

- **Approach B** — Under this approach, X should shorten the amortization period as of the date of initial application of ASC 842 so that it is aligned with the remaining lease term for measuring the lease, because only a single remaining lease term is contemplated in ASC 842-20-35-12. Therefore, if X uses this approach, upon adopting ASC 842, it would shorten the amortization period of the leasehold improvements to align it with the remaining lease term.16

In the example above, because X did not elect the hindsight practical expedient, the remaining lease term upon the adoption of ASC 842 is two years (i.e., three years as of the date of the business combination less one year that has passed before the adoption of ASC 842). We believe that because ASC 842-10-65-1 does not specifically address amortization of leasehold improvements, a lessee applying Approach B may recognize a cumulative-effect adjustment to retained earnings for the change in amortization period. In the example above, X amortized one-eighth of the leasehold improvements as of the effective date of ASC 842, but if the amortization period would have always been consistent with the three-year remaining lease term at the time of the business combination, one-third of the leasehold improvements would have been amortized before the effective date.

We believe that either of the above approaches is acceptable, provided that it is applied consistently as an accounting policy.

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16 Since this approach uses the remaining lease term as of the date of initial application of ASC 842 as the revised amortization period of the leasehold improvements, it would not be appropriate to fully write off leasehold improvements that have remaining utility through equity as of the date of initial application of ASC 842.
Q&A 16-3  Discount Rate Considerations in Transition

In transition, the present value of the lease liability is determined by using a discount rate “established at the application date.”

**Question**

On what date should entities identify the discount rate applied to measure the minimum rental payments used in the lease liability?

**Answer**

The discount rate (generally, for the lessee, its incremental borrowing rate) used to measure the lease liability is established as of the later of the (1) date of initial application or (2) commencement date of the lease. This has been consistently interpreted as meaning that a lessee should use the interest rate environment as of the appropriate later-of date. Factors that affect the interest rate environment include, but are not limited to, the credit standing of the lessee and the economic environment on the initial measurement date (see Chapter 7 for additional information on determining the appropriate discount rate). However, an incremental borrowing rate is also affected by the lease term (i.e., the length of the borrowing) and the lease payments (i.e., how much is being borrowed). Questions have arisen about whether (1) the original lease term and lease payments should be determined and incorporated into the discount rate calculation or (2) those inputs should be determined as of the same date on which the interest rate environment is considered (i.e., whether the remaining lease term and lease payments should be considered).

On the basis of a technical inquiry with the FASB staff, we believe that either approach is acceptable as an accounting policy choice. Although the lease term and lease payments should be higher under approach 1 (resulting in a higher discount rate), we expect that the information an entity needs to apply approach 2 will be more readily available. In addition, the SEC staff confirmed this position at the 2017 AICPA Conference on Current SEC and PCAOB Developments, stating that “the selection of either of these rates, that is either the rate based on the original lease term or the remaining lease term, is reasonable” and that the staff “ultimately did not object to a registrant’s consistent application of either approach to determine the lessee’s lease liabilities in transition.”

**Connecting the Dots — Hindsight Impact on Discount Rate**

When hindsight is applied, any impact on the lease term will indirectly affect the discount rate (e.g., a longer term will generally result in a higher discount rate). As discussed above, an entity must also consider the credit standing of the lessee, the nature and quality of the security provided, and the economic environment in which the transaction occurs. Because these factors are unrelated to the lease term, we do not believe that an entity can elect to apply hindsight when evaluating them.
Unamortized Initial Direct Costs Not Capitalized Under ASC 842

The accounting for initial direct costs when the practical expedient package is not elected is the same regardless of whether classification changes upon an entity's adoption of ASC 842. ASC 842 reduces the types (and therefore amounts) of costs that qualify as initial direct costs. As discussed in Section 16.5.2.3, lessees that elect the practical expedient package do not need to reassess previously capitalized initial direct costs. However, if the practical expedient package is not elected, previously capitalized initial direct costs that no longer meet the definition of initial direct costs under ASC 842 must be accounted for as follows:

- Any costs incurred before the date of initial application should be recognized as an adjustment to equity.
- Any costs incurred on or after the date of initial application should be recognized in earnings for the respective comparative period under ASC 842, if applicable.

Modifications and Reassessment of Lease Liability in Comparative Periods (Only Applicable if the Comparatives Under 840 Option Is Not Elected)

The transition guidance is clear that the provisions of ASC 842 should be applied to modifications on or after the effective date as well as to any reassessments of the lease liability (see Section 8.5). However, the guidance is less clear on the framework for modifications and potential reassessments that occur during the transition period. Entities may therefore encounter significant complexities in transition, since the modification and reassessment guidance in ASC 842 significantly differs from that in ASC 840. For leases previously classified as operating leases under ASC 840, the transition paragraphs ASC 842-10-65-1(k)-(q) do not mention modifications or reassessments during the transition period. However, the transition guidance for capital leases does provide some insight into the potential framework. Specifically, ASC 842-10-65-1(r)(4) indicates that if a capital lease under ASC 840 is classified as a finance lease under ASC 842 (i.e., classification did not change), the lease should be subsequently measured in accordance with ASC 840 during the transition period. In contrast, ASC 842-10-65-1(s)(4) stipulates that if a capital lease under ASC 840 is classified as an operating lease under ASC 842 (i.e., classification changed), the lease should be subsequently measured under ASC 842 during the transition period.

On the basis of these insights, we believe that the modification and reassessment guidance should generally be governed by whether lease classification changes when an entity adopts ASC 842. That is, if lease classification changes upon the adoption of ASC 842 (which can only occur if the practical expedient package is not elected), an entity should apply ASC 842 modification and reassessment guidance throughout the transition period. However, if lease classification does not change upon the adoption of ASC 842 (irrespective of whether the practical expedient package was elected), an entity should apply ASC 840's guidance on modifications and reassessment.

We note that there is no “measurement” guidance in ASC 840 for operating leases because they are off-balance-sheet. Therefore, although an entity would apply the ASC 840 modification guidance to determine whether lease classification has changed, the general ASC 842 measurement principles would be applied to the revised lease payments. That is, unless lease classification changes as of the earliest period presented (e.g., a company that does not elect the practical expedient package and has a lease whose classification changes from operating to finance), this framework creates a mixed model in transition. The lease classification and impact on the income statement during transition is governed by previous ASC 840 treatment. However, the balance sheet is governed by the ASC 842 measurement principles applied to the minimum rental payments, as described in Q&A 16-1.
Chapter 16 — Effective Date and Transition

16.3.1.1 Lease Is an Operating Lease Under ASC 840 and ASC 842

The graphic below outlines the steps lessees should perform in transition for leases that were previously classified as operating leases and that are considered operating leases under ASC 842 because either (1) an entity elected the practical expedient package and therefore would not reassess lease classification or (2) classification was assessed in transition to ASC 842 and the lease retains its classification as an operating lease. In this transition scenario (i.e., operating lease classification was retained), the election of the practical expedient package only affects the amounts that qualify as initial direct costs for inclusion in the ROU asset.

Example 29 from ASC 842 illustrates the measurement of the lease liability and ROU asset in transition:

**Measure the Lease Liability**
- Present value of the minimum rental payments and expected payment under any residual value guarantee discounted by a rate determined as of the later of the date of initial application or the lease commencement date

**Measure the ROU Asset**
- Lease liability + prepaid rent – accrued rent + unamortized initial direct costs – unamortized lease incentives – impairment of the ROU asset – the carrying amount of any liability recognized under ASC 420

**Recognize the ROU Asset and Lease Liability**
- Recognize an ROU asset and lease liability as of the later of (1) the date of initial application or (2) the lease commencement date

Example 29 from ASC 842 illustrates lessee accounting for the transition of existing operating leases when an entity elects the transition method in paragraph 842-10-65-1(c)(1).

**ASC 842-10**

<table>
<thead>
<tr>
<th>Illustration of Lessee Transition — Existing Operating Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-248</strong> Example 29 illustrates lessee accounting for the transition of existing operating leases when an entity elects the transition method in paragraph 842-10-65-1(c)(1).</td>
</tr>
</tbody>
</table>

**Example 29 — Lessee Transition — Existing Operating Lease**

**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.
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.

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).

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).

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.

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.

The following is a summary of the steps a lessee would perform in calculating the lease liability and the ROU asset in the scenario above:

**Step 1: Measure the Lease Liability as of the Earliest Period Presented**

<table>
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<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$112,462</td>
</tr>
</tbody>
</table>

**Step 2: Measure the ROU Asset**
Lease liability – accrued rent + unamortized initial direct costs

$112,462 – $1,200 + 400 = $111,662

**Step 3: Record the Journal Entries**

| ROU asset | 111,662 |
| Accrued rent | 1,200 |
| Lease liability | 112,462 |
| Initial direct costs, net | 400 |
16.3.1.1.1 Lease Is an Operating Lease Under ASC 840 and ASC 842 — Initial Measurement of Lease Liability

In transition, when a lease is an operating lease under ASC 840 and ASC 842, the lease liability is calculated as the present value of the minimum rental payments and expected payment under any residual value guarantee discounted by the rate determined at the later of the date of initial application or the lease commencement date.

16.3.1.1.2 Lease Is an Operating Lease Under ASC 840 and ASC 842 — Initial Measurement of ROU Asset

<table>
<thead>
<tr>
<th>ASC 842-10</th>
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65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

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. . .

In transition, when a lease is an operating lease under ASC 840 and ASC 842, the ROU asset is calculated as follows:

- The sum of:
  - The lease liability calculated in accordance with the guidance in Section 16.3.1.1.1 above.
  - Prepaid rent (i.e., any amounts prepaid but not yet expensed under ASC 840).
  - Unamortized initial direct costs — after consideration of whether the practical expedient package is applied in the manner described in Section 16.5.2.3.

- Less the sum of:
  - Accrued rent (i.e., any amounts previously recognized under ASC 840 but not yet paid).
  - Lease incentives (i.e., recorded and not yet expensed in accordance with ASC 840-20-25-6 and 25-7).
  - Impairment (as described below).
  - The carrying amount of any ASC 420 liability (as described below).
Q&A 16-3A Initial Measurement in Transition of an Operating Lease When the ROU Asset Would Be Reduced Below Zero Because of Accrued Rent

In the transition to ASC 842, the ROU asset is measured at the amount of the lease liability adjusted by (1) accrued or prepaid rents, (2) remaining unamortized initial direct costs and lease incentives, (3) impairments of the ROU asset, and (4) the carrying amount of any liability recognized under ASC 420. An accrued rent balance would have been established when escalating lease payments are present for a portion of the lease term (e.g., fixed lease payments in early years are lower than those in later years). In a long-term lease with escalating lease payments (e.g., a 40-year ground lease), the accrued rent balance can be greater than the lease liability balance as of the date of initial application. Therefore, if the full amount of the accrued rent were applied against the lease liability, the ROU asset in transition would be negative (i.e., the measurement exercise described in ASC 842-10-65-1(m) would yield an amount below zero).

Question

When applying the transition guidance related to an operating lease, how should a lessee account for the ROU asset when the accrued rent balance is greater than the lease liability as of the date of initial application?

Answer

We believe that when the ROU asset would be reduced below zero because the accrued rent balance is greater than the lease liability, the ROU asset should be reclassified and presented as a liability as of the date of initial application. This presentation would be retained until the balance of the ROU asset returns to a positive amount, at which point the balance should be presented as an ROU asset rather than as a liability. We think that this approach is appropriate because we do not believe that it is appropriate to present a negative ROU asset, thereby offsetting other positive ROU assets. Similarly, we do not believe that it would be appropriate to adjust the discount rate (i.e., impute a lower discount rate) in these situations to “solve” for this problem (i.e., disallow the ROU asset from becoming negative). See Q&A 8-9C for a discussion of accrued rent balances that would result in a negative ROU asset after the date of initial application (which could apply to leases that commenced before or after the adoption date), along with a discussion of the subsequent accounting and an illustrative example.

Impairment

The ROU asset should initially be measured net of impairment. However, several implementation questions have arisen regarding how impairment should be measured during the transition period, if at all, because the ROU asset will generally be included with other assets in a preexisting asset group. On the basis of the Q&As below, an entity is generally not required to consider the ROU asset separately for impairment in the comparative periods presented under ASC 842, if applicable. See also Section 16.5.1.2 for a discussion of the impact of electing the hindsight practical expedient.
Q&A 16-4  Reallocating Prior Impairment Losses Within an Asset Group

ASC 360 provides guidance on identifying, recognizing, and measuring an impairment of a long-lived asset or asset group that is held and used. Under the ASC 360 impairment testing model, a lessee is required to test a long-lived asset (asset group) for impairment when impairment indicators are present. Under this testing approach, a lessee would be required to test the asset (asset group) for recoverability and, when necessary, recognize an impairment loss that is calculated as the difference between the carrying amount and the fair value of the asset (asset group).

A lessee must subject an ROU asset to impairment testing in a manner consistent with its treatment of other long-lived assets (i.e., in accordance with ASC 360). Also, upon transition, a lessee is required to include any associated impairment losses in its initial measurement of an ROU asset (see Q&A 16-4A).

If the ROU asset related to an operating lease is impaired, the lessee would amortize the remaining ROU asset in accordance with the subsequent-measurement guidance that applies to finance leases — typically, on a straight-line basis over the remaining lease term. Thus, the operating lease would no longer qualify for the straight-line treatment of total lease expense. However, in periods after the impairment, a lessee would continue to present the ROU asset amortization and interest expense together as a single line item.

**Question**

Upon transition to ASC 842, is a lessee required to reallocate prior impairment losses of an asset group to the ROU asset?

**Answer**

No. An ROU asset will typically be added to a preexisting asset group under ASC 360. However, the effect of recognizing an ROU asset on an asset group’s allocation of a prior impairment loss is an indirect effect of a change in accounting principle. In accordance with ASC 250-10-45-3 and ASC 250-10-45-8, indirect effects of a change in accounting principle should not be recognized.

At the FASB’s November 30, 2016, meeting, the Board indicated that on the effective date of ASC 842 and in all comparative periods presented under ASC 842 (if applicable), a lessee should not revisit prior impairment loss allocations within the asset group. In addition, the Board indicated that a lessee should not include in the initial measurement of an ROU asset at transition any allocation of prior impairment losses recognized within the asset group. Therefore, lessees should not revisit any impairment losses that were allocated to the asset group before the effective date of the standard regardless of whether an impairment loss was recognized in a comparative period.
Q&A 16-4A  Accounting for Impairment (Including “Hidden” Impairments) Upon Adoption of ASC 842

Questions have arisen regarding whether the guidance in Q&A 16-4 implies that a lessee may never recognize an impairment related to a newly created ROU asset as an adjustment to equity upon adopting ASC 842. That is, because operating leases were not previously subject to an impairment test under ASC 360, stakeholders have questioned whether an ROU asset should only be reduced in transition if the lessee previously recognized a liability under ASC 840 or ASC 420. Although that is generally the implication, there are limited situations in which an impairment to an ROU asset may need to be recognized as of the effective date of ASC 842 (i.e., as an adjustment to equity).

For example, a retailer may have fully impaired all of the long-lived assets (e.g., leasehold improvements) in an asset group (e.g., an individual store) before adopting ASC 842. That is, long-lived assets in an asset group may have been previously written down to their individual fair values (which may have been zero). In those instances, it is not uncommon for unrecorded “hidden” impairments to exist as of the previous impairment date for the asset group. A hidden impairment can occur because of the mechanics of the ASC 360 impairment test. If an asset group is tested for recoverability (see ASC 360-10-35-21) and the undiscounted cash flows are less than the carrying amount of the asset group, the impairment loss is measured as the amount by which the carrying amount of the asset group exceeds its fair value (see ASC 360-10-35-17). However, the impairment loss recorded is limited to the carrying value of the long-lived assets in the asset group, and individual long-lived assets within that asset group cannot be written down below their individual fair values (see ASC 360-10-35-28). As a result of these limitations, additional economic impairment could have been previously measured but not previously recognized as a loss in the income statement.

Question 1

Should a lessee consider whether impairment indicators exist for ROU assets recognized upon the adoption of ASC 842?

Answer

Yes. A lessee should consider whether events or changes in circumstances exist that indicate that the carrying value of the asset group (which includes or solely consists of an ROU asset) is not recoverable as part of the adoption of ASC 842. That is, the lessee should determine whether impairment indicators exist upon adoption.

The requirement to consider whether impairment indicators exist is not equivalent to a requirement to perform the two-step impairment test in ASC 360. ASC 360 does not require an entity to perform the ASC 360 impairment test for all asset groups. Rather, ASC 360 requires entities to consider whether there are indicators that the carrying value of an asset group may not be recoverable (i.e., the asset group may be impaired). When such indicators are identified, the entity must perform the recoverability test (step 1) for any affected asset group and would be required to evaluate fair value in step 2 of the test if the asset group does not pass step 1. (See Q&A 8-12 for additional considerations related to performing the ASC 360 impairment test.)

Throughout this Q&A, we have assumed that the lessee used the Comparatives Under 840 Option to adopt ASC 842 and therefore does not present comparative periods under ASC 842. However, the same concepts would apply if the lessee presented comparative periods under ASC 842 upon adoption. See Question 5 for more information.
Chapter 16 — Effective Date and Transition

ASC 360-10-35-21 lists examples of indicators of potential impairment. In addition, decisions to sublease or cease use of an asset under lease (even if the conditions for recognizing a liability in accordance with ASC 420 have not been met) may be indicators of potential impairment because, in both cases, future cash flows may not be sufficient to cover the contractual lease payments. Further, previous impairments to asset groups are indicators of potential impairment when the assets subject to ASC 360 in the asset group were written down to their fair values (which may have been zero) and an additional unrecognized economic impairment remained. (See Question 5 for more information.)

Questions 2, 3, and 4 below only apply to asset groups that existed before adoption (i.e., they do not solely consist of a newly recognized ROU asset). Asset groups that solely consist of newly recognized ROU assets would not have existed as of the reporting date immediately before the adoption of ASC 842. See Question 5 for further considerations related to situations in which an asset group solely consists of a newly recognized ROU asset.

**Question 2**

As of which date should a lessee consider whether impairment indicators exist for preexisting asset groups that include newly recognized ROU assets (“asset groups”)?

**Answer**

ASC 842 must be applied as of the first day of an entity's fiscal year of adoption. However, while ASC 842 requires lessees to recognize new assets at adoption, it does not introduce any new requirements for how the lessee should consider asset groups for potential impairment. Therefore, a lessee should evaluate whether impairment indicators exist for asset groups as of the last day of the lessee's reporting period before the adoption of ASC 842, as the entity otherwise would have been required to do under ASC 360.

Accordingly, at the end of the reporting period immediately before the adoption of ASC 842, a lessee should follow its normal processes and procedures (as supported by relevant internal controls) in an effort to determine whether there have been events or changes in circumstances indicating that the carrying value of an asset group may not be recoverable.

**Question 3**

If no impairment indicators for a preexisting asset group are identified as of the reporting date immediately before the adoption of ASC 842, or if indicators existed but the asset group's carrying value was determined to be recoverable, is a lessee required to test the asset group for impairment upon the adoption of ASC 842?

**Answer**

No. A lessee does not need to test the asset groups for recoverability on the adoption date when there are no impairment indicators or when the lessee concluded that the asset group's carrying value was recoverable at the end of the previous reporting period. The addition of an ROU asset to an asset group should not change the conclusion that the asset group's carrying value is recoverable (i.e., recognition of adoption-date ROU assets is a neutral event in the determination of whether the asset group's carrying value is recoverable). This is because a lessee will either (1) include the corresponding lease liability in the asset group in such a way that the net carrying value of the asset group is unchanged (because the ROU asset and lease obligation would generally offset) and the net undiscounted cash flows would not decrease.
or (2) exclude the lease liability from the asset group and adjust the cash outflows used in performing the step 1 impairment test to exclude the corresponding lease payments in such a way that the increased carrying value of the asset group is offset by an increase in future net cash flows. See Q&A 8-12 for considerations related to including or excluding the lease liability in an asset group for both finance and operating leases.

**Question 4**

Are there situations in which impairment indicators exist for a preexisting asset group as of the reporting date immediately before the adoption of ASC 842 but the lessee would not be required to test the asset group for impairment upon the adoption of ASC 842?

**Answer**

Yes. A lessee would not be required to test asset groups for impairment on the adoption date of ASC 842 when the lessee performed the ASC 360 test as of the reporting date immediately before the adoption of ASC 842 and concluded either of the following:

1. The asset group was not impaired because there were sufficient net future cash flows to recover the asset group's carrying value or the fair value of the asset group exceeded its carrying value.

2. There was an impairment to the asset group but the assets subject to ASC 360 in the asset group were not fully written down to their respective fair values, or such assets were written down to their respective fair values and there was no additional unrecognized economic impairment (i.e., no hidden impairment).

In these situations, a carrying value (which may be the fair value of individual assets in the asset group when an impairment is recognized) related to the asset group generally remains and this remaining carrying value is recoverable. Therefore, despite the existence of impairment indicators, we do not believe that a lessee would be required to test asset groups for impairment upon the adoption of ASC 842 in these circumstances for the reasons noted in the answer to **Question 3**. That is, the recognition of new ROU assets is generally expected to be a neutral event that should not change the conclusion that the asset group's carrying value is recoverable.

**Question 5**

Provided that a lessee adopts ASC 842 by using the Comparatives Under 840 Option (rather than presenting comparative periods under ASC 842), are there situations in which it would be appropriate for a lessee to recognize an impairment of a newly created ROU asset as an adjustment to equity upon adopting ASC 842?
**Answer**

Yes. We believe that a lessee will generally only have an impairment of an ROU asset upon the adoption of ASC 842, and thus recognize a transition-period adjustment to equity, in either of the following situations:

1. There was a hidden impairment, as discussed above and illustrated in the retail example below. That is, the lessee previously fully impaired all of the long-lived assets in the asset group that now includes the ROU asset (e.g., fully impaired leasehold improvements for an individual retail store), and an additional economic impairment was measured but was not previously recognized as a loss in the income statement. Further, the events and conditions that resulted in the previous impairment (an impairment that was not recognized to the extent that it was measured) continue to exist as of the ASC 842 adoption date.

2. The ROU asset represents its own asset group under ASC 360 and is determined to be impaired as of the effective date of ASC 842. That is, impairment indicators existed before (and continue to exist upon) the adoption of ASC 842, but because there were no ROU assets recognized for operating leases under ASC 840 and there are no other long-lived assets in the asset group, no impairment exercise was performed and no impairment charge was recognized in the lessee’s historical financial statements.

In these situations, when impairment indicators continue to exist, we believe (as discussed above) that a lessee must apply the ASC 360 impairment guidance (as described in Q&A 8-12) as of the effective date of ASC 842. 18 If an impairment exists, the lessee should recognize a reduction of the ROU asset in transition that is equal to the lesser of (1) an amount to adjust the ROU asset to its fair value or (2) an amount to adjust the asset group’s excess carrying value to fair value. This impairment should generally be recognized as an adjustment to equity on the date of adoption, unless the impairment conditions did not exist as of the reporting date immediately before the adoption of ASC 842.

Although expected to be rare, there may be events or changes in circumstances occurring on the adoption date that indicate that the carrying value of the asset group may not be recoverable. Because such events or changes in circumstances occurred after the adoption of ASC 842, if an asset group is impaired as a result, the associated impairment charge should be recognized through earnings (i.e., not through equity).

### Example

Retailer A leases two store locations under operating leases. The two stores are separate asset groups under ASC 360. Retailer A uses the Comparatives Under 840 Option to adopt ASC 842 on January 1, 2019.

**Store 1**

Store 1 has had and continues to have robust sales and positive cash flows and is located in a metropolitan area in which the real estate market is (and has been) strong. In addition, Store 1 has had no prior impairments. As of December 31, 2018, because there were no events or changes in circumstances to suggest that Store 1’s carrying value is not recoverable, Retailer A did not test Store 1 for recoverability in accordance with ASC 360. When Retailer A adopts ASC 842 on January 1, 2019, and recognizes an adoption-date ROU asset, it would be reasonable for Retailer A to conclude that there is no reason to test the asset group containing the adoption-date ROU asset for impairment.

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18 We do not believe that it would be appropriate for a lessee to impair the ROU asset simply because it would have been previously impaired if it existed at the time that a historical impairment was recognized for the asset group. A lessee should only recognize an impairment of the ROU asset as of the date of initial application of ASC 842 if an economic impairment exists as of that date.
Example (continued)

Store 2

Store 2 is located in a depressed economic area and has had significantly reduced sales and cash flows. In 2017, on the basis of impairment indicators at that time, Retailer A tested Store 2 for recoverability under ASC 360 and concluded that Store 2 was impaired. Retailer A reduced the long-lived assets (consisting completely of leasehold improvements) to zero, but an excess unrecognized impairment remained. Sales and cash flows have not sufficiently recovered since 2017 and, although impairment indicators existed as of December 31, 2018, no impairment testing was performed because there were no additional assets in the asset group that could be reduced in accordance with ASC 360.

Because of Store 2's hidden impairment and conditions (i.e., impairment indicators) that continue to exist as of the date of adoption of ASC 842, Retailer A should test Store 2 for recoverability at adoption. That is, because the recoverability test is a new test (rather than a reallocation of a previous impairment), Retailer A should perform the ASC 360 test for the asset group as of January 1, 2019 (i.e., the asset group should include the ROU asset). Further, because (1) the events and conditions that led to the recognition of the adoption-date impairment existed before the adoption date and (2) Retailer A elected the Comparatives Under 840 Option, any impairment should be recognized as an adjustment to Retailer A’s beginning equity on January 1, 2019.

The following flowchart summarizes the discussion in this Q&A regarding how to determine whether an asset group containing a newly created ROU asset should be evaluated for impairment upon the adoption of ASC 842, provided that an entity elects the Comparatives Under 840 Option.

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19 See Q&A 8-12 for additional information regarding testing the asset group that is or includes an ROU asset.
As noted above, throughout this Q&A, we have assumed that the lessee used the Comparatives Under 840 Option to adopt ASC 842 and, therefore, does not present comparative periods under ASC 842. However, the same concepts would apply if the lessee presented comparative periods under ASC 842 upon adoption.
We generally believe that, if the lessee presents comparative periods under ASC 842, the timing of recognizing the hidden impairment should be based on an assessment of when the impairment economically occurred/existed. Therefore, the lessee should consider whether the incremental impairment should be recognized as (1) an adjustment to equity as of the beginning of the earliest period presented or (2) an impairment loss in the income statement for a comparative period. Nevertheless, on the basis of discussions with the FASB staff, we also believe that it would be permissible for a company to recognize those impairments (whether related to (1) or (2) in the preceding sentence) in the income statement as of the effective date (e.g., January 1, 2019, for a calendar-year-end public company). We think that such an approach is consistent with Q&A 16-4 and may limit the need for entities to search for previous “hidden” impairments as well as new impairment indicators during the comparative periods, which could be numerous for some entities. Under this approach, the impact of the impairments would be recorded as a charge to income in the first period after the effective date (e.g., January 1, 2019, for a calendar-year-end public company), since it would be inappropriate to record an adjustment to equity on that date when the date of initial application (the only date on which an equity adjustment would be appropriate) is January 1, 2017. This approach is meant to simplify the transition accounting and is restricted to entities that choose to recast the comparative periods upon adoption. That is, we generally do not believe that it would be appropriate for a company that elects the Comparatives Under 840 Option to record an impairment charge on January 1, 2019, if the impairment economically occurred/existed on December 31, 2018. If a company is contemplating an alternative approach to the recognition of an impairment charge in these circumstances, discussion with the company’s accounting advisers and auditors is highly encouraged.

**Transition for Cease-Use Liabilities and Sublease Liabilities**

ASC 420 required entities to recognize a liability for the cost associated with an exit or disposal activity, including operating leases when an entity ceases to use a leased asset and the underlying asset has no remaining benefit to the entity. ASC 420-10-25-11 describes “contract termination costs” as either of the following:

a. Costs to terminate the contract before the end of its term
b. Costs that will continue to be incurred under the contract for its remaining term without economic benefit to the entity.

Entities accrue for the remaining costs to be incurred under the lease and, if applicable, the cost of terminating the lease contract. Therefore, to the extent that such balances were recognized, the balances should reduce the ROU asset balance as of transition. This balance should be recognized against the ROU asset as of the later of the date of initial application or the date the ASC 420 liability was recognized.
Chapter 16 — Effective Date and Transition

Consider the following example from ASC 420:

**ASC 420-10**

**55-12** An entity leases a facility under an operating lease that requires the entity to pay lease rentals of $100,000 per year for 10 years. After using the facility for five years, the entity commits to an exit plan. In connection with that plan, the entity will cease using the facility in 1 year (after using the facility for 6 years), at which time the remaining lease rentals will be $400,000 ($100,000 per year for the remaining term of 4 years). In accordance with paragraphs 420-10-30-7 through 30-9, a liability for the remaining lease rentals, reduced by actual (or estimated) sublease rentals, would be recognized and measured at its fair value at the cease-use date (as illustrated in the following paragraph). In accordance with paragraphs 420-10-35-1 through 35-4, the liability would be adjusted for changes, if any, resulting from revisions to estimated cash flows after the cease-use date, measured using the credit-adjusted risk-free rate that was used to measure the liability initially (as illustrated in paragraph 420-10-55-15).

**55-13** Based on market rentals for similar leased property, the entity determines that if it desired, it could sublease the facility and receive sublease rentals of $300,000 ($75,000 per year for the remaining lease term of 4 years). However, for competitive reasons, the entity decides not to sublease the facility (or otherwise terminate the lease) at the cease-use date. The fair value of the liability at the cease-use date is $89,427, estimated using an expected present value technique. The expected net cash flows of $100,000 ($25,000 per year for the remaining lease term of 4 years) are discounted using a credit-adjusted risk-free rate of 8 percent. In this case, a risk premium is not considered in the present value measurement. Because the lease rentals are fixed by contract and the estimated sublease rentals are based on market prices for similar leased property for other entities having similar credit standing as the entity, there is little uncertainty in the amount and timing of the expected cash flows used in estimating fair value at the cease-use date and any risk premium would be insignificant. In other circumstances, a risk premium would be appropriate if it is significant. Thus, a liability (expense) of $89,427 would be recognized at the cease-use date.

**55-14** Accretion expense would be recognized after the cease-use date in accordance with the guidance beginning in paragraph 420-10-35-1 and in paragraph 420-10-45-5. (The entity will recognize the impact of deciding not to sublease the property over the period the property is not subleased. For example, in the first year after the cease-use date, an expense of $75,000 would be recognized as the impact of not subleasing the property, which reflects the annual lease payment of $100,000 net of the liability extinguishment of $25,000).

**55-15** At the end of one year, the competitive factors referred to above are no longer present. The entity decides to sublease the facility and enters into a sublease. The entity will receive sublease rentals of $250,000 ($83,333 per year for the remaining lease term of 3 years), negotiated based on market rentals for similar leased property at the sublease date. The entity adjusts the carrying amount of the liability at the sublease date to $46,388 to reflect the revised expected net cash flows of $50,000 ($16,667 per year for the remaining lease term of 3 years), which are discounted at the credit-adjusted risk-free rate that was used to measure the liability initially (8 percent). Accretion expense would be recognized after the sublease date in accordance with the guidance beginning in paragraph 420-10-35-1 and in paragraph 420-10-45-5.

On the basis of the facts in the above example, the entity would have recorded the following (assume that rental payments and sublease income receipts are paid at the beginning of each year):

**Years 1–6 — Record Lease Expense**

| Lease expense | 100,000 |
| Cash | 100,000 |
Beginning of Year 7 — Record Cease-Use Expense and Liability and Recognize Prepaid Rent

Cease-use expense  
89,427
Cease-use liability  
89,427
Cease-use liability  
25,000
Prepaid rent  
75,000
Cash  
100,000

During Year 7 — Accrete Cease-Use Liability and Amortize Prepaid Rent

Accretion expense  
5,154
Cease-use liability  
5,154
Cease-use expense  
75,000
Prepaid rent  
75,000

Beginning of Year 8 — Adjust Cease-Use Liability, Record Sublease Cash Received, and Record Lease Payment

Cease-use liability  
23,194
Cease-use expense  
23,194
Cash  
83,333
Cease-use liability  
83,333
Cease-use liability  
100,000
Cash  
100,000

During Year 8 — Accrete Cease-Use Liability

Accretion expense  
2,378
Cease-use liability  
2,378

Beginning of Year 9 — Record Sublease Cash Received and Record Lease Payment

Cash  
83,333
Cease-use liability  
83,333
Cease-use liability  
100,000
Cash  
100,000

During Year 9 — Accrete Cease-Use Liability

Accretion expense  
1,235
Cease-use liability  
1,235

Beginning of Year 10 — Record Sublease Cash Received and Record Lease Payment

Cash  
83,333
Cease-use liability  
83,333
Cease-use liability  
100,000
Cash  
100,000

During Year 10 — No Accretion Entry in Year 10 Because Lease and Sublease Amounts Are Paid in Advance
Only the initial measurement of the ROU asset should be affected by any ASC 420 liability associated with the lease. Therefore, if the ASC 420 liability is recorded before the date of initial application, the balance as of the date of initial measurement should be recognized as a reduction to the ROU asset.

Assume that the entity is a calendar-year-end public company, it did not elect the Comparatives Under 840 Option, and that January 1, 2017, is the beginning of Year 8 in the example above. The entity would initially measure the ROU asset reduced by the ASC 420 liability balance (including any true-ups) as of December 31, 2016. Further assume a discount rate of 14 percent.

Measurement of the ROU Asset as of January 1, 2017

<p>| | |</p>
<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Lease liability balance</td>
<td>$ 264,666</td>
</tr>
<tr>
<td>ASC 420 liability</td>
<td>(69,581)</td>
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<td>$ 195,085</td>
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Reclassification of Incremental ASC 420 Liability During the Periods Ended December 31, 2017, and December 31, 2018

2017 (Year 8)

<p>| | |</p>
<table>
<thead>
<tr>
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<tbody>
<tr>
<td>ROU asset</td>
<td>23,194</td>
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<tr>
<td>Cease-use liability</td>
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<td>ROU asset</td>
<td>16,667</td>
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<tr>
<td>Cease-use liability</td>
<td></td>
</tr>
<tr>
<td>Cease-use liability</td>
<td>2,378</td>
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<tr>
<td>ROU asset</td>
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</tbody>
</table>

2018 (Year 9)

<p>| | |</p>
<table>
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<th></th>
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<tbody>
<tr>
<td>ROU asset</td>
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<tr>
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<td>1,235</td>
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<tr>
<td>ROU asset</td>
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</tr>
</tbody>
</table>

Connecting the Dots — Impact of Hindsight Practical Expedient on ASC 420 Liabilities Versus That on Impairment

We do not believe that the hindsight practical expedient can be applied to ASC 420 liabilities. For example, if an entity ceases use of a leased asset during the comparative periods, it would not be appropriate to push back that conclusion to the earliest period presented. While the impact of incorporating ASC 420 liabilities is similar to the impact of an impairment, they are nonetheless not the same, because the triggering event for an ASC 420 liability is related to terminating or ceasing use of the property, which should not be moved into a reporting period different from that in which the event occurred.
Q&A 16-5A  Transition Considerations Related to Lease Measurement
When an Entity Ceases Use of a Leased Asset Before the Adoption of
ASC 842

Under ASC 840, when an entity ceases use of an asset subject to an operating lease, the entity applies the guidance in ASC 420 to determine whether to recognize a liability for its costs related to terminating the operating lease and costs that will continue to be incurred without economically benefiting the entity. Provided that the criteria in ASC 420 related to recognizing a liability are met, the liability is measured as the difference between the remaining lease costs to be paid by the lessee, offset by an assumption for sublease income. In accordance with ASC 420-10-30-8, an entity would record the liability in this manner regardless of whether the lessee has the intent to sublease the asset. ASC 420-10-30-8 states:

If the contract is an operating lease, the fair value of the liability at the cease-use date shall be determined based on the remaining lease rentals, adjusted for the effects of any prepaid or deferred items recognized under the lease, and reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease. Remaining lease rentals shall not be reduced to an amount less than zero. [Emphasis added]

Therefore, under ASC 420 and ASC 840, an entity is considered to have ceased use of an asset even if the entity has the intent and ability to sublease the asset. However, under ASC 842, the cease-use determination is no longer relevant; rather, an entity must determine whether the leased asset is abandoned in accordance with ASC 360.

Under ASC 842, if an entity plans to abandon the leased asset, we believe that the entity should change the useful life of the ROU asset prospectively in such a way that the ROU asset is fully amortized by the abandonment date.

Question 1

Under ASC 842, is an ROU asset considered abandoned if an entity has ceased use of the underlying asset but is currently subleasing (or plans to sublease) the asset?

Answer

No. Under ASC 842, an ROU asset is recognized during the period in which an entity has the right to use an asset subject to a lease. One of the conditions for a lease is that the entity must obtain substantially all of the economic benefits from the use of the underlying asset. In a sublease scenario, although the entity itself is not using the asset, the entity's receipt of sublease payments would be considered as obtaining economic benefits from use of the underlying asset under ASC 842. ASC 842-10-15-17 provides evidence for this notion and states, in part:

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. [Emphasis added]

Because the entity is still obtaining economic benefits from use of the asset through subleasing the asset, we do not believe that a lessee has abandoned an asset if an entity has both the intent and ability to sublease. This holds true even if the lessee has not yet identified a sublessee before the lessee ceases use of the asset.
Question 2
If an entity ceases use of a leased asset before adopting ASC 842 and does not have the intent and ability to sublease the asset, should the entity recognize an ROU asset upon adopting ASC 842?

Answer
No. We do not believe that it is appropriate to recognize an ROU asset upon adopting ASC 842 if an entity both (1) has ceased using an asset before the adoption date of ASC 842 and that designation has not changed as of the adoption date and (2) does not have the intent and ability to sublease the asset. However, the entity would still be required to recognize a lease liability equal to the present value of the remaining lease payments under the contract. Normally, the entity would recognize a corresponding ROU asset; however, in this situation, any liabilities previously recognized under ASC 420 (e.g., cease-use liabilities) would be recognized as a reduction to the carrying amount of the ROU asset. Furthermore, to the extent that the ASC 420 liability is less than the carrying amount of the ROU asset that would otherwise be recognized to offset the corresponding lease liability, any remaining portion of the ROU asset not offset by the ASC 420 liability would be written off as an adjustment to equity. We believe that it is appropriate to record the adjustment through equity because the cease-use event occurred before the date of initial application of ASC 842. See Q&A 16-5B below for discussion of the effect of a previously recognized ASC 420 liability that exceeds the lease liability that must be recognized in transition.

Q&A 16-5B  Initial Measurement of an ROU Asset When a Previously Recognized ASC 420 Liability Exceeds the Lease Liability Recognized in Transition
Before adopting ASC 842, a lessee may have recognized, in accordance with ASC 420, a liability for the cost associated with an exit or disposal activity related to an operating lease. Specifically, ASC 420-10-30-9 states that a “liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity shall be [recognized and] measured at its fair value” when the entity ceases using the right conveyed by the contract. In addition, ASC 420-10-30-8 indicates that “[i]f the contract is an operating lease, the fair value of the liability at the cease-use date shall be determined based on the remaining lease rentals.”

Under ASC 840, a lessee may have included amounts related to maintenance (including CAM), insurance, and property taxes in the measurement of its ASC 420 liability. The lessee would have done so regardless of whether such costs were fixed or variable, in which case they would be estimated.

When a lessee is applying the transition requirements in ASC 842, to the extent that ASC 420 liabilities were recognized, such balances should reduce the carrying amount of the ROU asset in accordance with ASC 842-10-65-1(m)(2), which states:

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: . . .

2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease.
In certain circumstances, the carrying amount of a lessee’s ASC 420 liability immediately before the ASC 842 effective date for an existing operating lease may exceed the amount that will be recognized for the lease liability as of the effective date (e.g., if the lessee’s ASC 420 liability included CAM, insurance, and property taxes). Consequently, measuring the ROU asset, including the full adjustment for an ASC 420 liability in accordance with ASC 842-10-65-1(m)(2), may result in an ROU asset carrying amount below zero.

**Question**

How should a lessee account for a lease at transition in which the existing ASC 420 liability exceeds the ROU asset that would otherwise be recognized at transition?

**Answer**

We do not believe that it would be appropriate for a lessee to recognize a negative ROU asset at transition. Although ASC 842 does not provide clear guidance on this situation, we think that it would be acceptable for a lessee to use one of the following approaches:

- **Approach 1: Retain the ASC 420 liability for amounts that exceed the initial ROU asset** — An entity could reduce the ROU asset to zero, with a corresponding decrease to the ASC 420 liability. The remaining portion of the ASC 420 liability would be retained and would be accounted for after the effective date in the same manner as it was accounted for before the effective date (i.e., in accordance with ASC 420). We believe that this approach is acceptable because it would allow a lessee to effectively “run off” its remaining liability. As part of this approach, an entity would not be required to recognize those costs through the income statement a second time (i.e., once when the ASC 420 liability was established before the effective date and again when those costs are actually incurred after the effective date).

- **Approach 2: Retain the portion of the ASC 420 liability related to the executory costs** — As discussed in Q&A 16-5A, if an entity (1) has ceased using an asset before the adoption date of ASC 842 and that designation has not changed as of the adoption date and (2) does not have the intent and ability to sublease the asset as of the adoption date, we do not believe that it is appropriate for an entity to recognize an ROU asset upon adoption. Accordingly, the application of Approach 2 will depend on an entity’s intent and ability to sublease.
  - **Approach 2(a)** — If the entity has the intent and ability to sublease, the entity could reduce the ROU asset by the portion of the ASC 420 liability related to the lease costs. An entity would also reduce the ASC 420 liability by a corresponding amount and retain the portion of the ASC 420 liability to the extent that it is related to executory costs.
  - **Approach 2(b)** — If the entity does not have the intent and ability to sublease, the entity could reduce the ROU asset to zero, with a corresponding decrease to the ASC 420 liability, retaining the ASC 420 liability only for the remaining portion related to executory costs.
In both Approach 2(a) and Approach 2(b), the ASC 420 liability that remains would be accounted for after the effective date in the same manner as it was accounted for before the effective date (i.e., in accordance with ASC 420). As with Approach 1, we believe that this approach is acceptable because it would allow a lessee to effectively “run off” its remaining liability. As part of this approach, an entity would not be required to recognize those costs through the income statement a second time (i.e., once when the ASC 420 liability was established before the effective date and again when those costs are actually incurred after the effective date).

- **Approach 3: Derecognize any remaining ASC 420 liability, after the ROU asset is written to zero, through an adjustment to equity** — An entity could reduce the ASC 420 liability by the same amount that reduced the ROU asset to zero. The remaining portion of the ASC 420 liability could be written off with an adjustment through equity. The costs underlying the amount that would be adjusted to equity would be recognized through the income statement in future periods as an expense since they are incurred after the effective date. Accordingly, under this approach, a lessee will recognize certain costs through the income statement twice (i.e., once in periods before the adoption of ASC 842 when the ASC 420 liability was established with its corresponding expense, and again when those costs are incurred after the adoption of ASC 842, because an offsetting liability on the balance sheet no longer exists). Although we do not think that this is an intended outcome of the transition guidance in ASC 842 or a desirable outcome for lessees, we do believe that this approach is acceptable because it would allow the removal of the existing ASC 420 liability, as contemplated under the ASC 842 transition guidance.

**Q&A 16-5C  Treatment of Existing Sublease Liabilities Under ASC 840 Upon Transition to ASC 842**

Under ASC 842, when the costs expected to be incurred under an operating sublease exceed the expected related revenue, a sublessor should consider whether the ROU asset of the head lease is impaired in accordance with ASC 842-20-35-9. However, under ASC 840, the sublessor would have instead recognized a sublease liability for this anticipated loss. Specifically, ASC 840-20-25-15 states:

> If costs expected to be incurred under an operating sublease (that is, executory costs and either amortization of the leased asset or rental payments on an operating lease, whichever is applicable) exceed anticipated revenue on the operating sublease, a loss shall be recognized by the sublessor.

The transition guidance in ASC 842-10-65-1(m) states, in part:

> 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.

Therefore, the ROU asset is established in transition and adjustments are made for items in ASC 842-20-35-3(b), including “impairment of the [ROU] asset” and the carrying amount of ASC 420 liabilities.
**Question**

How should a sublessor account for an existing sublease liability recognized under ASC 840-20-25-15 upon transition to ASC 842?

**Answer**

ASC 842 does not provide explicit guidance on accounting for existing sublease liabilities upon transition. The ASC 842 transition guidance states that the initial ROU asset recognized in transition should be net of ASC 420 liabilities and ROU impairment but does not mention existing sublease liabilities. In the absence of explicit guidance, we believe that the following are acceptable approaches for a sublessor to use in accounting for an existing sublease liability upon transition:

- **Approach A** — The sublessor writes off the existing sublease liability upon transition to ASC 842, with a credit to equity. Contemporaneously, the sublessor must test the asset group containing the ROU asset for impairment in accordance with ASC 842 (see Q&A 16-4A), because subleasing at an amount less than the head lease payments may be an indicator of impairment. If the ROU asset is impaired, any impairment would also be an adjustment to equity in transition.

- **Approach B** — The sublessor nets the existing sublease liability recognized under ASC 840-20-25-15 against the ROU asset established upon transition to ASC 842. Under this approach, the existing sublease liability is considered akin to an impairment loss. As a result, in accordance with ASC 842-20-25-7, the sublessor would subsequently amortize the remaining ROU asset balance on a straight-line basis; accordingly, the sublessor would not recognize total lease expense on a straight-line basis (see Section 8.4.4 for additional discussion of subsequent measurement of the ROU asset after an impairment is recognized).

A sublessor should elect one of the above approaches and apply it consistently to all existing sublease liabilities in transition.

### 16.3.1.1.3 Subsequent Measurement

**ASC 842-10**  

**65-1** The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, *Leases (Topic 842)* . . .  

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 . . .
For operating leases whose balance neither reflects an impairment nor includes an ASC 420 liability upon transition, the ROU asset and liability should be subsequently measured in accordance with ASC 842-20-35-3(b). A lessee’s expense recognition pattern for lease payments is the same under ASC 840 as it is under ASC 842 (i.e., generally straight-line). Therefore, during the comparative periods under ASC 842 (if applicable), the expense recognized under ASC 840 does not need to be altered. For operating leases whose balance reflects an impairment or includes an ASC 420 liability, the lessee should subsequently measure the ROU asset and liability in accordance with ASC 842-20-25 and ASC 842-20-35 as if the ROU asset had been impaired. The ROU asset should be amortized on a straight-line basis over the remaining lease term, unless a more 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. The entity should accrete the lease liability initially measured at the amount that produces a constant periodic discount rate related to the remaining balance of that liability.

Further, as discussed in Section 16.3.1, an entity should apply the provisions of ASC 842 to the accounting for modifications and the reassessment of the lease liability on and after the effective date. During the comparative periods presented under ASC 842 (if applicable), the accounting for modifications and the reassessment of the lease liability should be in line with the provisions of ASC 840 (if lease classification did not change upon the adoption of ASC 842) or ASC 842 (if lease classification did change upon the adoption of ASC 842).

### 16.3.1.2 Lease Is a Finance Lease Under ASC 842 (Operating Lease Under ASC 840)

The graphic below outlines the steps lessees should perform in transition for leases that were previously classified as operating leases and are considered finance leases under ASC 842.

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**Measure the Lease Liability**

Present value of the remaining lease payments and payment under any expected residual value guarantee discounted by a rate determined as of the later of the date of initial application or the lease commencement date.

**Measure the ROU Asset**

Divide the remaining lease term as of the date of initial application by the total lease term and multiply this amount by the original (or imputed) lease liability. Add any prepaid lease payments and subtract any accrued lease payments and ASC 420 liabilities.

**Recognize the ROU Asset and Lease Liability**

Recognize an ROU asset and lease liability as of the later of (1) the date of initial application or (2) the lease commencement date.

---

20 As discussed in Q&A 16-5C, we believe that netting an existing sublease liability against an ROU asset in transition (i.e., Approach B in the Q&A) is akin to an impairment loss and thus should result in the same subsequent measurement as an impairment.
16.3.1.2.1 Initial Measurement of Lease Liability

For more information about the initial measurement of the lease liability, see Section 16.3.1.1. For leases classified as operating under ASC 840, the initial measurement of lease liabilities in transition is the same, regardless of whether classification changes.

16.3.1.2.2 Initial Measurement of ROU Asset

The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

- 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 application date as determined in (c) 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.

The measurement of the ROU asset is intended to reflect the proportion of the ROU asset that would have remained if the lease had always been classified as a finance lease, including any prepaid (or accrued) balances and ASC 420 liabilities. However, the guidance above indicates that this amount “can be imputed from the lease liability determined in accordance with (l).” This appears to be an accommodation, because the calculation of the lease liability under ASC 842-10-65-1(l) only takes into account remaining lease payments as of the date of initial application for any lease that commences before that time. That is, a true calculation of the lease liability as of the commencement date would include payments that were made before the date of initial application. ASC 842 does not provide additional guidance on how a lessee may impute the lease liability without using all the payments since lease commencement. However, the 2013 ED of the leases standard did illustrate how this may be done. Under the approach discussed in the ED, an entity would average the remaining minimum rental payments from the calculation in ASC 842-10-65-1(l) and would assume that those average payments existed for the entire lease term. This calculation could materially differ from a true calculation of the original lease liability at lease commencement. For example, this could occur if the lease payments significantly differed from those on a straight-line basis (e.g., step rents or significant deferred payments). Therefore, we believe that a lessee could either calculate the original lease liability at lease commencement (Alternative 1 below) or develop a policy that is consistent with imputing the amount related to the components from the calculation in ASC 842-10-65-1(l) (Alternative 2 below).
Alternative 1

Example 16-2

Assume the same facts as in Example 29 of ASC 842 (see Section 16.3.1.1) except that the lessee did not elect the practical expedient package and the lease was determined to be a finance lease in transition. Further assume that the entity did not elect the Comparatives Under 840 Option and that the remaining balance of initial direct costs as of the earliest period presented is $250 because of the exclusion of certain initial direct costs capitalized under ASC 842. Finally, assume that the payment made in 20X1 was $31,000.

**Step 1: Measure the Lease Liability as of the Earliest Period Presented**

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X2</td>
<td>31,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20X3</td>
<td>33,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20X4</td>
<td>33,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20X5</td>
<td>33,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$112,462</td>
<td>= NPV (0.06, B1:B4)</td>
<td></td>
</tr>
</tbody>
</table>

**Alternative 1**

**Step 2: Measure the ROU Asset**

Calculate the present value of the lease payments from lease commencement and multiply this amount by the remaining lease term divided by the original lease term.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>31,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20X2</td>
<td>31,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20X3</td>
<td>33,000</td>
<td></td>
<td></td>
</tr>
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<td>20X4</td>
<td>33,000</td>
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<tr>
<td>20X5</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>$135,341</td>
<td>= NPV (0.06, B1:B5)</td>
<td></td>
</tr>
</tbody>
</table>

$135,341 \times 4/5 = $108,273
Example 16-2 (continued)

Step 3: Record the Journal Entries

<p>| | |</p>
<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>ROU asset*</td>
<td>107,323</td>
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<tr>
<td>Accrued rent</td>
<td>1,200</td>
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<tr>
<td>Retained earnings</td>
<td>4,339</td>
</tr>
<tr>
<td>Lease liability</td>
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</tr>
<tr>
<td>Initial direct costs, net</td>
<td>400</td>
</tr>
</tbody>
</table>

* The ROU asset comprises the proportion of the present value of the lease payments that remain on the lease ($108,273) plus the remaining balance of initial direct costs that can be capitalized ($250) less accrued rent ($1,200).

Alternative 2

Step 2: Measure the ROU Asset

Determine the average lease payments over the remaining term as of the earliest period presented, as calculated in step 1 \((31,000 + 33,000 + 33,000 + 33,000) ÷ 4 = 32,500\).

Calculate the present value of the average lease payments imputed over the entire lease term and multiply this amount by the remaining lease term divided by the original lease term.

<p>| | |</p>
<table>
<thead>
<tr>
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<th></th>
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<tbody>
<tr>
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<tr>
<td>B</td>
<td>32,500</td>
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<tr>
<td>C</td>
<td>32,500</td>
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<td>20X1</td>
<td>32,500</td>
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<tr>
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<td>20X3</td>
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</tr>
<tr>
<td>20X4</td>
<td>32,500</td>
</tr>
<tr>
<td>20X5</td>
<td>32,500</td>
</tr>
</tbody>
</table>

\[
\text{NPV (0.06, B1:B5)} = 136,902
\]

\[
136,902 × 4/5 = 109,522
\]

Step 3: Record the Journal Entries

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>ROU asset*</td>
<td>108,572</td>
</tr>
<tr>
<td>Accrued rent</td>
<td>1,200</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>3,090</td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
</tr>
<tr>
<td>Initial direct costs, net</td>
<td>400</td>
</tr>
</tbody>
</table>

* The ROU asset comprises the proportion of the present value of the lease payments that remain on the lease ($109,522) plus the remaining balance of initial direct costs that can be capitalized ($250) less accrued rent ($1,200).

16.3.1.2.3 Subsequent Measurement

There are no separate paragraphs in the transition guidance on subsequent measurement for a lease that was an operating lease under ASC 840 and becomes a finance lease upon the adoption of ASC 842. However, since the lease classification in this scenario changed to a finance lease in accordance with ASC 842, the finance lease must be subsequently measured in accordance with ASC 842 after the date of initial application.
16.3.2 Lease Previously Classified as a Capital Lease Under ASC 840

Leases previously classified as a capital lease under ASC 840 could be accounted for as either a finance lease or an operating lease under ASC 842. The classification considerations related to the practical expedient package are the same as those for leases previously classified as operating leases (see Section 16.3.1).

The two transition scenarios for a capital lease under ASC 840 are as follows:

<table>
<thead>
<tr>
<th>ASC 840 Classification</th>
<th>ASC 842 Classification</th>
<th>Roadmap Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>Finance</td>
<td>16.3.2.1</td>
</tr>
<tr>
<td>Capital</td>
<td>Operating</td>
<td>16.3.2.2</td>
</tr>
</tbody>
</table>

16.3.2.1 Lease Is a Finance Lease Under ASC 842 (Capital Lease Under ASC 840)

The below graphic illustrates how an entity should recognize the ROU asset and lease liability for leases that were previously classified as capital leases and are considered finance leases under ASC 842 because either (1) an entity elected the practical expedient package so that lease classification would not be reassessed or (2) classification is assessed in transition to ASC 842 and the lease is determined to be a finance lease.

In short, other than changing the characterization of the asset (to an ROU asset) and obligation (to a lease liability), the lessee does not record any entries as part of the transition from a capital lease to a finance lease, except the impact of any nonqualifying initial direct costs, if any, when the practical expedient package is not applied. Example 28 in ASC 842 illustrates this transition as follows:

**Example 28 — Lessee Transition — Existing Capital Lease**

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.
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.

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.

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).

16.3.2.1.1 Initial Measurement of Lease Liability and ROU Asset

65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

   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 application date as determined in (c).
      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. If a lessee does not elect the practical expedients described in (f), write off any unamortized initial direct costs 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 as an adjustment to equity unless the entity elects the transition method in (c)(1) and the costs were incurred after the beginning of the earliest period presented, in which case those costs shall be written off as an adjustment to earnings in the period the costs were incurred.

If a lease was previously classified as a capital lease under ASC 840 and the lease remains a finance lease, the entity should recognize an ROU asset and lease liability in transition at their existing carrying amounts as lease assets and capital lease obligations, respectively. That is, the transition guidance for a capital lease that is classified as a finance lease under ASC 842 results in the carryforward of existing assets and liabilities recognized under ASC 840. The amounts should be recognized at the later of the date of initial application or the commencement date of the lease.

In addition, any unamortized initial direct costs (after an entity considers the ASC 842 definition, unless the practical expedient described in Section 16.5.2.3 is applied) should be added to the ROU asset.

21 We believe that in addition to carrying forward the existing assets and liabilities recognized under ASC 840, an entity should also carry forward the discount rate used under ASC 840.
Connecting the Dots — Hindsight Impact Related to Lease Term and Liability Measurement (Lease Classified as a Capital Lease Under ASC 840)

The measurement of the lease liability is affected by the identification of the lease term. If an entity elects the hindsight practical expedient, any changes to the lease term during the comparative period should be reflected in the measurement of the lease liability as of the later of the date of initial application or lease commencement. Therefore, a different initial measurement of the finance lease could be required in transition, since balances under ASC 840 will reflect a different lease term assumption. See Section 16.5.1 for more information on the hindsight practical expedient.

For capital leases that are finance leases under ASC 842, the only difference between electing and not electing the practical expedient package is that an entity that does not apply the package would only include in its ROU asset initial direct costs that qualify as such costs under ASC 842. Previously capitalized initial direct costs that no longer meet the definition of initial direct costs under ASC 842 must be accounted for as follows:

- Any costs incurred before the date of initial application should be recognized as an adjustment to equity.
- Any costs incurred on or after the date of initial application should be recognized in earnings for the respective comparative period under ASC 842, if applicable.

16.3.2.1.2 Subsequent Measurement

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .</td>
</tr>
<tr>
<td>r. For each lease classified as a finance lease in accordance with this Topic, a lessee shall do all of the following: . . .</td>
</tr>
<tr>
<td>4. If an entity elects the transition method in (c)(1), subsequently measure the right-of-use asset and the lease liability in accordance with Section 840-30-35 before the effective date.</td>
</tr>
<tr>
<td>5. Regardless of the transition method selected in (c), 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).</td>
</tr>
<tr>
<td>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. . . .</td>
</tr>
<tr>
<td>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. . . .</td>
</tr>
</tbody>
</table>

A finance lease must be subsequently measured in accordance with ASC 840 in the comparative periods before the effective date. That is, if classification does not change as of the earliest period presented, the ASC 840 reassessment, modification, and measurement principles should be retained (other than those related to the classification of the assets and liabilities as ROU assets and lease liabilities, respectively, for presentation and disclosure purposes). On and after the effective date, an entity must apply the ASC 842 subsequent-measurement guidance, including that on modifications and reassessment of the lease liability.
Connecting the Dots — Lessee Does Not Remeasure Residual Value Guarantee Upon Transition

Under ASC 840, a lessee includes in its minimum lease payments the entire amount of the residual value guarantee; however, under ASC 842, a lessee only includes in its lease payments those amounts that it is probable the lessee will owe under the residual value guarantee at the end of the lease term. As a result, the ROU asset and lease liability recognized on the lessee’s balance sheet for a new lease under ASC 842 will generally be lower than it would have been had the same lease been classified as a capital lease under ASC 840.

However, for existing leases that were classified as capital leases under ASC 840 and that will be classified as finance leases under ASC 842, ASC 842 specifically states that a lessee is not allowed to “remette [upon transition] the lease payments for amounts probable of being owed under residual value guarantees.” As a result, a lessee’s lease payments would not be reduced only to reflect the change in the amount of the residual value guarantee that is included in lease payments under the two standards.

16.3.2.2 Lease Is an Operating Lease Under ASC 842 (Capital Lease Under ASC 840)

For leases that were previously classified as capital leases and are considered operating leases under ASC 842 (which can only occur if the practical expedient package is not elected), the lessee must derecognize the previous capital lease amounts at the later of the date of initial application or the commencement date. Upon derecognition of the previous capital lease amounts, the lease is accounted for as an operating lease under ASC 842, as discussed further below.

1. Derecognize the Previous Capital Lease
   
   Derogate the previous capital lease asset and liability as of the later of the date of initial application or the commencement date of the lease and recognize any difference as part of the new ROU asset (i.e., treat as prepaid/accrued rent).

2. Measure the ROU Asset and Lease Liability
   
   Measure and recognize the ROU asset and lease liability in accordance with the guidance in ASC 842-20-35-3 (if lease commenced before the date of initial application) or ASC 842-20-30-1 (if lessee did not elect Comparatives Under 840 Option and lease commenced during the comparative periods).
The lessee should measure the ROU asset and lease liability under ASC 842-20-30-1 as of the later of the date of initial application or the date the lease commenced. Before measuring the ROU asset and lease liability, the lessee would need to identify and allocate the consideration to the separate lease and nonlease components in the contract (see Chapter 4). Because the lessee could not have elected the practical expedient package if the classification of a lease changes upon the adoption of ASC 842, any unamortized initial direct costs that would not be capitalized under the changed definition of such costs in ASC 842 should be written off as an adjustment to equity if the costs are incurred before the date of initial application or as expense in the period in which the costs are incurred, which is only applicable if the Comparatives Under 840 Option is not elected.

16.3.2.2.1 Subsequent Measurement

After the commencement date, the lessee should subsequently measure the operating lease under ASC 842 in a manner similar to how it would measure any other operating lease that commenced after the effective date (see Section 8.4.3.2). That is, since lease classification changed upon the adoption of ASC 842, an entity should apply all of the guidance on subsequent measurement (including that on modifications and reassessment of the lease liability) under ASC 842 during the comparative periods presented (if applicable) and on or after the effective date.
### 16.4 Lessor

The table below summarizes the ASU's modified retrospective transition requirements for lessors (and assumes that the practical expedient package has not been elected).

<table>
<thead>
<tr>
<th>Current U.S. GAAP (ASC 840)</th>
<th>New Model (ASC 842)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating lease</strong></td>
<td><strong>Direct Financing or Sales-Type Lease</strong></td>
</tr>
<tr>
<td>As of the later of (1) the date of initial application or (2) the lease commencement date:</td>
<td></td>
</tr>
<tr>
<td>• Derecognize the carrying amount of the underlying asset.</td>
<td></td>
</tr>
<tr>
<td>• Recognize a net investment in the lease as if the lease had been accounted for as a direct financing lease or sales-type lease since lease commencement.</td>
<td></td>
</tr>
<tr>
<td>• Recognize as an adjustment to equity the difference between the newly recognized net investment and the derecognized asset.</td>
<td></td>
</tr>
</tbody>
</table>

Note that there are additional considerations under ASC 842-10-65-1 for modifications of a lease that occur on or after the standard's effective date and do not result in a separate contract. For more information about lease modifications, see Chapter 8 (for lessees) and Chapter 9 (for lessors).
16.4.1 Lease Classified as an Operating Lease Under Both ASC 840 and ASC 842

ASC 842-10

65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

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 application date as determined in (c) 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. If a lessor does not elect the practical expedients described in (f), write off any unamortized initial direct costs that do not meet the definition of initial direct costs in this Topic as an adjustment to equity unless the entity elects the transition method in (c)(1) and the costs were incurred after the beginning of the earliest period presented, in which case those costs shall be written off as an adjustment to earnings in the period the costs were incurred. . . .

For leases that were previously classified as operating leases and are considered operating leases under ASC 842 either because the practical expedient package was elected and lease classification therefore was not reassessed or because classification was assessed in transition to ASC 842 and the lease retained its classification as an operating lease, the lessor must continue to recognize any underlying assets and liabilities (e.g., the leased asset, deferred or accrued rent, and initial direct costs) on the later of the date of initial application or the lease commencement date. The amounts recognized should be the same as those under ASC 840. The lessor will continue to account for previously recognized securitized receivables as secured borrowings in accordance with other GAAP because operating leases are still not recognized financial assets for the lessor under ASC 842. In this transition scenario (i.e., operating lease classification was retained), the election of the practical expedient package only affects what amounts qualify as initial direct costs. If the lessor did not elect the practical expedient package, any unamortized initial direct costs that would not be capitalized under the changed definition of such costs in ASC 842 should be written off as an (1) adjustment to equity if they are incurred before the date of initial application or (2) an expense in the comparative period in which they were incurred if the lessor does not elect the Comparatives Under 840 Option.

Connecting the Dots — Effect of Hindsight Practical Expedient on Lease Term and Straight-Line Rent Revenue

The hindsight practical expedient may affect a lessor’s measurement of lease component revenue. If an entity elects hindsight, the lease may include a renewal term whose exercise was not previously considered reasonably certain (or exclude a term whose exercise is no longer reasonably certain but was deemed reasonably certain at lease commencement). When there is level rent in both the initial term and renewal term, there may be no practical effect on the measurement of lease component revenue. However, if a lessor receives uneven rent payments (e.g., escalating payments), the lessor may need to adjust its straight-line rent revenue recognized (and any lease-related balance sheet items).
Example 16-3

Hummingbird Inc., a public calendar-year-end entity, leases an office building to a tenant beginning on January 1, 2014, and receives $12,000 per annum with a 2 percent annual increase for a four-year noncancelable term as well as one four-year renewal option at a 2 percent annual increase. As of lease commencement, it is not reasonably certain that the lessee will exercise its renewal option. On January 1, 2018, the lease is renewed. Also, Hummingbird Inc. did not elect the Comparatives Under 840 Option under which it would not restate its comparative-period financial statements under ASC 842 in the period of adoption. Assume the following:

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Rent Paid</th>
<th>Straight-Line Rent</th>
<th>Straight-Line Rent With Hindsight</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>12,000</td>
<td>12,365</td>
<td>12,874</td>
</tr>
<tr>
<td>2015</td>
<td>12,240</td>
<td>12,365</td>
<td>12,874</td>
</tr>
<tr>
<td>2016</td>
<td>12,485</td>
<td>12,365</td>
<td>12,874</td>
</tr>
<tr>
<td>2017</td>
<td>12,734</td>
<td>12,365</td>
<td>12,874</td>
</tr>
<tr>
<td>2018</td>
<td>12,989</td>
<td>13,384</td>
<td>12,874</td>
</tr>
<tr>
<td>2019</td>
<td>13,249</td>
<td>13,384</td>
<td>12,874</td>
</tr>
<tr>
<td>2020</td>
<td>13,514</td>
<td>13,384</td>
<td>12,874</td>
</tr>
<tr>
<td>2021</td>
<td>13,784</td>
<td>13,384</td>
<td>12,874</td>
</tr>
</tbody>
</table>

As of January 1, 2017

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred rent receivable</td>
<td>370*</td>
</tr>
<tr>
<td>Deferred rent receivable with hindsight</td>
<td>1,897**</td>
</tr>
<tr>
<td>True-up</td>
<td>1,527</td>
</tr>
</tbody>
</table>

* Comprises the sum of the differences between the cash rent paid and the straight-line rent for the period from 2014 to 2016.

** Comprises the sum of the differences between the cash rent paid and the straight-line rent with hindsight for the period from 2014 to 2016.

True-Up to 2017

Deferred rent receivable 1,527
Equity 1,527

2017 — Add Incremental Straight-Line Rent

Deferred rent receivable 509
Straight-line rent revenue 509

2018 — Reverse Incremental Straight-Line Rent

Straight-line rent revenue 510
Deferred rent receivable 510
### 16.4.2 Lease Is a Direct Financing Lease or a Sales-Type Lease Under ASC 842 (Operating Lease Under ASC 840)

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>65-1</strong> The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .</td>
</tr>
<tr>
<td>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 application date as determined in (c) 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:</td>
</tr>
<tr>
<td>1. Derecognize the carrying amount of the underlying asset at the application date as determined in (c).</td>
</tr>
<tr>
<td>2. Recognize a net investment in the lease at the application date as determined in (c) 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.</td>
</tr>
<tr>
<td>3. Record any difference between the amounts in (w)(1) and (w)(2) as follows:</td>
</tr>
<tr>
<td>i. If an entity elects the transition method in (c)(1), as an adjustment to equity (if the commencement date of the lease was before the beginning of the earliest period presented or if the lease was acquired as part of a business combination; see also (h)(3)) or earnings (if the commencement date of the lease was on or after the beginning of the earliest period presented).</td>
</tr>
<tr>
<td>ii. If an entity elects the transition method in (c)(2), as an adjustment to equity.</td>
</tr>
<tr>
<td>4. Account for the lease in accordance with this Topic after the application date as determined in (c). . . .</td>
</tr>
</tbody>
</table>

An entity that has not elected the practical expedient package must reassess the classification of its leases under ASC 842. As noted above, for leases that were previously classified as operating leases under ASC 840 but that are accounted for as direct financing leases or sales-type leases under ASC 842, an entity must “account for the lease, beginning on the application date . . . as if it had always been accounted for as a direct financing lease or a sales-type lease” (emphasis added). That is, if the lease classification changes for a lease that commenced before the date of initial application, the lessor will be required to retrospectively determine the lease balances as of lease commencement so that it can roll those balances forward to the date of initial application. As of this date, the underlying asset subject to the lease should be derecognized, a net investment in the lease should be recognized, and any difference between the two balances should be reflected as an adjustment to equity (or earnings if the lease commenced during the comparative periods and the lessor does not elect the Comparatives Under 840 Option). After the initial recognition date, the lessor should subsequently account for the lease (including any modifications) in accordance with ASC 842. See Chapter 9 for more information on the lessor’s accounting for sales-type and direct financing leases.
Example 16-4

Company B, a calendar-year-end PBE, did not elect the practical expedient package and, in transition, a lease of real estate that was classified as an operating lease under ASC 840 was determined to be a sales-type lease under ASC 842. Further, B did not elect the practical expedient that permits it not to restate its comparative-period financial statements in the period of adoption. The lease commenced in 2012. As of the date of the earliest comparative period presented, the carrying amount of the leased asset was $3 million. The net investment in the lease was determined to be $3.5 million, which represents the present value of the lease payments and unguaranteed residual value determined as of the commencement date and then rolled forward to the earliest period presented. Company B would record the following transition-related journal entry on January 1, 2017:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net investment in the lease</td>
<td>3.5 million</td>
</tr>
<tr>
<td>Net carrying value of underlying asset</td>
<td>3.0 million</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>0.5 million</td>
</tr>
</tbody>
</table>

Connecting the Dots — Hindsight Practical Expedient May Affect Lease Classification

The hindsight practical expedient may affect a lessor’s classification test if the practical expedient package is not elected. If an entity elects hindsight, the lease may include a renewal term whose exercise was not previously considered reasonably certain (or exclude a term whose exercise is no longer reasonably certain but was deemed reasonably certain at lease inception), which could affect the lease classification. Specifically, the lease term is relevant to the determination of whether the lease term represents a major part of the remaining economic life of the asset and whether the present value of the lease payments exceeds substantially all of the fair value of the underlying asset. We believe that this is only possible if the practical expedient package is not elected. We believe that if that package is elected, it is appropriate to retain the ASC 840 classification regardless of the potential for hindsight to alter the lease term assumptions used in that lease classification.
16.4.3 Lease Classified as a Direct Financing Lease or a Sales-Type Lease Under ASC 840 (and Is Still Classified as a Direct Financing Lease or a Sales-Type Lease Under ASC 842)

ASC 842-10

65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

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 application date as determined in (c) 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. If an entity elects the transition method in (c)(1), before the effective date, a lessor shall account for the lease in accordance with Topic 840.

3. Regardless of the transition method selected in (c), 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 lease is classified as a direct financing lease before the modification or paragraph 842-10-25-17 if the lease is classified as a sales-type lease before 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). . .

As noted above, if the lease was classified as a direct financing lease or a sales-type lease under ASC 840 and continues to be classified as a direct financing lease or a sales-type lease under ASC 842, the lessor should “[c]ontinue to recognize a net investment in the lease at the application date . . . at the carrying amount of the net investment at that date.” In other words, the lessor should generally carry over its ASC 840 accounting during the transition period. The only exception to this general rule concerns initial direct costs. If the lessor does not elect the practical expedient package, any unamortized initial direct costs not capitalizable under ASC 842 must be written off to equity (if the lease commenced before the date of initial application) or earnings in the comparative period in which they were incurred, which is only applicable if the lessor does not elect the Comparatives Under 840 Option.

The lessor should subsequently measure the lease (including modifications) during the transition period in accordance with ASC 840. Beginning on the effective date, the lessor should apply the subsequent measurement, presentation, and disclosure guidance in ASC 842-30 as well as the modification guidance in ASC 842-10-25 (see Section 9.3.4 for guidance on modifications).

Connecting the Dots — Impact of Hindsight on Lease Classification and Measurement of Direct Financing Leases or Sales-Type Leases

The use of hindsight may affect the lease term and, in turn, the measurement of direct financing or sales-type leases, because a different lease term will typically result in different lease payments with respect to determining the net investment in the lease.

Note that the use of hindsight will not affect lease classification if the lessor applies the practical expedient package, because that election precludes a reassessment of ASC 840 lease classification determinations.
16.4.4 Lease Is an Operating Lease Under ASC 842 (Direct Financing or Sales-Type Lease Under ASC 840)

An entity that has not elected the practical expedient package must reassess lease classification under ASC 842. For leases previously classified as sales-type or direct financing leases under ASC 840 that are operating leases upon the adoption of ASC 842, the lessor should perform the steps in ASC 842-10-65-1(y) above. Further, as discussed in Q&A 16-6, although this transition guidance does not specifically address other lease-related balances, we believe that the broad objective would apply to all balances that would have otherwise been recognized had the lease always been accounted for as an operating lease.
Example

On October 1, 2010, Company A acquired an office building that had various leases in place; as a result, A became a lessor of office space. The lease agreements with the existing tenants included escalating lease payments over the contract period. On the basis of the lease classification criteria in ASC 840, A determined that the existing leases should be classified as direct financing leases. Therefore, on the acquisition date, A recognized a net investment in the leases and accounted for them in accordance with ASC 840.

On January 1, 2019, A adopts ASC 842 and does not elect the practical expedients in ASC 842-10-65-1(f) or the Comparatives Under 840 Option. As a result, A evaluates the classification criteria in ASC 842 and concludes that its existing direct financing leases should be classified as operating leases under ASC 842. Such an outcome could arise for various reasons, including use of hindsight that results in a different assumption regarding the lease term.

Assume that the lease had been classified as an operating lease in accordance with ASC 840. As a result of the rent escalations in the lease agreement, A then would have recognized a “straight-line rent receivable” of $25,000 as of the earliest period presented. Similarly, as of lease commencement, A would have recognized an in-place lease intangible, net of amortization, of $55,000, which represents the inherent value associated with full occupancy of the property by tenants on the acquisition date.

Question

Should A recognize the straight-line rent receivable and the in-place lease intangible asset when the lease’s classification changes from a direct financing lease under ASC 840 to an operating lease under ASC 842?

Answer

Yes. The straight-line rent receivable and the in-place lease intangible should be established in transition as if they had always been recorded in connection with the operating lease.

The transition method in ASC 842 is not a full retrospective approach. However, the objective under ASC 842-10-65-1(y) is to account for a lease as if it had always been accounted for as an operating lease in accordance with ASC 842. Therefore, while the transition guidance discusses only certain balances (e.g., the recognition of the underlying asset at what the carrying amount would have been had the lease been classified as an operating lease under ASC 840), we believe that the guidance is not intended to be all-inclusive and that the broad objective would apply to all balances that would have otherwise been recognized had the lease always been accounted for as an operating lease.
**Straight-Line Rent Receivable**

On the basis of the analysis above, when A transitions to ASC 842, it should do the following as of the beginning of the earliest period presented (i.e., January 1, 2017):

- Derecognize the net investment in the lease.
- Recognize the underlying asset at what its carrying amount would have been if the lease were always accounted for as an operating lease under ASC 840.
- Recognize a straight-line rent receivable balance in the amount at which it would have been recorded if the lease was always accounted for as an operating lease under ASC 842 (i.e., $25,000, which is the build-up of a straight-line rent receivable from lease commencement to the earliest period presented when A makes the transition to ASC 842).

In addition, A should recognize any resulting difference as an adjustment to opening equity and subsequently account for the operating lease in accordance with ASC 842.

**In-Place Lease Intangible**

Company A should apply the guidance in ASC 805-20-25-10A and recognize an in-place lease intangible as of January 1, 2017 (i.e., the beginning of the earliest period presented). That is, A should determine what the in-place lease intangible would have been as of October 1, 2010 (the date of initial acquisition), and factor in amortization of the intangible through January 1, 2017, the beginning of the earliest year presented. The resulting amount would be the in-place lease intangible amount that would have been recognized if the lease had always been accounted for as an operating lease. Company A should recognize an in-place lease intangible of $55,000 and amortize it over the remaining lease term.

The response to this question was informally discussed with the FASB staff, which agreed with the overall conclusion reached.

**Connecting the Dots — Principle Related to Accounting for the Operating Lease in Transition**

Although the scenario in the example above may not be common for many entities upon transition, we believe that the principle outlined therein — account for the operating lease in transition as if it had always been an operating lease — is critical. Specifically, we think that it is important to consider the objective of the transition guidance in each relevant paragraph of ASC 842-10-65-1.

For example, while ASC 842-10-65-1(h) describes the applicability of the guidance as depending on whether “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,” we believe that it would be similarly necessary to consider and carry forward other lease-related balances that would have been recognized, such as in-place lease intangibles.
16.4.5 Leveraged Leases

ASC 842-10

65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

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. . . .

Leveraged lease accounting is a special type of accounting that a lessor can apply under ASC 840 for certain direct financing leases that meet specific criteria (see ASC 840-10-25-43(c)). The unique economic effect of leveraged lease accounting stems from a combination of nonrecourse financing and a cash flow pattern that typically enables the lessor to recover its investment in the early years of the lease (as a result of tax benefits generated by depreciation, interest, and investment tax credit deductions) and, thereafter, affords it the temporary use of funds from which additional income can be derived.

The accounting for leveraged leases is complex but is based on two basic premises:

• The lessor's balance sheet reflects the lessor's equity in the property on an after-tax basis, net of the related debt.

• The lessor's income statement reflects an after-tax constant rate of return on the lessor's net investment. During periods in which the net investment is zero or below zero, no income is recognized.

Although ASC 842 removed leveraged lease accounting, leases that met the definition of a leveraged lease under ASC 840 and commenced before the effective date of ASC 842 are grandfathered in and are addressed in ASC 842-50 (see Section 9.5). A leveraged lease that is modified on or after the effective date (including an extension option whose exercise was not previously reasonably assured) must be accounted for as a new lease in accordance with ASC 842 (i.e., because leveraged lease accounting has been discontinued).
16.4.6 Leases for Which a Lessor Elects the Practical Expedient Related to Not Separating Lease and Nonlease Components

**ASC 842-10**

**65-2** The following represents the transition and effective date information related to Accounting Standards Update No. 2018-11, *Leases (Topic 842): Targeted Improvements*:

a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to paragraph 842-10-65-2, by class of underlying asset, to all new and existing leases when the entity first applies the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1.

b. An entity that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph, by class of underlying asset, to all new and existing leases either:
   1. In the first reporting period following the issuance of the pending content that links to paragraph 842-10-65-2
   2. At the original effective date of this Topic for that entity as determined in paragraph 842-10-65-1(a) and (b).

c. An entity that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph, by class of underlying asset, to all new and existing leases either:
   1. Retrospectively to all prior periods beginning with the fiscal years in which the pending content that links to paragraph 842-10-65-1 was initially applied
   2. Prospectively.

In July 2018, the FASB issued *ASU 2018-11*, which provides a practical expedient under which lessors can elect, by class of underlying asset, not to separate lease and nonlease components when certain criteria are met. The effective date of ASU 2018-11 is aligned with that of ASU 2016-02.\(^{22}\)

Entities that early adopted ASU 2016-02 before the issuance of ASU 2018-11 may apply the lessor practical expedient to all new and existing leases either retrospectively or prospectively and may elect to apply it as of either (1) the lessor’s first reporting period (interim or annual) after the issuance of ASU 2018-11 or (2) the mandatory effective date of ASC 842 (i.e., January 1, 2019, for calendar-year-end public entities). For example, an entity that has early adopted ASU 2016-02 and elects the practical expedient may decide not to recast past periods already presented under ASC 842, thereby choosing prospective application. However, from its date of initial application forward, the election would apply to all existing and new leases.

A lessor electing the practical expedient would be required to apply it to all new and existing transactions within a class of underlying assets that qualify for the expedient as of the date elected. That is, a lessor would not be permitted to apply the practical expedient only to new or modified transactions within a class of underlying assets. (See Sections 4.3.3.2 and 17.3.1.4.2 for further discussion of this practical expedient.)

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\(^{22}\) ASU 2019-10 delayed the effective date of ASU 2016-02 for all nonpublic companies. ASU 2020-05 further delayed the effective date for all nonpublic companies as well as for certain public NFPs. (See further discussion in Section 16.1.) The new effective date for nonpublic companies is annual periods beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. The effective date for public NFPs that qualify for the deferral under ASC 842-10-65-1(a) is annual periods beginning after December 15, 2019, and interim periods therein. The effective date for all other public companies remains unchanged. The delayed effective date for nonpublic companies also applies to all other ASUs associated with ASU 2016-02.
16.4.7 ASU 2018-20 on Narrow-Scope Improvements for Lessors

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>65-3</strong> The following represents the transition and effective date information related to Accounting Standards Update No. 2018-20, Leases (Topic 842): Narrow-Scope Improvements for Lessors:</td>
</tr>
<tr>
<td>a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph [842-10-65-3] to all new and existing leases when the entity first applies the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1.</td>
</tr>
<tr>
<td>b. An entity that has adopted the pending content that links to paragraph 842-10-65-1 before the issuance of the pending content that links to this paragraph shall adopt the pending content that links to this paragraph to all new and existing leases at the original effective date of this Topic for that entity as determined in paragraph 842-10-65-1(a) through (b). Alternatively, an entity that has adopted the pending content that links to paragraph 842-10-65-1 may adopt the pending content that links to this paragraph to all new and existing leases either:</td>
</tr>
<tr>
<td>1. In the first reporting period ending after the issuance of the pending content that links to this paragraph</td>
</tr>
<tr>
<td>2. In the first reporting period beginning after the issuance of the pending content that links to this paragraph</td>
</tr>
<tr>
<td>c. An entity that has adopted the pending content that links to paragraph 842-10-65-1 before the issuance of the pending content that links to this paragraph shall apply the pending content that links to this paragraph to all new and existing leases either:</td>
</tr>
<tr>
<td>1. Retrospectively to all prior periods beginning with the fiscal years in which the pending content that links to paragraph 842-10-65-1 was initially applied</td>
</tr>
<tr>
<td>2. Prospectively</td>
</tr>
</tbody>
</table>

In December 2018, the FASB issued **ASU 2018-20**, which addresses certain requests made by stakeholders regarding implementation issues associated with ASU 2016-02, specifically the accounting for the following by lessors:

- Sales taxes and other similar taxes collected from lessees.
- Lessor costs paid by a lessee directly to a third party.
- Recognition of variable payments for contracts with lease and nonlease components.

See Section 17.3.1.5 for detailed discussion of this ASU.

The effective date of ASU 2018-20 is aligned with that of ASU 2016-02.

If an entity has already adopted ASU 2016-02 as of the date of issuance of ASU 2018-20, the entity may adopt ASU 2018-20 by using the mandatory effective dates of ASU 2016-02. Alternatively, an entity may elect to apply ASU 2018-20 as of either (1) the first reporting period ending after the issuance of the ASU or (2) the first reporting period beginning after the issuance of the ASU. In addition, entities that elect to early adopt the ASU can apply it either (1) prospectively or (2) retrospectively to all prior periods beginning with the fiscal years in which ASC 842 was initially applied.

All entities should consistently apply the amendments to all leases existing as of the date on which ASU 2018-20 is initially applied and to new leases entered into after that date.
16.4.8 ASU 2019-01 on Codification Improvements

The following represents the transition and effective date information related to Accounting Standards Updates No. 2019-01, Leases (Topic 842): Codification Improvements, No. 2019-10, Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates, and No. 2020-05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities:

a. All entities within the scope of paragraph 842-10-65-1(a) 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 those fiscal years (with an exception for those entities that have not yet issued their financial statements or made financial statements available for issuance as described in the following sentence). 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 that has not yet issued financial statements or made financial statements available for issuance as of June 3, 2020 shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. All other entities shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Earlier application is permitted.

b. An entity shall apply the pending content that links to this paragraph as of the date that it first applied the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1 in accordance with paragraph 842-10-65-1(c).

In March 2019, the FASB issued ASU 2019-01, which makes Codification improvements related to the following three issues under ASC 842:

- Determination of the fair value of the underlying asset by lessors that are not manufacturers or dealers.
- Presentation in the statement of cash flows for sales-type and direct financing leases by lessors within the scope of ASC 942.
- Clarification of interim disclosure requirements during transition.

See Section 17.3.1.7 for detailed discussion of this ASU.

The ASU is effective for (1) public companies for fiscal years beginning after December 15, 2019, and interim periods therein; (2) public NFP entities (that have not issued or made financial statements available for issuance as of June 3, 2020) for fiscal years beginning after December 15, 2019, and interim periods therein; and (3) all other entities for fiscal years beginning after December 15, 2021, and interim periods beginning after December 15, 2022. Early adoption is permitted.

All entities should consistently apply the transition method elected for ASU 2016-01 and its subsequent amendments when adopting the guidance in this ASU.
16.5 Transition Relief

Under ASC 842's modified transition approach, an entity must apply the standard as of the earliest period presented (or as of the effective date if the Comparatives Under 840 Option is elected). In addition, the standard contains practical expedients that an entity may elect when adopting the standard as well as other transition guidance intended to make adoption easier. For example, the so-called run-off approach described in the Background Information and Basis for Conclusions of ASU 2016-02 was meant to make the transition from providing ASC 840 disclosures to recognizing a lease under ASC 842 less cumbersome. Specifically, paragraph BC390 of ASU 2016-02 states:

The practical effect of the modified retrospective transition method, particularly when combined with the practical expedients that are offered, is that an entity will “run off” those leases existing at the beginning of the earliest comparative period presented in accordance with previous GAAP with the exception that, for operating leases, a lessee will present a lease liability in the statement of financial position at each reporting date equal to the present value of the remaining minimum rental payments (as that term was applied in previous GAAP) and a right-of-use asset that is derived from the lease liability in the manner described in paragraph 842-20-35-3. Entities will, in effect, “run off” existing leases, as described, unless the lease is either modified (and that modification is not accounted for as a separate contract) or, for lessees only, the lease liability is remeasured in accordance with the subsequent measurement guidance in [ASC 842-30] on or after the effective date.

In theory, a lessee should be able to measure its lease obligations on the basis of the amounts disclosed in its future minimum rental payments table under ASC 840 (see Q&A 16-1 for additional discussion). Similarly, a lessor should be able to run off its existing leases by using its ASC 840 allocation to income streams deemed within the scope of the leasing standard. The transition relief of the run-off approach for preparers is premised on the fact that the entity prepared its previous ASC 840 disclosures completely and accurately.

16.5.1 Hindsight Practical Expedient

As noted above, as part of its transition to ASC 842, an entity may elect to use hindsight “in determining the lease term . . . and in assessing impairment” of ROU assets. The hindsight practical expedient does not need to be elected in conjunction with the practical expedient package (see Section 16.5.2).

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23 See footnote 13.
Q&A 16-7 Application of the Use-of-Hindsight Practical Expedient

Paragraph BC394 of ASU 2016-02 states, in part:

> [T]he Board considered that a similar practical expedient related to the use of hindsight in determining the transaction price (that is, estimating variable consideration) was provided in the transition requirements in Topic 606. Similar to the rationale for that expedient, the Board decided that reflecting expectations that an entity knows at the time of reporting are incorrect does not provide useful information to users. In the context of this practical expedient, the Board considered that it would generally not provide useful information to recognize a lease liability on the basis of a lease term that assumes the entity is reasonably certain to exercise an option to extend the lease when at the time of reporting the entity knows that it did not exercise that option.

While an entity does not need to use hindsight, the FASB contends that using hindsight in transition results in better information for users.

**Question 1**

When applying the use-of-hindsight practical expedient, should an entity consider only discrete events (e.g., the lessee’s renewal of the lease) that occurred between the original lease commencement date and the date of adoption?

**Answer**

No. In addition to discrete events, an entity that applies the use-of-hindsight practical expedient should consider changes in facts and circumstances from commencement through the effective date of ASC 842 when determining the lease term and assessing the impairment of the ROU asset. For example, in addition to known events, such as the lessee’s exercise of renewal options, an entity should consider other events and changes, as discussed in ASC 842-10-55-26 (e.g., a strategic shift in business, changes in market rentals, evolution of the industry as a whole), that may affect whether it is reasonably certain that the lessee will exercise (or not exercise) any remaining renewal options.

The response to this question was informally discussed with the FASB staff, which agreed with the overall conclusion reached.

**Question 2**

To which date does the hindsight assessment extend when an entity applies the use-of-hindsight practical expedient?
Answer

When performing its hindsight assessment, an entity must consider events and circumstances that occurred up to the effective date of ASC 842.

Example

In 2003, Company A entered into a 15-year lease of a store that included three 5-year renewal options. None of the renewals were deemed reasonably assured to be exercised at inception. On January 1, 2019, when A adopts ASC 842, it elects to apply the use-of-hindsight practical expedient. Since the execution of the lease, the following events occurred:

- On November 9, 2017, A exercised the first of the three 5-year renewal options.
- During 2018, the market rent in the area had increased to a point such that A’s rent is now significantly discounted.
- On January 15, 2019, A’s CEO decided on a strategic shift in business such that the company would exit brick-and-mortar retail and move to online only.

When applying hindsight in determining the lease term, A should consider the events that occurred up to the effective date of ASC 842. Therefore, since A adopted ASU 2016-02 as of January 1, 2019, A should consider (1) that it exercised the first renewal option in 2017 and (2) the effect of the significant increase in market rent in 2018 in its assessment of whether it would exercise additional renewal options. Company A should not consider its decision to exit brick-and-mortar retail when evaluating the lease term, since this event occurred after the effective date of ASC 842.

16.5.1.1 Impact of Hindsight on the Lease Term

The use of hindsight in transition may affect the lease term (see Chapter 5 for a discussion of lease term). If the practical expedient package described in Section 16.5.2 is not elected, the impact of the hindsight practical expedient on lease term could affect lease classification (e.g., a renewal option that is assumed to be exercised results in a longer lease term and therefore higher lease payments, both of which increase the likelihood that a lease is a finance lease or sales-type lease). Regardless of whether lease classification is affected, an entity’s application of hindsight in establishing the lease term may affect the initial measurement of a lease. Any change in the lease term as a result of applying the use-of-hindsight practical expedient should be reflected in the measurement of the related lease assets and lease liabilities (i.e., any lease assets or liabilities should be adjusted as if the lease term determined by using hindsight had always applied). For example, when operating lease payments are not even throughout the lease term, the application of a different lease term would have changed the cumulative straight-line income or expense recognized as of the date of initial application of ASC 842. This cumulative difference should be reflected in the lease assets and liabilities as of the date of initial application of ASC 842, with a corresponding cumulative-effect adjustment to equity. This is consistent with the overall objective of the use-of-hindsight practical expedient, which, as described in paragraph BC394 of ASU 2016-02, is to provide “more accurate, updated information to users.”
Example 16-5

Retailer, a calendar-year-end PBE, enters into a 10-year operating lease of retail space on January 1, 2014. Annual lease payments are $50,000 for the first five years and $60,000 for the next five years. Retailer has a five-year renewal option for $70,000 per year, for which exercise is not reasonably assured as of lease inception. Therefore, as of the adoption date of ASC 842 on January 1, 2019, Retailer has recorded cumulative straight-line lease expense of $275,000 and has a deferred rent balance of $25,000.

Retailer elects the Comparatives Under 840 Option and the use-of-hindsight practical expedient. Because significant leasehold improvements have been installed in 2018, Retailer concludes that exercise of the renewal option is reasonably certain as of January 1, 2019. Accordingly, Retailer recalculates the deferred rent balance as if the lease term had always been 15 years. Since the cumulative straight-line lease expense would have been $300,000 instead of $275,000, Retailer increases the deferred rent balance in transition from $25,000 to $50,000 (which is then subtracted from the opening ROU asset balance), with a corresponding debit to equity.

Q&A 16-7A Impact of Hindsight on Lease Classification

Question
If an entity elects both the use-of-hindsight practical expedient and the “package of three” practical expedients, is the entity required or permitted to reassess lease classification when the lease term changes as a result of applying the use-of-hindsight practical expedient?

Answer
No. We believe that the “package of three” practical expedients has priority over the use-of-hindsight practical expedient with respect to lease classification. Because one of the practical expedients in the “package of three” allows an entity not to reassess lease classification for existing leases, a change in the lease term resulting from the use-of-hindsight practical expedient would not override the entity’s election not to reassess lease classification. However, as stated above, if an entity does not elect the “package of three” practical expedients, a change in the lease term resulting from the use-of-hindsight practical expedient could affect the lease classification.

Connecting the Dots — Hindsight May Increase Complexity
While the election of hindsight may result in a more accurate reflection of the measurement of ROU assets and liabilities in transition, it creates complexity for lessors or lessees. The modified retrospective approach, in combination with the practical expedient package, gives entities the opportunity to apply the existing ASC 840 accounting and disclosure requirements during the transition period (provided that the entity does not elect the Comparatives Under 840 Option, which would eliminate the transition period). For example, a lessee can use the original assumptions for operating leases for its existing ASC 840 disclosures and to capitalize the present value of those minimum rental payments. Because hindsight directly affects the lease term, the inclusion of additional periods in the lease term may affect straight-line rent calculations for lessors and lessees as well as the measurement of lease liabilities.
16.5.1.2 The Impact of Hindsight on Impairment

ASC 842 indicates that, if hindsight is elected in transition, the impairment of an ROU asset by a lessee may be affected. However, as discussed in Q&As 16-4 and 16-4A, an ROU asset does not generally need to be tested for impairment during the transition period, given the interaction with ASC 360 and feedback from the FASB staff. Therefore, we generally believe that the use of hindsight in the assessment of impairment will not affect the measurement of an ROU asset in transition, except when (1) an entity does not elect the Comparatives Under 840 Option, (2) a hidden impairment exists within an asset group that includes an ROU asset (as discussed in Q&A 16-4A), and (3) the impairment event arose during the comparative periods.

16.5.2 Practical Expedient Package

<table>
<thead>
<tr>
<th>ASC 842-10</th>
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</table>

65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

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 (for example, 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 . . .

An entity has the option of electing the practical expedient package in transition, provided that it elects all of them and applies them consistently to all of its leases.

16.5.2.1 Whether a Contract Is or Contains a Lease

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
</table>

65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

f. An entity may elect the following practical expedients . . .

1. An entity need not reassess whether any expired or existing contracts are or contain leases. . . .

An entity that elects this practical expedient would not revisit whether a contract is or contains a lease under the ASC 842 definition of a lease. In other words, if an entity appropriately determines whether a contract is or contains a lease under ASC 840 before the effective date of ASC 842, the entity would not reevaluate that conclusion (i.e., the entity would carry forward the conclusions reached under ASC 840 even though it may reach a different conclusion under ASC 842). After the effective date of ASC 842, if there is a substantive change to the terms and conditions of a contract, the entity should reassess whether the contract is or contains a lease under ASC 842. See Q&A 8-15AA for additional discussion.
Changing Lanes — Definition of a Lease
The definition of a lease under ASC 842 is broadly similar to that under ASC 840; however, there are differences that can affect the determination of whether a lease exists. For example, under ASC 840, a lease can exist if it is remote that more than a minor amount of the output or other utility of PP&E will be received by a party other than the reporting entity. Under ASC 842, that condition alone would not cause a contract to contain a lease. Rather, in addition to receiving substantially all of the output (benefits), a reporting entity must have the power over HAFWP the asset is used. Therefore, in some instances, a contract containing a lease under ASC 840 will not contain a lease under ASC 842. The inverse is less likely (i.e., a contract that does not meet the definition of a lease under ASC 840 but does meet the definition under ASC 842). See Chapter 3 for more information on how to identify a lease within the definition of ASC 842, including a description of the changes from ASC 840.

Connecting the Dots — Identification Errors May Not Be Carried Forward
In applying the practical expedient in ASC 842-10-65-1(f)(1), entities may not carry forward any previous “errors” (i.e., incomplete identification of leases). In certain circumstances, for example, an entity may not have previously identified contracts that met the definition of a lease under ASC 840. This lack of identification may not have had a material impact on the entity’s financial statements because the resulting accounting may have had a similar impact on profit or loss (e.g., an executory contract and an operating lease may have had similar profit and loss profiles). Similarly, lessors may not have properly identified which income streams are within the scope of ASC 840 and which are within the scope of the revenue recognition guidance in ASC 605. This failure to identify the scope of the contracts may not have had a material impact on the financial statements of an entity under ASC 840 because the resulting accounting would have a similar impact on profit or loss. However, because ASC 842 prescribes on-balance-sheet treatment for most leases, the accounting related to properly identifying all leases may materially affect the entity’s financial statements under ASC 842. Similarly, it will be important for a lessor to identify contracts that contain leases because of differences between ASC 842 and ASC 606 regarding classification, recognition, subsequent measurement, and disclosures.

An entity that applies the practical expedient in ASC 842-10-65-1(f)(1) should ensure that its identification of leases under ASC 840 was complete and accurate.

Q&A 16-8 Whether Arrangements Entered Into Before May 28, 2003, Are Accounted for as Leases
EITF Issue 01-8 (codified in ASC 840) was updated in 2003 and defined the scope of contracts (or parts of contracts) that should be accounted for as leases. EITF Issue 01-8 indicated that it only applied to “(a) arrangements agreed to or committed to, [footnote omitted] if earlier, after the beginning of an entity’s next reporting period beginning after May 28, 2003, (b) arrangements modified after the beginning of an entity’s next reporting period beginning after May 28, 2003, and (c) arrangements acquired in business combinations initiated after the beginning of an entity’s next reporting period beginning after May 28, 2003.” Therefore, there are contracts that otherwise would have been considered leases in accordance with the definition in EITF Issue 01-8 (as codified in ASC 840) but were previously not accounted for as leases because they did not meet the effective-date criteria in (a)–(c) above.
**Question**

If an entity elects the practical expedient package, would a contract that was not previously accounted for as a lease because of the above effective dates (but that otherwise meets the definition of a lease in accordance with ASC 840) need to be considered a lease in the transition to ASC 842?

**Answer**

No. Contracts that qualified for exclusion from the scope of ASC 840 would not be considered leases in the transition to ASC 842. Since the practical expedient applies, an entity is not required to change any of its conclusions that it appropriately reached under ASC 840.

16.5.2.2 **Lease Classification**

By electing the above practical expedient, an entity can retain its classification conclusion under ASC 840. In other words, a lease that was deemed an operating lease under ASC 840 will be an operating lease in the transition to ASC 842 (conversely, a lease that was deemed a capital lease under ASC 840 will be a finance lease). This practical expedient applies to all comparative periods presented, if applicable. On or after the effective date, the previous lease classification is retained (and not reassessed) unless the contract is modified or a reassessment event described in ASC 842-10-25-1 takes place.

**Q&A 16-9 Impact on Electing the Practical Expedient Package on Separating Land From Building**

Under ASC 840, in classifying a lease involving both land and a building, an entity is required to assess the land separately from the building when (1) the lease meets either the transfer-of-ownership or the bargain-purchase-option classification criteria or (2) the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception. Under ASC 842, as discussed in Section 4.2.2, land must be accounted for as a separate lease component (regardless of its relative fair value) unless the accounting effect of doing so would be insignificant.

**Question**

Does an entity that elects the practical expedient package need to separately assess lease classification for the land in transition to ASC 842 if it was considered part of a single lease component with a building under ASC 840?
**Answer**

No. An entity should not assess lease classification for the land separately upon adopting ASC 842. Rather, the practical expedient package applies to all lease classification determinations appropriately made in accordance with ASC 840.

**Changing Lanes — Classification Under ASC 842 May Differ From That Under ASC 840**

The impact of this practical expedient will depend on whether an entity's policies for lease classification under ASC 842 differ from those under ASC 840. The terminology in two of the lease criteria is more principles-based under ASC 842. Specifically, in ASC 842, the FASB substituted the terms (1) “major part” for the 75 percent bright line related to the length of the lease term and (2) “substantially all” for the 90 percent bright line related to the present value of lease payments. However, the Board acknowledged that an entity may use those bright lines to apply the principles. Further, while the lease classification assessment under ASC 842 is performed as of lease commencement, ASC 840 requires entities to determine classification as of lease inception. See Chapters 8 and 9 for more information on how lessees and lessors, respectively, classify a lease under ASC 842, including a description of the changes from ASC 840.

**Connecting the Dots — Classification Errors May Not Be Carried Forward**

In applying the practical expedient in ASC 842-10-65-1(f)(2), an entity may not carry forward any previous “errors” (i.e., incorrect lease classification).

An entity that applies the practical expedient in ASC 842-10-65-1(f)(2) should ensure that its classification of leases under ASC 840 was accurate.

**Q&A 16-10 Inception Date Before Effective Date but Commencement Date After Effective Date**

If an entity elects the practical expedient package and therefore retains its ASC 840 lease classification conclusions up to ASC 842’s effective date, the entity must determine the appropriate cutoff for contracts that are within the scope of the ASC 840 classification.

**Question**

For an entity that elects the practical expedient package, if the inception date of a lease contract (i.e., the date the contract is executed) precedes the effective date of ASC 842 but the commencement date of the lease is on or after the effective date of ASC 842, should the entity carry forward its classification conclusion under ASC 840 or apply the ASC 842 classification criteria as of the commencement date?

**Answer**

The entity should apply ASC 842 as of the commencement date. In accordance with ASC 842-10-65-1(f), the practical expedient package applies to “leases that commenced before the effective date.” Therefore, while an entity may have evaluated classification at the inception of the lease agreement under ASC 840, such considerations should be disregarded even if the practical expedient is elected.

24 Although this Q&A specifically addresses classification, we believe that the same conclusion would apply to the entire practical expedient package. For example, an entity that has elected the practical expedient package should reassess whether a contract is or contains a lease (under the ASC 842 definition of a lease) if the lease commencement date would be on or after the effective date of ASC 842.
Connecting the Dots — Impact of Hindsight on Lease Classification Considerations

The application (or lack thereof) of hindsight has no impact on the lease classification considerations when the practical expedient package is also elected. However, hindsight would affect measurement for lessees and lessors in situations in which the exercise (or nonexercise) of options that existed in the original contracts became reasonably certain before the effective date.

Q&A 16-11  Classification Date When Practical Expedient Package Is Not Elected

Question

Upon transition to ASC 842, if a lease commenced before the date of initial application and an entity did not elect the practical expedient package, what date should the entity use to determine lease classification as of the date of initial application?

Answer

In such cases, the lease should be classified in accordance with the ASC 842 lease classification criteria and facts and circumstances as of the later of the (1) lease commencement date or (2) date the lease was last modified in accordance with ASC 840. If a lease was renewed or extended before the date of initial application, the renewal or extension date would be considered the lease commencement date for this purpose unless the renewal was assumed to be reasonably certain as of the initial lease commencement date.

Example

Entity A, a public calendar-year-end entity, enters into a lease agreement and obtains the right to use an office building on June 1, 2013. On June 1, 2016, A and the lessor modify the terms of the lease to reduce the leased space and increase the lease payments on the remaining space to reflect current market rates. The change to the terms represents a modification in accordance with ASC 840-10-35-4. As a public calendar-year-end entity that did not elect the practical expedient package, A must determine the appropriate classification of the lease as of the date of initial application. Because the lease was modified after lease commencement, the lease classification assessment is performed under ASC 842 as of June 1, 2016 (the ASC 840 modification date).

The Q&A above addresses the date as of which to assess lease classification and what inputs should be used as of the assessment date. The inputs used (e.g., lease payments and discount rate) as of the classification date would not be the same for measurement of the lease. For example, for an operating lease that commenced before the date of initial application, an entity should measure the lease obligation and ROU asset by using the remaining lease payments and discount rate that existed as of the date of initial application.
16.5.2.3 **Initial Direct Costs**

This practical expedient permits a company to carry forward previously capitalized initial direct costs under ASC 840, which would be included in the ROU asset. ASC 842 narrows the definition of initial direct costs as follows:

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

See Section 6.11 for more information on the scope of and accounting for initial direct costs.

16.5.3 **Land Easements**

The FASB received a significant amount of feedback from stakeholders in several industries who were concerned about the cost and complexity of evaluating all existing land easements under ASC 842’s definition of a lease at transition. The Board observed that the costs of requiring an entity to evaluate all existing land easements under ASC 842’s definition of a lease outweighed the benefits to financial statement users. Accordingly, the FASB provided transition relief in the form of a practical expedient (see Section 2.4).

An entity that elects the expedient is relieved from applying ASC 842 to evaluate all existing land easements that were not previously accounted for in accordance with ASC 840. The FASB explains in paragraph BC15 of ASU 2018-01 that the historical accounting treatment for existing land easements — when the expedient is elected — would be “run off” unless or until the arrangement is modified on or after the date the entity adopts ASU 2016-02.
The transition practical expedient for existing land easements may be elected alone or with any of the other transition practical expedients. In a manner consistent with the other transition practical expedients, entities must disclose whether they are electing the transition practical expedient for land easements.

The effective date of ASU 2018-01 is aligned with that of ASU 2016-02.

16.6 Illustrative Examples — Transition Approaches

In summary, there are several potential transition approaches an entity may select, some of which will affect lease classification:

<table>
<thead>
<tr>
<th>Practical Expedient Package</th>
<th>Hindsight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approach A</td>
<td>Yes</td>
</tr>
<tr>
<td>Approach B</td>
<td>Yes</td>
</tr>
<tr>
<td>Approach C</td>
<td>No</td>
</tr>
<tr>
<td>Approach D</td>
<td>No</td>
</tr>
</tbody>
</table>

As discussed above, hindsight does not affect lease classification, when the practical expedient package is also elected, but may have an impact on lease measurement in transition. The examples below illustrate the potential impact of these approaches on sample leases. These examples should be read in conjunction with the guidance above and the “Modification and Reassessment of Lease Liability” discussion in Section 16.3.1. In all examples, assume that the entity is a calendar-year-end public entity; the entity’s adoption date is January 1, 2019; the entity did not elect the Comparatives Under 840 Option; and the entity’s earliest comparative period presented is January 1, 2017.

Lease A

<table>
<thead>
<tr>
<th>Lessee or Lessor?</th>
<th>Lessee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease Inception:</td>
<td>February 10, 2015</td>
</tr>
<tr>
<td>Lease Commencement:</td>
<td>February 14, 2015</td>
</tr>
<tr>
<td>Original Lease Term:</td>
<td>10 years</td>
</tr>
<tr>
<td><strong>ASC 840 Lease Classification:</strong></td>
<td>Operating</td>
</tr>
<tr>
<td>Other Terms:</td>
<td>No renewal options or purchase options</td>
</tr>
<tr>
<td>Approaches A and B</td>
<td>Retain the operating lease classification upon transition, because the practical expedient package was elected. The election of hindsight has no impact on lease term because there are no renewal options to consider.</td>
</tr>
<tr>
<td>Approaches C and D</td>
<td>Assess lease classification under ASC 842 as of the commencement date of the lease (i.e., February 14, 2015). The election of hindsight has no impact on lease term because there are no renewal options to consider.</td>
</tr>
</tbody>
</table>
### Lease B

**Lessee or Lessor? Lessee**

*Lease Inception:* February 10, 2015  
*Lease Commencement:* February 14, 2015  
*Lease Term:* Three years, exercise of renewal option not reasonably assured as of lease inception  
*ASC 840 Lease Classification:* Operating  
*Other Terms:* One two-year renewal option, no purchase option; renewal option was exercised in 2018  
*Previous ASC 840 Considerations:* Upon renewal, the lease was also classified as an operating lease under ASC 840

<table>
<thead>
<tr>
<th>Approach</th>
<th>Transition Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Approach A</strong></td>
<td>Retain the operating lease classifications in all periods presented, because the practical expedient package was elected. For measurement purposes, since hindsight was elected, the renewal exercised in 2018 would be included retrospectively, as if its exercise were reasonably certain, in the measurement of the lease as of the earliest period presented.</td>
</tr>
<tr>
<td><strong>Approach B</strong></td>
<td>Retain the operating lease classifications in all periods presented, because the practical expedient package was elected. Do not alter ASC 840 accounting performed in 2018 other than to increase the lease liability and the ROU asset (because the renewal option is exercised).</td>
</tr>
<tr>
<td><strong>Approach C</strong></td>
<td>Assess lease classification under ASC 842 as of the commencement date (i.e., February 14, 2015). Since hindsight is elected, the exercised renewal would affect lease term for both the ASC 842 classification test and the measurement of the lease as of the earliest period presented.</td>
</tr>
<tr>
<td><strong>Approach D</strong></td>
<td>Assess lease classification under ASC 842 as of the commencement date (i.e., February 14, 2015). Since hindsight was not elected, the exercised renewal would not affect the original lease term as of lease commencement for the ASC 842 classification test. If lease classification did not change upon the adoption of ASC 842, do not alter ASC 840 accounting performed in 2018 other than to increase the lease liability and the ROU asset (because the renewal option is exercised). However, if the lessee concludes that the lease is a finance lease upon adopting ASC 842 (i.e., classification changed), all of the reassessment and subsequent-measurement guidance in ASC 842 should be applied during the comparative periods.</td>
</tr>
</tbody>
</table>

See “Modifications and Reassessment of Lease Liability” in Section 16.3.1 for more information.
### Lease C

<table>
<thead>
<tr>
<th>Lessee or Lessor? Lessee</th>
<th><strong>Transition Impact</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lease Inception:</strong> February 10, 2015</td>
<td></td>
</tr>
<tr>
<td><strong>Lease Commencement:</strong> February 14, 2015</td>
<td></td>
</tr>
<tr>
<td><strong>Lease Term:</strong> 8 years</td>
<td></td>
</tr>
<tr>
<td><strong>ASC 840 Lease Classification:</strong> Capital</td>
<td></td>
</tr>
<tr>
<td><strong>Other Information:</strong> The lessee and lessor modified the terms of the contract so that the lessee would pay less rent over the remaining lease term on August 6, 2017</td>
<td></td>
</tr>
<tr>
<td><strong>Previous ASC 840 Considerations:</strong> Modification would have changed classification if the terms were in effect as of the original lease inception; new contract was deemed an operating lease as of August 6, 2017</td>
<td></td>
</tr>
<tr>
<td><strong>Approaches A and B</strong></td>
<td>Because the practical expedient package was elected, ASC 840 accounting should be retained in the comparative periods. Therefore, the lessee should retain finance (capital) lease classification as of the earliest comparative period through the date of modification and retain operating lease classification as of the modification date for the new lease contract. Further, hindsight does not affect this fact pattern because the modification only affected the amount the lessee would pay, which had no effect on the lease term. In addition, a modification should never result in an adjustment to the lease balances in transition before the modification date.</td>
</tr>
</tbody>
</table>
Lease C

Approaches C and D

Assess lease classification under ASC 842 as of the commencement date (i.e., February 14, 2015). The transition guidance is not clear on situations in which the practical expedient package is not elected and a modification occurs during the transition period. In accordance with the principles discussed in Section 16.3.1, when lease classification does not change upon the adoption of ASC 842, the ASC 840 subsequent-measurement guidance would be applied until the effective date (i.e., January 1, 2019). However, this principle appears incompatible with Approach C and D, because the practical expedient package was not elected. That is, for a modification date of August 6, 2017, an entity is required to perform an additional lease classification determination under ASC 842. We believe that there may be multiple acceptable approaches to analyzing this lease, including applying the ASC 842 modification and reassessment guidance entirely under ASC 842 or a mixed model that takes into account relevant concepts from both ASC 840 and ASC 842.

If the lessee concludes that the lease is an operating lease at lease commencement upon adopting ASC 842 (i.e., classification changed), all of the ASC 842 reassessment and subsequent-measurement guidance should be applied during the comparative periods (see Section 16.3.2.2).

Hindsight does not affect this fact pattern because the modification only affected the amount the lessee would pay, which had no effect on the lease term. In addition, a modification should never result in an adjustment to the lease balances in transition before the modification date.
### Lease D

<table>
<thead>
<tr>
<th>Lessee or Lessor?</th>
<th>Lessor</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lease Inception:</strong></td>
<td>August 9, 2006</td>
</tr>
<tr>
<td><strong>Lease Commencement:</strong></td>
<td>September 2, 2006</td>
</tr>
<tr>
<td><strong>Lease Term:</strong></td>
<td>12 years</td>
</tr>
<tr>
<td><strong>ASC 840 Lease Classification:</strong></td>
<td>Operating</td>
</tr>
<tr>
<td><strong>Other Terms:</strong></td>
<td>The lessor and lessee modified the terms of the contract for the lessee to extend the lease for an additional five years on June 6, 2016</td>
</tr>
<tr>
<td><strong>Previous ASC 840 Considerations:</strong></td>
<td>Modification changed classification to a sales-type lease as of the modification date</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Approaches A and B</th>
<th>Since the practical expedient package was elected (and the classification changed before the earliest comparative period presented), sales-type lease classification would be retained upon adopting ASC 842. In addition, since the extension occurred before the earliest period presented and there are no lessee-controlled options after the earliest period presented, the application of hindsight would not have any impact on lease term at adoption.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Approach C</strong></td>
<td>Assess lease classification under ASC 842 as of the modification date (i.e., June 6, 2016). In addition, since the extension occurred before the earliest period presented and there are no lessee-controlled options after the earliest period presented, the application of hindsight would not have any impact on lease term at adoption.</td>
</tr>
<tr>
<td><strong>Approach D</strong></td>
<td>Assess lease classification under ASC 842 as of the modification date (i.e., June 6, 2016).</td>
</tr>
</tbody>
</table>
### Lease E

<table>
<thead>
<tr>
<th><strong>Lessee or Lessor?</strong></th>
<th>Lessor</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lease Inception:</strong></td>
<td>August 9, 2006</td>
</tr>
<tr>
<td><strong>Lease Commencement:</strong></td>
<td>September 2, 2006</td>
</tr>
<tr>
<td><strong>Lease Term:</strong></td>
<td>12 years</td>
</tr>
<tr>
<td><strong>ASC 840 Lease Classification:</strong></td>
<td>Operating</td>
</tr>
</tbody>
</table>

**Other Terms:** The lessor and lessee modified the terms of the contract for the lessee to extend the lease for an additional five years on June 6, 2018

**Previous ASC 840 Considerations:** Modification changed classification to a sales-type lease as of the modification date

<table>
<thead>
<tr>
<th><strong>Transition Impact</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Approach A</strong></td>
</tr>
<tr>
<td>Since the practical expedient package was elected, the lessor would not change lease classification upon adopting ASC 842 (i.e., the lease would be an operating lease as of the earliest period presented and the ASC 840 modification guidance would apply to the modification to a sales-type lease). In addition, although hindsight was elected, since the extension was the result of a mutual negotiation to modify and extend the lease (rather than a lessee-controlled option to extend), the application of hindsight would not have any impact on lease term.</td>
</tr>
</tbody>
</table>

| **Approach B** |
| Since the practical expedient package was elected, the lessor would not change lease classification upon adopting ASC 842 (i.e., the lease would be an operating lease as of the earliest period presented and the ASC 840 modification guidance would apply to the modification to a sales-type lease). |

| **Approaches C and D** |
| Assess lease classification under ASC 842 as of lease commencement (i.e., September 2, 2006). In addition, even if hindsight was elected under Approach C, since the extension was the result of a mutual negotiation to modify and extend the lease (rather than a lessee-controlled option to extend), the application of hindsight would not have any impact on lease term. |

If lease classification did not change upon the adoption of ASC 842, the ASC 840 modification and subsequent-measurement guidance should be applied (including the guidance on the assessment, classification and measurement of the lease on June 6, 2018, the date of the extension).

If lease classification changed upon the adoption of ASC 842, all of the modification and subsequent-measurement guidance in ASC 842 should be applied during the comparative periods.
<table>
<thead>
<tr>
<th>Lease F</th>
<th>Transition Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lessee or Lessor? Lessee</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Lease Inception:</strong> July 10, 2010</td>
<td></td>
</tr>
<tr>
<td><strong>Lease Commencement:</strong> July 13, 2010</td>
<td></td>
</tr>
<tr>
<td><strong>Lease Term:</strong> 10 years; the lessee has a 5-year renewal option for which exercise was determined not to be reasonably assured as of the inception date</td>
<td></td>
</tr>
<tr>
<td><strong>ASC 840 Lease Classification:</strong> Operating</td>
<td></td>
</tr>
<tr>
<td><strong>Other Information:</strong> On September 15, 2018, the lessee installs and pays for tenant improvements with a useful life that extends through 2025. The tenant improvements would be costly to remove and, at that time, it is reasonably assured that the lessee will exercise the renewal option.</td>
<td></td>
</tr>
<tr>
<td><strong>Previous ASC 840 Considerations:</strong> There are no changes to the lease as a result of the exercise of the renewal option becoming reasonably assured. That is, there are no reassessment requirements in ASC 840 other than modifications, extensions, or renewals.</td>
<td></td>
</tr>
<tr>
<td><strong>Approach A</strong></td>
<td>Retain the operating lease classification in all periods presented because the practical expedient package was elected. We believe that, under this approach, lease classification would not need to be reassessed as of the effective date despite the change in facts and circumstances before this date. However, for measurement purposes, since hindsight was elected, the renewal would be included retrospectively as if its exercise were reasonably certain in the measurement of the lease as of the earliest period presented.</td>
</tr>
<tr>
<td><strong>Approach B</strong></td>
<td>Since the practical expedient package was elected, the operating lease classification should be retained during comparative periods. We believe that lease classification would not need to be reassessed as of the effective date despite the change in facts and circumstances before this date. In accordance with ASC 842-10-35-1, lease term is reassessed when an event “occurs.” However, because the lessee elected the practical expedient package and did not elect hindsight, we do not believe that the lessee should consider events that occurred before the effective date but did not result in a modification under ASC 840.</td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>Lease F</th>
<th>Transition Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Approach C</strong></td>
<td>Assess lease classification under ASC 842 as of the commencement date (i.e., July 13, 2010). Since hindsight is elected, the change in facts and circumstances regarding the renewal would affect the lease term for both the ASC 842 classification test and the measurement of the lease as of the earliest period presented. If lease classification did not change upon the adoption of ASC 842, the ASC 840 subsequent-measurement guidance should be applied until the effective date (i.e., January 1, 2019). However, if the lessee concludes that the lease is a finance lease at lease commencement upon adopting ASC 842 (i.e., classification did change), all of the reassessment and subsequent-measurement guidance in ASC 842 should be applied during the comparative periods. Therefore, in accordance with ASC 842-10-35-1, lease term is reassessed as of September 15, 2018, because an event occurred (installing leasehold improvements) for which reassessment was required under ASC 842 and that was controlled by the lessee.</td>
</tr>
<tr>
<td><strong>Approach D</strong></td>
<td>Assess lease classification as of the commencement date (i.e., July 13, 2010). If lease classification did not change upon the adoption of ASC 842, the ASC 840 subsequent-measurement guidance should be applied until the effective date (i.e., January 1, 2019). However, if the lessee concludes that the lease is a finance lease at lease commencement upon adopting ASC 842 (i.e., classification did change), all of the reassessment and subsequent-measurement guidance in ASC 842 should be applied during the comparative periods. Therefore, in accordance with ASC 842-10-35-1, lease term is reassessed as of September 15, 2018, because an event occurred (installing leasehold improvements) for which reassessment was required under ASC 842 and that was controlled by the lessee.</td>
</tr>
</tbody>
</table>

16.7 Separation and Allocation of Consideration to Components in a Contract in Transition

16.7.1 Separation of Lease and Nonlease Components for Lessors Upon Adoption of ASC 606

As stated in ASC 606-10-15-2, the revenue standard does not apply to lease contracts within the scope of ASC 840 (or ASC 842, upon adoption of the new leasing standard). Although lease contracts are generally outside the scope of the revenue standard, ASC 606-10-15-4 states that a “contract with a customer may be partially within the scope of this Topic [ASC 606] and partially within the scope of other Topics listed in paragraph 606-10-15-2.” An example of a contract that may be partially within the scope of ASC 606 and partially within the scope of another ASC topic is a lease contract entered into by a lessor that contains both lease and service elements.²⁵

²⁵ Note that this would not apply to lessees because a lessee does not perform services or generate revenue under a lease contract.
Under ASC 840, the scope guidance in ASC 840-10-15-19 states the following (pending content effective upon adoption of ASC 606 {in braces}):

For purposes of applying this Topic, payments and other consideration called for by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into:

a. Those for the lease, **including the related executory costs and profits thereon**

b. Those for other services on a relative fair value basis (relative standalone selling price basis), consistent with the guidance in paragraph 605-25-15-3A(b) (paragraph 606-10-15-4 and paragraphs 606-10-32-28 through 32-41). [Emphasis added]

ASC 840 further states that executory costs (such as a lessor’s property taxes, insurance, and maintenance) are excluded from the lessor’s minimum lease payments for purposes of lease classification and measurement. Although these costs are excluded from the lessor’s minimum lease payments, the costs are generally still considered part of the lease contract in accordance with ASC 840-10-15-19(a) rather than “other services” or substantial services\(^2\) that are separated and excluded from the scope of ASC 840 and therefore typically within the scope of revenue recognition guidance (historically, under ASC 605 or industry guidance). That is, executory costs are generally not separately accounted for under the legacy revenue recognition guidance in ASC 605.

In addition, ASC 605-25-55-3 contains the following example clarifying when to apply the allocation guidance in ASC 605 and that in ASC 840:

For example, leased assets are required to be accounted for separately under the guidance in Subtopics 840-20 and 840-30. Consider an arrangement that includes the lease of equipment under an operating lease, the maintenance of the leased equipment throughout the lease term (executory cost), and the sale of additional equipment unrelated to the leased equipment. The arrangement consideration should be allocated between the deliverables subject to the guidance in Subtopic 840-20 and the other deliverables using the relative selling price method. (Although Topic 840 does not provide guidance regarding the accounting for executory costs, it does provide guidance regarding the allocation of arrangement consideration between the lease and the executory cost elements of an arrangement. Therefore, this example refers to the leased equipment and the related maintenance as deliverables subject to the guidance in Topic 840.) The guidance in Topic 840 would then be applied to separate the maintenance from the leased equipment and to allocate the related arrangement consideration to those two deliverables. This Subtopic would be applied to further separate any deliverables not subject to the guidance in Topic 840 and to allocate the related arrangement consideration.

In accordance with this illustrative example in ASC 605, deliverables within the scope of the leasing guidance (including both the leased asset and executory costs) would be within the scope of ASC 840 and subject to the allocation guidance in ASC 840. However, the separate deliverable of the sale of additional equipment would not be covered by ASC 840 and would instead be subject to the accounting and allocation guidance in ASC 605.

In contrast to this approach under ASC 840, upon adoption of the new leasing standard, a lessor will be required to separate lease and nonlease components in a contract (unless the scope criteria in ASC 842-10-15-42A are met and the lessor elects to use the practical expedient of combining lease and nonlease components, as discussed in Section 16.7.2). As illustrated above, a common example of a nonlease component under ASC 842 is maintenance services (commonly referred to as CAM services) performed by the lessor, which may be currently accounted for as an executory cost under ASC 840. That is, upon a lessor’s adoption of ASC 842, maintenance services will be considered a service within the scope of ASC 606 rather than an executory cost accounted for under lease accounting guidance.

\(^2\) “Substantial services” is a term used in EITF issue 01-8 to differentiate services not accounted for under lease accounting from executory costs accounted for under lease accounting. This distinction between maintenance services, which are executory costs that historically have been accounted for under ASC 840, and substantial services, which historically have been accounted for under ASC 605, was raised in EITF Issue 08-2 but was not further clarified.
Connecting the Dots — Questions About Effect of Interaction Between ASC 606 and ASC 842 on Accounting for Nonlease Components

Because the effective dates of ASC 606\(^{27}\) and ASC 842\(^{28}\) are not the same, questions have been raised about whether and, if so, when a lessor would be required to separate nonlease components currently accounted for as executory costs (e.g., CAM) and account for those activities as services within the scope of ASC 606. Specifically, stakeholders have questioned whether a lessor would be required to separately account for CAM under ASC 606 (1) upon the adoption of ASC 606, (2) upon the adoption of ASC 842, or (3) in some other manner.

After these questions were raised, we participated in informal meetings with both the FASB staff and the SEC staff to discuss the interaction between ASC 606 and ASC 842 and how adoption of the new revenue and new leasing standards will affect the accounting for nonlease components (e.g., CAM). On the basis of our discussions with both parties, our understanding is that a lessor would not be required, upon adoption of the new revenue standard, to separate existing executory costs accounted for under ASC 840 that will meet the definition of a nonlease component under ASC 842 (e.g., CAM) and account for those activities as services within the scope of ASC 606. However, we believe that while a lessor would not be required to separate nonlease components, it would be acceptable for a lessor to elect to separate nonlease components and account for them as revenue-generating activities upon adoption of ASC 606.

Upon adoption of ASC 842, a lessor’s accounting for executory costs in existing leases that historically have been accounted for under ASC 840 would depend on whether:

- The lessor elects the practical expedient in ASC 842-10-65-1(f) of not reassessing lease classification for existing leases at transition.
- The lessor does not elect the practical expedient in ASC 842-10-65-1(f), and the lessor’s lease classification changes.
- The lessor elects the practical expedient in ASC 842-10-15-42A of combining lease and nonlease components.

Accordingly, a lessor should consider the following scenarios:

- **Scenario 1: The lessor does not elect the practical expedient in ASC 842-10-65-1(f), and the lessor’s lease classification changes upon adoption of ASC 842 (excluding a change from sales-type to direct financing)** — If a lessor’s lease classification changes upon adoption of ASC 842, the lessor must apply the guidance in the new leasing standard on separating components of a contract as of the lessor’s date of initial application, which, depending on the transition method elected, could be either (1) the beginning of the earliest period presented under ASC 842 (e.g., January 1, 2017, for calendar-year-end public entities) or (2) the date of adoption (e.g., January 1, 2019, for calendar-year-end public entities) when the lessor uses the Comparatives Under 840 transition method. Accordingly, the lessor would be required to separate, and allocate consideration to, nonlease components (e.g., CAM services) unless the lessor elects the practical expedient in ASC 842-10-15-42A of combining lease and nonlease components. If the lessor either does not qualify for the practical expedient in ASC 842-10-15-42A or does not elect to use it, the nonlease components would be accounted for in accordance with the revenue recognition guidance in ASC 606.

\(^{27}\) For public companies, ASC 606 is effective for annual reporting periods beginning after December 15, 2017, and interim periods therein.

\(^{28}\) For public companies, ASC 842 is effective for annual reporting periods beginning after December 15, 2018, and interim periods therein (i.e., one year after the effective date of ASC 606).
Scenario 2: The lessor’s lease classification does not change upon adoption of ASC 842 because the lessor either (1) elects to apply the practical expedient in ASC 842-10-65-1(f) of not reassessing lease classification for existing leases at transition or (2) elects instead to reevaluate classification, but the lease classification does not change (or changes only from sales-type to direct financing) upon reassessment at transition — We believe that if a lessor’s lease classification does not change upon adoption of ASC 842 for either of the reasons stated above, the lessor’s accounting for executory costs in existing leases would depend on whether the lessor elects to use the practical expedient in ASC 842-10-15-42A of combining lease and nonlease components:

- Scenario 2(a): The lessor elects the practical expedient in ASC 842-10-15-42A of combining lease and nonlease components — In this scenario, any executory costs historically accounted for under ASC 840 should be combined with the lease and nonlease components and accounted for under either ASC 606 (if the nonlease component is the predominant component in the contract) or ASC 842 (if the nonlease component is not the predominant component in the contract).

- Scenario 2(b): The lessor does not elect the practical expedient in ASC 842-10-15-42A of combining lease and nonlease components — We believe that in this scenario, it is acceptable for a lessor to account for executory costs that transfer a good or service to the lessee, including CAM, either as (1) a nonlease component under ASC 606 (i.e., separately from the lease component) by aligning existing leases to the lessor’s policy election of separating nonlease components under ASC 842 or (2) part of the lease component under ASC 842 (i.e., as if the lessor were “running off” its existing leases in a manner consistent with its accounting treatment under ASC 840).

In contrast to the discussion above on executory costs (including maintenance services), an entity should account for “other services” or substantial services that are not within the scope of ASC 840 in accordance with the guidance in ASC 606 as of the effective date applicable to the entity.

### 16.7.2 Lessor Practical Expedient

<table>
<thead>
<tr>
<th>ASC 842-10</th>
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</thead>
</table>
| 15-42A As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not 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 component if the nonlease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers and both of the following are met:  
  a. The timing and pattern of transfer for the lease component and nonlease components associated with that lease component are the same.  
  b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3. |

In July 2018, the FASB issued ASU 2018-11, under which lessors may elect not to separate lease and nonlease components when certain conditions are met. A lessor may elect to combine lease and associated nonlease components provided that the nonlease component(s) would otherwise be accounted for under ASC 606 and both of the conditions in ASC 842-10-15-42A(a) and (b) ("Criterion A" and "Criterion B") are met. For further considerations related to these two criteria, see Section 4.3.3.2.1.
The ASU also clarifies that the presence of a nonlease component that is ineligible for the practical expedient does not preclude a lessor from electing the expedient for the lease component and nonlease component(s) that meet the criteria. Rather, the lessor would account for the nonlease components that do not qualify for the practical expedient separately from the combined lease and nonlease components that do qualify.

**Connecting the Dots — Assessing the Timing and Pattern of Transfer**

In ASU 2018-11, the Board amended Criterion A to focus on the timing and pattern of transfer (i.e., a “straight-line pattern of transfer . . . to the customer over the same time period”) rather than on the timing and pattern of revenue recognition (as was originally proposed). The purpose of this amendment was to address concerns that the originally proposed practical expedient was unnecessarily restrictive and excluded contracts with variable consideration from its scope, since variable payments are accounted for differently under ASC 606 than they are under ASC 842.

**16.7.2.1 Determining Which Component Is Predominant**

The FASB originally proposed that a lessor should always be required to account for the combined component as a lease under ASC 842 in a manner consistent with a similar practical expedient afforded to lessees. However, on the basis of feedback it received, the Board revised the final ASU to require an entity to perform another evaluation to determine whether the combined unit of account is accounted for as a lease under ASC 842 or as a revenue contract under ASC 606. Specifically, an entity should determine whether the nonlease component (or components) associated with the lease component is the predominant component of the combined component. If so, the entity is required to account for the combined component in accordance with ASC 606. Otherwise, the entity must account for the combined component as an operating lease in accordance with ASC 842.

**Connecting the Dots — An Entity Will Need to Use Judgment to Determine the Predominant Component**

As indicated in ASU 2018-11’s Background Information and Basis for Conclusions, the FASB decided not to include a separate definition or threshold for determining whether “the nonlease component is the predominant component of the combined component.” Rather, the Board indicates that a lessor should consider whether the lessee would “ascribe more value to the nonlease component(s) than to the lease component.” Further, the Board acknowledged that the term “predominant” is used elsewhere in U.S. GAAP, including ASC 842 and ASC 606.

The Board also explains that it does not expect that an entity will need to perform a quantitative analysis or allocation to determine whether the nonlease component is predominant. Rather, it is sufficient if an entity can reasonably determine whether to apply ASC 842 or ASC 606. Therefore, we expect that entities will need to use judgment in making this determination.

At its March 28, 2018, meeting, the Board discussed a scenario in which the components were evenly split (e.g., a 50/50 split of value) and suggested that, in such circumstances, the combined component should be accounted for under ASC 842 because the nonlease component is not predominant. That is, the entity would need to demonstrate that the predominant element is the nonlease component; otherwise, the combined unit of account would be accounted for as a lease under ASC 842.

We believe that the final language in ASU 2018-11 is intended to indicate that an entity would need to determine whether the lease or nonlease component (or components) is larger (i.e., has more value); only when the nonlease component is larger should the combined component be accounted for under ASC 606.
16.8 Build-to-Suit Transition

**ASC 842-10**

65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

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 (if an entity elects the transition method in (c)(1)) or that are existing at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)) 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 shall do the following:
   i. If an entity elects the transition method in (c)(1), the entity shall 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.
   ii. If an entity elects the transition method in (c)(2), the entity shall derecognize those assets and liabilities at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.
   iii. Any difference in (i) or (ii) shall be recorded as an adjustment to equity at the date that those assets and liabilities were derecognized in accordance with (u)(1)(i) or (ii).
   iv. 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 (if the entity elects the transition method in (c)(1)) or if it concluded before the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if the entity elects the transition method in (c)(2)), and the transaction qualified as a sale and leaseback transaction in accordance with Subtopic 840-40 before that date, the entity shall follow the general lessee transition requirements for the lease . . .

Under ASC 840, a lessee may have capitalized the construction cost of an asset under construction with an offsetting liability on the basis of an assessment of the involvement during construction, which is primarily based on the risks to which the lessee was exposed. In addition, if a lessee is deemed the owner of the construction project, it is required to assess whether a sale and leaseback is achieved, which often results in a failed sale and leaseback because of continuing involvement. ASC 842 significantly changes the assessment of whether a lessee is the accounting owner of the asset during construction, which is an assessment of control (see Chapter 11 for a general overview of these arrangements). As a result, it will be common for a lessee to be the deemed owner of the asset under ASC 840; however, the lessee may not be the deemed owner of an asset under ASC 842 because it does not meet ASC 842's concept of control. The general transition provisions indicate that a lessee that recognized an asset solely because it was the deemed owner under the ASC 840 build-to-suit guidance would derecognize the related assets and liabilities as of the later of the date of initial application or the date the lessee was determined to be the deemed owner.
Although the transition guidance indicates that the difference between the asset and liability should be recognized as an adjustment to equity as of that later-of date, we think that a lessee should carefully consider the impact of such adjustments as follows:

- If a lease has not commenced as of the date of initial application, the asset and liability will generally be equal, because the lessee's accounting as the deemed owner before placing the asset into service is a gross-up of the asset with an offsetting financing obligation. Therefore, the adjustments in transition to ASC 842 generally will not affect equity for leases that commenced after the date of initial application.

- A lessee should reverse any of the accounting entries that were recognized during the comparative periods for the respective line items (e.g., depreciation expense, interest expense) rather than as an adjustment to equity. That is, it would not be appropriate to reverse the accounting after placing the asset into service through equity if those comparative periods are shown in accordance with ASC 842.

- If a lease commenced before the date of initial application and the lessee continued to recognize the asset and liability as a failed sale and leaseback under ASC 840, there typically will be a difference between the asset and liability that should be recognized in equity as of the date of initial application.

- Although the transition guidance related to build-to-suit arrangements does not specifically address situations in which the lessee is the deemed owner of an asset under construction in accordance with ASC 842, we have provided our interpretive guidance on such scenarios in Q&A 16-12 below.

**Q&A 16-12 Derecognition of Existing Build-to-Suit Assets and Liabilities in Transition**

The build-to-suit transition guidance specifies that any build-to-suit assets and liabilities recognized under ASC 840 should be derecognized in transition. However, the transition guidance does not explicitly address whether ASC 842's principles related to controlling an asset under construction should be applied during the comparative periods under ASC 842, if applicable.

**Question 1**

Must ASC 842's principles related to controlling an asset during construction be applied when construction was completed and the lease commenced before ASC 842's effective date?

**Answer**

No. An entity is not required to assess ASC 842's principles of control (regardless of whether the lessee was the deemed owner under ASC 840) as long as construction is complete and the lease commenced before the ASU's effective date. The FASB staff agreed with this application of transition for build-to-suit arrangements. This answer is applicable regardless of whether an entity elects the Comparatives Under 840 Option.
Therefore, in such circumstances, the transition derecognition guidance in ASC 842-10-65-1(u) should be applied. ASC 842-10-65-1(u) states:

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 (if an entity elects the transition method in (c)(1)) or that are existing at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)) 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 shall do the following:
   i. If an entity elects the transition method in (c)(1), the entity shall 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.
   ii. If an entity elects the transition method in (c)(2), the entity shall derecognize those assets and liabilities at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.
   iii. Any difference in (i) or (ii) shall be recorded as an adjustment to equity at the date that those assets and liabilities were derecognized in accordance with (u)(1)(i) or (ii).
   iv. 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 (if the entity elects the transition method in (c)(1)) or if it concluded before the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if the entity elects the transition method in (c)(2)), and the transaction qualified as a sale and leaseback transaction in accordance with Subtopic 840-40 before that date, the entity shall follow the general lessee transition requirements for the lease. [Emphasis added]

Accordingly, the lessee should (1) derecognize any build-to-suit assets and liabilities that were recognized solely as a result of the lessee’s being the deemed accounting owner and (2) recognize the difference, if any, in equity. However, lessee-paid costs that were included in the build-to-suit asset may not have been capitalized solely as a result of the build-to-suit designation. For example, the deemed accounting owner may have funded part of the construction costs and such costs may be considered prepaid lease payments or payments for lessee-owned improvements when the arrangement is accounted for as a lease. Accordingly, in transition, these costs would be carried over and retained at their currently recognized amount (i.e., the amortized or depreciated balance). That is, these costs would have been recognized in the absence of the build-to-suit designation and therefore should not be derecognized through equity upon transition.
Example

Company C, a calendar-year public entity that has elected the option not to recast the comparative periods presented when transitioning to ASC 842 (the Comparatives Under 840 Option), entered into an agreement with Developer D to lease a newly constructed corporate headquarters.\(^{29}\) Developer D began building the corporate headquarters on August 1, 2016, and construction is expected to be complete on November 12, 2018, at which time the lease will commence. Company C funded $6 million of the construction costs during the construction period, and the total project costs are expected to be $40 million. Therefore, D will fund $34 million of the construction costs. In addition, C incurred $1 million for furniture and fixtures (the “improvements”). Assume that C was considered the accounting owner of the corporate headquarters during construction and that sale-and-leaseback accounting would not be achieved upon lease commencement under ASC 840. The various journal entries to account for the construction project resulted in the following account balances as of November 12, 2018:

<table>
<thead>
<tr>
<th>Account</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>PP&amp;E</td>
<td>41 million</td>
</tr>
<tr>
<td>Cash</td>
<td>7 million</td>
</tr>
<tr>
<td>Financing obligation</td>
<td>34 million</td>
</tr>
</tbody>
</table>

Upon transition to ASC 842, C is required to derecognize the amounts related to the build-to-suit accounting because construction of the corporate headquarters was completed, and the lease commenced, before January 1, 2019 (the effective date of ASC 842). Therefore, on its adoption date (January 1, 2019), C would derecognize the entire financing obligation because it was recognized solely as a result of the build-to-suit designation. Company C would retain a portion of its PP&E balance related to the amount it paid before lease commencement less adjustments for subsequent measurement (i.e., depreciation), even though this amount was included in the carrying amount of the build-to-suit asset. As a result, the unamortized portion of the $6 million construction funding payment should be carried forward into the ROU asset because it represents a prepaid lease payment. Similarly, the unamortized balance of the $1 million for improvements paid by the lessee should be carried forward in transition and not written off as an equity adjustment. The remaining build-to-suit asset would be derecognized. The offset between the resulting build-to-suit asset balance and the financing obligation, if any, would be recognized in equity.

The subsequent accounting for the improvements should be consistent with that for other leasehold improvements. That is, the amortization period would be limited to the lease term in accordance with ASC 842-20-35-12.

The journal entries in transition are shown below. Note that, for simplicity, there are no adjustments for subsequent measurement between November 12, 2018, and the effective date of ASC 842 (i.e., depreciation of the building, amortization of the $6 million in prepaid rent, or payments on the financing obligation). These subsequent-measurement adjustments would most likely result in an adjustment to equity, which is not depicted below.

<table>
<thead>
<tr>
<th>Account</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing obligation</td>
<td>34 million</td>
</tr>
<tr>
<td>ROU asset</td>
<td>6 million</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>40 million*</td>
</tr>
</tbody>
</table>

* The balance of the $1 million of improvements paid for by the lessee was included in the PP&E account balance of $41 million as of November 12, 2018. Because this amount is retained, only $40 million of the PP&E account balance is removed in the transition journal entry.

Company C would also recognize any remaining lease payments as a lease liability, along with an offsetting ROU asset, in accordance with the lessee transition requirements in ASC 842-10-65-1(k)–(t).

\(^{29}\) The outcome of this example would not be affected by whether the entity elected the Comparatives Under 840 Option.
Chapter 16 — Effective Date and Transition

**Question 2**

How should a lessee approach the transition for a build-to-suit arrangement when construction was not completed, and the lease had not commenced, as of the effective date of ASC 842?

**Answer**

The table below summarizes the transition approach an entity should use in those circumstances.

<table>
<thead>
<tr>
<th>ASC 840 Determination</th>
<th>ASC 842 Determination</th>
<th>Transition Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lessee was the deemed owner</td>
<td>Lessee has control during construction</td>
<td>No change in accounting; asset and financing obligation remain on the balance sheet during the comparative periods and as of the effective date.</td>
</tr>
<tr>
<td>Lessee was the deemed owner</td>
<td>Lessee does not have control during construction</td>
<td>If the lessee was determined to be the deemed accounting owner under ASC 840 before the date of initial application, derecognize the asset and financing obligation recognized solely as a result of the build-to-suit designation and reflect the difference, if any, in equity. If the lessee was determined to be the accounting owner of the asset during the comparative periods (i.e., construction commenced during the comparative periods), and the Comparatives Under 840 Option was not elected, the lessee should reverse the impact of the accounting for the appropriate line items and not reverse the impact through equity.</td>
</tr>
<tr>
<td>Lessee was not the deemed owner</td>
<td>Lessee has control during construction</td>
<td>Recognize the asset and financing obligation as of the later of the date of initial application or the date as of which the lessee is determined to be the accounting owner of the asset in accordance with ASC 842. If a lessee elects the Comparatives Under 840 Option, the asset and financing obligation will be recognized as of the effective date of ASC 842. See the example below.</td>
</tr>
</tbody>
</table>

**Example**

Company A, a calendar-year-end public entity that has not elected the Comparatives Under 840 Option, has entered into an agreement with Company B to lease a newly constructed television studio. Company B began building the television studio on June 8, 2017, and construction is expected to be complete on November 5, 2019. The lease will commence once construction is complete. During the construction period, A can acquire the television studio in process of construction and therefore is deemed to control the construction project under ASC 842. Assume that A was not determined to be the deemed owner in accordance with ASC 840. When A initially applies ASC 842, because A is deemed to control the construction project under ASC 842 as of the effective date, it must recognize the cost of the in-process asset (and an offsetting financing obligation) during the comparative periods beginning June 8, 2017.

If A had elected the Comparatives Under 840 Option, A would first recognize the asset and financing obligation as of January 1, 2019 (the ASC 842 effective date).
Connecting the Dots — Lease Classification Assessment for Derecognized Build-to-Suit Arrangements in Transition

If a previous build-to-suit arrangement (for which construction was completed and the lease commenced before the effective date of ASC 842) was capitalized under ASC 840 and reversed upon the adoption of ASC 842, we generally believe that the appropriate framework for determining lease classification will depend on multiple factors as follows:

- If the practical expedient package is not elected, lease classification should be determined under ASC 842, as follows:
  - If the lease commenced before the date of initial application, lease classification would generally be determined as of the later of the (1) lease commencement date or (2) date the lease was last modified. If a lease was renewed or extended before the date of initial application, the renewal or extension date would be considered the lease commencement date for this purpose unless the renewal was assumed to be reasonably certain as of the initial lease commencement date.
  - If the lease commenced after the date of initial application, the initial lease classification would generally be determined as of the lease commencement date.

- The transition guidance is not clear on situations in which the practical expedient package is elected and the lessee has accounted for the transaction as a failed sale and leaseback through the effective date of ASC 842. We believe that, notwithstanding the election of the practical expedient package, it would be acceptable to determine lease classification in accordance with ASC 842 (i.e., as of the later of the (1) lease commencement date or (2) date the lease was last modified — see bullet above), because the lease (for accounting purposes) was never recognized or assessed under ASC 840 (i.e., the lease classification is assessed for the first time upon adopting ASC 842). However, we understand that others believe, because of the lack of clear guidance, that it would also be acceptable to determine lease classification as of lease inception under ASC 840. We think that either approach would also be acceptable as an accounting policy that must be applied consistently.

Q&A 16-12A  Accounting for a Previously Impaired Build-to-Suit Asset

Under ASC 840, a build-to-suit asset and financing obligation may be recognized on a lessee’s balance sheet as a result of a transaction’s build-to-suit designation, as described in Q&A 16-12. Thereafter, under ASC 360, a lessee could have determined that the asset group containing the build-to-suit asset was impaired, resulting in the measurement of an impairment loss, of which a portion was recognized against the build-to-suit asset.
The general transition provisions in ASC 842 indicate that a lessee that recognized an asset because it was the deemed owner under the ASC 840 build-to-suit guidance would, in accordance with ASC 842-10-65-1(u), derecognize the asset and financing recognized solely as a result of the build-to-suit designation and apply the general lessee transition requirements. Further, ASC 842-10-65-1(m)(2) and ASC 842-10-65-1(o), which apply to operating leases and finance leases, respectively, provide the following guidance on accounting for the ROU asset at transition when there is an existing ASC 420 liability:

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: . . .

2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease. . . .

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 application date as determined in (c) 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.

On the basis of the above guidance, it is clear that the initial ROU asset is generally recorded net of any ASC 420 liability at transition. However, under a deemed ownership model, entities have historically looked to the impairment guidance in ASC 360 instead of the exit cost guidance in ASC 420. As a result, entities have questioned how previous impairment charges recognized on a build-to-suit asset should be treated in transition given that the asset to which the impairment is related will be derecognized upon adoption of ASC 842. In other words, entities have asked whether the historical ASC 360 impairment charge should or could affect the measurement of the ROU asset in transition.

**Question**

When a lessee previously recognized impairment for a build-to-suit asset subject to derecognition under ASC 842-10-65-1(u)(1), how should the lessee consider the historical impairment when recognizing and measuring the related ROU asset at transition?

**Answer**

We believe that a lessee should subject the newly recognized ROU asset to a full impairment test in accordance with ASC 360 as of the effective date of ASC 842 if an impairment indicator continues to exist as of this date. Accordingly, a lessee would determine a “new” impairment amount on the basis of the test conducted as of the effective date. In addition, we believe that it is acceptable to recognize the impairment loss, if any, determined as of the date of initial application of ASC 842 through an adjustment to equity, with a corresponding reduction to the carrying amount of the ROU asset. We think that recognition of the impairment loss in equity is appropriate since it reflects a unique circumstance in which the adjustment effectively results from an impairment indicator that arose before the date of initial application of ASC 842.

However, since ASC 842 does not provide clear guidance on this situation, there may be other acceptable approaches. We encourage stakeholders who are affected by this issue to consult with their accounting advisers and auditors to understand their views.

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30 See Q&A 16-12 for an excerpt of the transition guidance in ASC 842-10-65-1(u).
16.9  Transition for Sale-and-Leaseback Transactions

ASC 842-10

65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

Sale and Leaseback Transactions Before the Effective Date

   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:

      1. If an entity elects the transition method in (c)(1), 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.

      2. If an entity elects the transition method in (c)(2), the entity shall reassess whether a sale would have occurred at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph in accordance with paragraphs 842-40-25-1 through 25-3 and recognize the sale as an adjustment to equity. The entity shall then account for the leaseback in accordance with the guidance in Subtopic 842-20 after the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.

   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 and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)) or that exists at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)), 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.
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 to equity unless the entity elects the transition method in (c)(1) and the date of sale is after the beginning of the earliest period presented, in which case any deferred gain or loss not resulting from off-market terms shall be recognized in earnings in the period the sale occurred.

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 later of the beginning of the earliest comparative period presented in the financial statements and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)) or at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)).

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 later of the beginning of the earliest comparative period presented in the financial statements and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)) or at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)).

According to the transition provisions for sale-and-leaseback transactions, (1) previous transactions that were accounted for as successful sale-and-leaseback transactions are grandfathered from consideration under the ASC 842 sale-and-leaseback derecognition rules and (2) previous transactions that were accounted for as failed sales are reassessed for possible derecognition under ASC 842. The real estate sale-and-leaseback rules are much less onerous under ASC 842, which will result in the unwinding of certain failed sales in the transition to ASC 842. Specifically, if a transaction was a failed sale-and-leaseback transaction under ASC 840 and remains so as of the effective date, the entity must reassess whether a sale would have occurred at any point on or after the date of initial application in accordance with the sale-and-leaseback provisions in ASC 842 (see Chapter 10). The sale-and-leaseback transaction must be recognized from the date a sale is determined to have occurred under ASC 842; if the sale occurred before the date of initial application, any gain or loss will be reflected in equity, and if the sale occurred during the comparative periods (which is only possible if a lessee does not elect the Comparatives Under 840 Option), any gain or loss must be recognized in the respective period. For successful sales, the related lease should be recorded in accordance with the ASC 842 transition requirements in a manner consistent with any other lease.

Connecting the Dots — Lease Classification Assessment in Transition for Unsuccessful Sale-and-Leaseback Transactions Under ASC 840

The lease classification determination in transition for previously unsuccessful sale-and-leaseback transactions is important because the classification of the lease is one of the primary conditions for achieving a sale in a sale-and-leaseback transaction under ASC 842. That is, a sale can only be recognized under ASC 842 if the leaseback would be classified as an operating lease (see Section 10.3.2). Since the lease (from an accounting perspective) did not exist under ASC 840 and a lease cannot be recognized under ASC 842 unless the leaseback would not be classified as a finance lease, the seller-lessee must determine the appropriate “would be” classification of the lease in transition before achieving sale-and-leaseback accounting under ASC 842.
The transition guidance is not clear on whether ASC 840 or ASC 842 should be used in these circumstances as the basis for determining the classification of the leaseback. However, we generally believe that if a previously unsuccessful sale-and-leaseback transaction meets the other criteria necessary to achieve a sale under ASC 842 (see Section 10.3), the “would be” classification of the lease will depend on the following:

- If the practical expedient package is not elected, lease classification should be determined under ASC 842 as follows:
  - If the lease commenced before the date of initial application, lease classification would generally be determined as of the later of the (1) lease commencement date or (2) date the lease was last modified. If a lease was renewed or extended before the date of initial application, the renewal or extension date would be considered the lease commencement date for this purpose unless the renewal was assumed to be reasonably certain as of the initial lease commencement date.
  - If the lease commenced after the date of initial application, the initial lease classification would generally be determined as of the lease commencement date.

- The transition guidance is not clear on situations in which the practical expedient package is elected and the lessee has accounted for the transaction as a failed sale and leaseback through the effective date of ASC 842. We believe that, notwithstanding the election of the practical expedient package, it would be acceptable to determine lease classification in accordance with ASC 842 (i.e., as of the later of the (1) lease commencement date or (2) date the lease was last modified — see bullet above), because the lease (for accounting purposes) was never recognized or assessed under ASC 840 (i.e., the lease classification is assessed for the first time upon adopting ASC 842). However, we understand that others believe, because of the lack of clear guidance, that it would also be acceptable to determine lease classification as of lease inception under ASC 840. We think that either approach would be acceptable as an accounting policy that must be applied consistently.

On the other hand, if a previously successful sale-and-leaseback transaction was accounted for as a sale and capital leaseback under ASC 840, the lessee continues to recognize any deferred gain or loss that exists at the later of the date of initial application presented in the financial statements or the date of the sale of the underlying asset. The deferred gain or loss should be subsequently recognized into income as follows:

- If the underlying asset is land only, straight-line over the remaining lease term.
- If the underlying asset is not land only and the leaseback is a finance lease under ASC 842, in proportion to the amortization of the ROU asset.
- If the underlying asset is not land only and the leaseback is an operating lease under ASC 842, in proportion to the recognition in profit or loss of the total lease cost.

If a previously successful sale-and-leaseback transaction was accounted for as a sale and operating leaseback under ASC 840, as long as the sale and the leaseback were at fair value and market terms, respectively, the lessee should recognize any deferred gain or loss as (1) a cumulative-effect adjustment to equity (if the sale would have occurred before the date of initial application) or (2) earnings in the respective comparative period (if the sale would have occurred during the comparative periods and provided that the entity does not elect the Comparatives Under 840 Option). If the sale and leaseback were not at fair value and market terms, respectively, at the time the sale-and-leaseback transaction was entered into, the amount by which the transaction was not at fair value and market terms should
not be recognized in transition. Rather, the lessee should recognize any such deferred loss or deferred gain that results because the consideration for the sale of the asset was not at fair value or the lease payments were not at market rates as an adjustment to the ROU asset or finance liability, respectively, at the later of lease commencement or the date of initial application. Any remaining gain/loss after the lessee adjusts for off-market values and terms would be recognized in a manner consistent with the criterion in ASC 842-10-65-1(ee)(1).

**Connecting the Dots — Buyer-Lessors Do Not Reassess Previous Sale-and-Leaseback Accounting**

ASC 840 did not require that buyer-lessees assess whether the seller was able to obtain sale recognition. That is, accounting symmetry was not required between the buyer-lessee and the seller-lessor; instead, the buyer-lessee would generally account for a sale-and-leaseback transaction as a purchase with a leaseback to the lessee even if the lessee accounts for the sale as a financing. Under ASC 842, such accounting symmetry is required, as described in Section 10.2. In transition, because the lessor generally considered all sale-and-leaseback transactions to be successful purchase-leasebacks, the lessor does not have to reassess any sale-and-leaseback transactions executed before the effective date of ASC 842. Therefore, there will continue to be asymmetry in the accounting for certain sale-and-leaseback transactions entered into under ASC 840 in which the lessee continues to fail sale-and-leaseback transaction under ASC 842 (i.e., both the lessor and lessee will continue to recognize the asset). In the unusual circumstance in which a lessor did conclude that an arrangement was a financing under ASC 840, we would expect it to revisit that accounting under ASC 842.

### 16.10 Amounts Previously Recognized From Business Combinations

**ASC 842-10**

**65-1** The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .

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 leases that are classified as operating leases in accordance with Topic 842 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 if assets or liabilities arise from leases that are classified as sales-type leases or direct financing leases in accordance with Topic 842 for which the entity is a lessor. Also see (w). . .

**Lessee**

For any assets or liabilities recognized in accordance with ASC 805 that are related to favorable or unfavorable terms of an operating lease for which an entity is a lessee, the entity should derecognize the asset or liability and commensurately adjust the ROU asset. In other words, if a lessee has a favorable lease intangible (asset), the lessee should derecognize the intangible asset and add an offsetting amount to the ROU asset. If a lessee has an unfavorable lease intangible (liability), the lessee should derecognize the liability and reduce the ROU asset by the same amount.
Lessor

When a lessor has previously recognized assets or liabilities for an off-market operating lease in a business combination, the asset or liability should continue to be recognized separately from the lease accounting. Generally, an acquirer in a business combination that is a lessor under a sales-type or direct financing lease would include any off-market assets or liabilities in the net investment in the lease (i.e., a separate asset or liability would not be recognized). In those cases, the lessor would not make any adjustment for the off-market terms. However, if any separate balances exist regarding a lessor’s sales-type or direct financing lease (other than in-place lease intangibles), the entity should derecognize the asset or liability and “make a corresponding adjustment to equity” in accordance with ASC 842-10-65-1(h).

16.11 Transition Disclosures

<table>
<thead>
<tr>
<th>ASC 842-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>65-1 The following represents the transition and effective date information related to Accounting Standards Update . . . No. 2016-02, Leases (Topic 842) . . .</td>
</tr>
</tbody>
</table>

**Disclosure**

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) and paragraph 250-10-50-3. An entity that elects the transition method in (c)(2) shall provide the transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the period of adoption rather than at the beginning of the earliest period presented.

**Note:** See paragraph 250-10-599-6 on disclosure of the impact that recently issued accounting standards will have on the financial statements of a registrant.

j. If an entity uses one or more of the practical expedients in (f), (g), and (gg), it shall disclose that fact.

jj. An entity electing the transition method in (c)(2) shall provide the required Topic 840 disclosures for all periods that continue to be in accordance with Topic 840.

An entity adopting ASC 842 should provide the transition disclosures required by ASC 250, excluding the disclosure in ASC 250-10-50-1(b)(2) about the effect of the change on income from continuing operations, net income, any other financial statement line item, and any per-share affected amounts for any of the periods. Moreover, entities do not need to provide the corresponding interim disclosures required by ASC 250-10-50-3. The disclosure required by ASC 250-10-50-1(b)(3) regarding “[t]he cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position” must be provided as of the date of initial application of ASC 842.

An entity adopting ASC 842 must also disclose the transition practical expedients used, as applicable.

An entity electing the Comparatives Under 840 Option must provide the ASC 840 disclosures for all periods that are presented in accordance with ASC 840 (see Section 16.1.1).

**Connecting the Dots — ASC 840 Disclosures Required in the Comparative Periods**

The Board revised the language in ASU 2018-11 to clarify that an entity must provide the ASC 840 disclosures for all periods that are presented in accordance with ASC 840. As part of this requirement, the entity must apply the guidance in ASC 840-20-50-2(a) (commonly referred to as the “lease commitments table”) as of the latest balance sheet presented. Further, paragraph BC14 of ASU 2018-11 indicates that the latest balance sheet date presented should be the latest balance sheet date presented under ASC 840 (e.g., December 31, 2018, for a PBE with a calendar year-end). Therefore, for a PBE with a calendar year-end, the ASC 840-20-50-2(a) lease commitments table as of December 31, 2018, will be presented in the annual financial
Chapter 16 — Effective Date and Transition

statements for the year ended December 31, 2019. Also, paragraph BC14 of ASU 2018-11 indicates that the ASU does not change, or create additional, “interim disclosure requirements that entities previously were not required to provide.” In discussions with the FASB staff regarding what disclosures are required in interim periods during the year of adoption, the staff clarified that it would expect an entity to disclose the lease commitments table as of December 31, 2018 (on the basis of the fact pattern described above) in each interim period in the year of adoption. For example, an entity would present the lease commitments table for the year ended December 31, 2018, in the first-quarter 2019 Form 10-Q. The table would not be updated to reflect a run-off of three months of activity that occurred during the first quarter of 2019, nor would the entity need to present a lease commitments table as of March 31, 2018. Rather, the table presented in the December 31, 2018, Form 10-K would be carried forward to the first-quarter 2019 Form 10-Q.

While ASC 842 may not require entities to provide certain of the above prescribed disclosures in interim financial statements, SEC rules and staff interpretations require SEC registrants to provide both annual and interim disclosures in the first interim period after the adoption of a new accounting standard and in each subsequent quarter in the year of adoption. Specifically, Section 1500 of the SEC Division of Corporation Finance Financial Reporting Manual (FRM) states:

[Regulation] S-X Article 10 requires disclosures about material matters that were not disclosed in the most recent annual financial statements. Accordingly, when a registrant adopts a new accounting standard in an interim period, the registrant is expected to provide both the annual and the interim period financial statement disclosures prescribed by the new accounting standard, to the extent not duplicative. These disclosures should be included in each quarterly report in the year of adoption.

See Chapter 18 for further discussion of SEC reporting considerations for SEC registrants, including SAB Topic 11.M disclosure requirements.

[Q&As 16-13 and 16-14 have been deleted.]
Chapter 17 — Stakeholder Activities

17.1 Overview
17.2 SEC Activities
   17.2.1 Removal of Certain SEC Staff Announcements and SEC Staff Observer Comments
17.3 FASB Activities
   17.3.1 Final and Proposed ASUs
   17.3.2 Other FASB Activity
   17.3.3 Ongoing FASB Activity
   17.3.4 FASB’s Response to the COVID-19 Pandemic

17.1 Overview
Since the issuance of ASU 2016-02 more than four years ago, the FASB has released various additional ASUs to (1) provide a practical expedient that offers entities transition relief related to reassessing land easement arrangements, (2) make certain technical corrections and improvements to the standard, (3) make targeted amendments to lessor accounting and provide transition relief to help decrease the costs of applying the standard’s guidance, and (4) make certain narrow-scope improvements for lessors. Regulators, such as the SEC, have also been involved in this standard-setting process. Given the far-reaching impact that ASC 842 will have on many industries, the level of implementation activity is not surprising.1 Stakeholders should continue to monitor activity at the FASB, SEC, and other standard setters or regulators for any relevant developments or interpretations.

For a comprehensive collection of news and publications about the latest developments related to ASC 842, see DART.

17.2 SEC Activities
The SEC is a critical stakeholder given its role in standard setting and in regulating the U.S. capital markets. The legacy SEC guidance on leases, which is codified in ASC 840-30-S99 and ASC 840-40-S99, is more limited than that on revenue. However, the SEC staff has been following the implementation efforts of registrants and has updated (and may still update) its interpretive guidance accordingly.

17.2.1 Removal of Certain SEC Staff Announcements and SEC Staff Observer Comments
Upon the effective date of ASC 842, an SEC staff announcement and certain SEC observer comments will be removed (i.e., will no longer be effective) in accordance with ASU 2017-13. The removed SEC staff announcement and SEC staff observer comments include those in ASC 840-30-S99 and ASC 840-40-

1 See Section 17.3.3 for information on ongoing FASB activity, including a public roundtable to discuss implementation challenges that we expect will occur during the second half of 2020.
S99. See Section 17.3.1.1 for further discussion of ASU 2017-13, which details the rescission of certain SEC guidance.

See Chapter 18 for further discussion of reporting considerations for SEC registrants.

17.3 FASB Activities

This Roadmap discusses the FASB's standard setting up through the May 20, 2020, Board meeting.

17.3.1 Final and Proposed ASUs

As noted above, the FASB has released various final and proposed ASUs to amend and clarify the guidance in ASC 842. These final and proposed standards, which were largely issued in response to stakeholder feedback, are discussed throughout this Roadmap as applicable.

• ASU 2017-13 on amendments to SEC paragraphs (Section 17.3.1.1 below).
• ASU 2018-01 on the land easement practical expedient for transition (Section 17.3.1.2).
• ASU 2018-10 on technical corrections and improvements (Section 17.3.1.3).
• ASU 2018-11 on targeted improvements (Section 17.3.1.4).
• ASU 2018-20 on narrow-scope improvements for lessors (Section 17.3.1.5).
• ASUs 2016-13 and 2018-19 on TRG activities — billed operating lease receivables (Section 17.3.1.6).
• ASU 2019-01 on Codification improvements (Section 17.3.1.7).
• ASUs 2019-10 and 2020-05 on deferrals of the effective dates of the leasing standard (Section 16.1).
• ASU 2020-02 on amendments to ASC 842 in response to SEC guidance (See Section 18.4).

17.3.1.1 ASU 2017-13 on Amendments to SEC Paragraphs

In September 2017, the FASB issued ASU 2017-13, which rescinds certain SEC guidance in light of ASUs 2014-09 and 2016-02. Specifically, ASU 2017-13 rescinds the following SEC guidance upon the adoption of ASU 2016-02:

• ASC 840-30-S99-1 on a lessor’s consideration of third-party value guarantees.
• ASC 840-40-S99-1 on sale treatment in sale-and-leaseback transactions with a repurchase option.
• ASC 840-40-S99-2 on the effect of the lessee’s involvement in asset construction.
• ASC 840-40-S99-3 on applying sale-and-leaseback guidance to certain sale-and-leaseback transactions.

In addition, ASU 2017-13 moved certain guidance in ASC 840-30-S99-2 on the effect of a change in tax law or rates on leveraged leases, which resulted from an SEC observer comment, to ASC 842-50-S99-1.

ASU 2017-13 also codified in ASC 842-10-S65-1 comments made by the SEC observer at the July 20, 2017, EITF meeting. In those comments, the SEC staff announced that it would not object when certain PBEs elect to use the non-PBE effective dates solely to adopt the FASB's new standards on revenue and leases. See Section 18.4 for further discussion of this election.

2 See Section 17.3.2 for additional FASB activity related to the accounting for impairment of operating lease receivables.
17.3.1.2  **ASU 2018-01 on the Land Easement Practical Expedient for Transition**

The FASB received a significant amount of feedback from stakeholders in several industries who were concerned about the cost and complexity of evaluating all existing land easements under ASC 842's definition of a lease at transition. Entities in these industries have potentially tens of thousands of existing land easements, many of which were executed decades ago, and the same complexities described in Section 2.4.3 would be relevant to these arrangements.

The Board observed that the costs of requiring an entity to evaluate all existing land easements under ASC 842's definition of a lease outweighed the benefits to financial statement users. Accordingly, the FASB provided transition relief in the form of a practical expedient in ASC 842-10-65-1(gg):

An entity also may elect a practical expedient to not assess whether existing or expired land easements that were not previously accounted for as leases under Topic 840 are or contain a lease under this Topic. For purposes of (gg), a land easement (also commonly referred to as a right of way) refers to a right to use, access, or cross another entity's land for a specified purpose. This practical expedient shall be applied consistently by an entity to all its existing and expired land easements that were not previously accounted for as leases under Topic 840. This practical expedient may be elected separately or in conjunction with either one or both of the practical expedients in (f) and (g). An entity that elects this practical expedient for existing or expired land easements shall apply the pending content that links to this paragraph to land easements entered into (or modified) on or after the date that the entity first applies the pending content that links to this paragraph as described in (a) and (b). An entity that previously accounted for existing or expired land easements as leases under Topic 840 shall not be eligible for this practical expedient for those land easements.

In short, an entity that elects the expedient is relieved from applying ASC 842 to evaluate all existing land easements that were not previously accounted for in accordance with ASC 840. The FASB explains in paragraph BC15 of ASU 2018-01 that an entity may thus elect to “run off” all such easements by using its historical accounting approach for land easements unless or until the arrangement is modified on or after the date on which the entity adopts ASU 2016-02.

The objectives of the land easement amendments in **ASU 2018-01** are to:

- Clarify that land easements entered into (or existing land easements modified) on or after the effective date of ASC 842 must be assessed under ASC 842.
- Provide a transition practical expedient for existing or expired land easements that were not previously accounted for in accordance with ASC 840. The practical expedient would allow entities to elect not to assess whether those land easements are, or contain, leases in accordance with ASC 842 when transitioning to ASC 842.

The amendments in ASU 2018-01 do not, and are not intended to:

- Provide illustrative or application guidance on whether land easements are, or contain, leases in accordance with the definition of a lease in ASC 842.
- Help entities identify the appropriate accounting framework for situations in which a land easement is not determined to be a lease under ASC 842.

See Section 2.4 for more information about the land easement practical expedient for transition.

17.3.1.2.1  **Scope**

ASU 2018-01 only addresses land easements. Although the FASB does not define this term, ASC 842-10-65-1(gg) and paragraph BC3 of ASU 2018-01 describe both a land easement and a right of way as a “right to use, access, or cross another entity's land for a specified purpose.”
Further, ASU 2018-01 effectively breaks land easements into two groups on the basis of the effective date of ASU 2016-02: (1) land easements entered into (or existing easements modified) on or after the effective date (collectively, “new land easements”) and (2) land easements that existed as of, or expired before, the effective date (collectively, “existing land easements”). See Section 2.4.2 for further discussion of the scope of ASU 2018-01.

17.3.1.2.2 Identifying a Lease

ASU 2018-01 is not intended to provide illustrative or application guidance about whether new land easements meet the definition of a lease in ASC 842. Therefore, stakeholders and respondents may continue to raise questions about the application of the definition of a lease to new land easement arrangements, and it is possible that the FASB, IASB, and SEC staffs will want to share their perspectives as those questions are raised. Companies involved in land easement arrangements should consult with their accounting advisers and monitor developments on the topic. See Section 2.4.3 for further discussion of whether new land easements meet the definition of a lease in ASC 842.

17.3.1.2.3 Effective Date and Transition

The transition practical expedient for existing land easements may be elected alone or with any of the other transition practical expedients. In a manner consistent with the other transition practical expedients, entities must disclose whether they are electing the transition practical expedient for land easements.

The effective date of ASU 2018-01 is aligned with that of ASU 2016-02. See Section 16.5.3 for more information about the effective date and transition provisions of ASU 2018-01.3

17.3.1.3 ASU 2018-10 on Technical Corrections and Improvements

In July 2018, the FASB issued ASU 2018-10 to make narrow-scope amendments (i.e., minor changes and clarifications) to certain aspects of the new leasing standard (i.e., ASC 842). The following table, reproduced from ASU 2018-10, summarizes the 16 amendments that were made to ASC 842:

<table>
<thead>
<tr>
<th>Area for Improvement</th>
<th>Summary of Amendments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Issue 1: Residual Value Guarantees</strong></td>
<td>- Stakeholders noted that paragraph 460-10-60-32 incorrectly refers readers to the guidance in Topic 842 about sale-leaseback transactions, when, in fact, it should refer readers to the guidance about guarantees by a seller-lessee of the underlying asset's residual value in a sale and leaseback transaction.</td>
</tr>
<tr>
<td></td>
<td>- The amendment corrects the cross-reference in paragraph 460-10-60-32. [See Section 10.3.1.2 of this Roadmap.]</td>
</tr>
<tr>
<td><strong>Issue 2: Rate Implicit in the Lease</strong></td>
<td>- Stakeholders raised questions about the treatment of certain sales-lease leases with significant variable payments under Topic 842 and whether the application of Topic 842 could result in a negative rate implicit in the lease, rather than a loss at the commencement date of the lease.</td>
</tr>
<tr>
<td></td>
<td>- The amendment clarifies that a rate implicit in the lease of zero should be used when applying the definition of the term rate implicit in the lease results in a rate that is less than zero. [See Sections 7.3.1 and 9.3.7.1 of this Roadmap.]</td>
</tr>
</tbody>
</table>

3 ASU 2019-10 delayed the effective date of the new leasing standard (ASU 2016-02) for all nonpublic companies. ASU 2020-05 further delayed the effective date for all nonpublic companies, as well as for certain public NFPs. (See further discussion in Section 16.1.) The new effective date for nonpublic companies is annual periods beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. The effective date for public NFPs that qualify for the deferral under ASC 842-10-65-1(a) is annual periods beginning after December 15, 2019, and interim periods therein. The effective date for all other public companies remains unchanged. The delayed effective date also applies to all ASUs associated with ASU 2016-02.
Issue 3: Lessee Reassessment of Lease Classification

Topic 842 is clear that when a lease is modified and that modification is not accounted for as a separate contract, an entity (that is, a lessee or a lessor) should reassess, at the effective date of the modification, lease classification on the basis of the modified terms and conditions and the facts and circumstances existing as of that date. Although Topic 842 also requires a lessee to reassess lease classification if there is a change in the lease term or the assessment of a lessee option to purchase the underlying asset, stakeholders expressed that it is not clear whether the lessee should reassess lease classification on the basis of the facts and circumstances existing as of the date the reassessment is required.

The amendment consolidates the requirements about lease classification reassessments into one paragraph and better articulates how an entity should perform the lease classification reassessment, that is, on the basis of the facts and circumstances, and the modified terms and conditions, if applicable, as of the date the reassessment is required. [See Sections 8.3, 8.3.4, and 8.6.3 of this Roadmap.]

Issue 4: Lessor Reassessment of Lease Term and Purchase Option

Topic 842 requires a lessor to not reassess the lease term or a lessee purchase option unless the lease is modified and that modification is not accounted for as a separate contract. Topic 842 also requires a lessor to account for the exercise of a lessee option to extend or terminate the lease, or to purchase the underlying asset, in the same manner as a lease modification. Stakeholders questioned why a lessor should account for a lessee exercise of such options in a manner similar to a lease modification when the exercise of those options is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date of the lease (or the most recent effective date of a modification that is not accounted for as a separate contract).

The amendment clarifies that a lessor should account for the exercise by a lessee of an option to extend or terminate the lease or to purchase the underlying asset as a lease modification unless the exercise of that option by the lessee is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date of the lease (or the most recent effective date of a modification that is not accounted for as a separate contract). [See Section 5.4.2 of this Roadmap.]

Issue 5: Variable Lease Payments That Depend on an Index or a Rate

Stakeholders noted that the guidance in paragraph 842-10-35-4(b) about remeasurement of the lease payments when a contingency upon which some or all of the variable lease payments are based is resolved might be perceived as applying to any variable lease payments, including those that depend on an index or rate, which would be inconsistent with the Board’s decisions on this issue.

The amendment clarifies that a change in a reference index or rate upon which some or all of the variable lease payments in the contract are based does not constitute the resolution of a contingency subject to the guidance in paragraph 842-10-35-4(b).

Variable lease payments that depend on an index or a rate should be remeasured, using the index or rate at the remeasurement date, only when the lease payments are remeasured for another reason (that is, when one or more of the events described in paragraph 842-10-35-4(a) or (c) occur or when a contingency unrelated to a change in a reference index or rate under paragraph 842-10-35-4(b) is resolved). [See Sections 6.3 and 8.5.3.2 of this Roadmap.]
**Issue 6: Investment Tax Credits**

Stakeholders indicated that there is an inconsistency in terminology used about the effect that investment tax credits have on the fair value of the underlying asset between the definition of the term *rate implicit in the lease* and the lease classification guidance in paragraph 842-10-55-8.

The amendment removes that inconsistency in terminology. [See Sections 8.3.3.6.2 and 9.2.1.4 of this Roadmap.]

**Issue 7: Lease Term and Purchase Option**

Stakeholders indicated that the description in paragraph 842-10-55-24 about lessor-only termination options is inconsistent with the description in paragraph 842-10-55-23 about the noncancellable period of a lease.

The amendment removes that inconsistency by clarifying that the period covered by a lessor-only option to terminate the lease is included in the lease term. [See Section 5.2.4.1 of this Roadmap.]

**Issue 8: Transition Guidance for Amounts Previously Recognized in Business Combinations**

Stakeholders indicated that the transition guidance for lessees in paragraph 842-10-65-1(h)(3) is unclear because it relates to leases classified as direct financing leases or sales-type leases under Topic 840, while the lead-in sentence to paragraph 842-10-65-1(h) provides transition guidance for leases classified as operating leases under Topic 840.

The amendment clarifies that paragraph 842-10-65-1(h)(3) applies to lessees for leases classified as direct financing leases or sales-type leases under Topic 842, not Topic 840. In other words, paragraph 842-10-65-1(h)(3) applies when an entity does not elect the package of practical expedients in paragraph 842-10-65-1(f), and, for a lessor, an operating lease acquired as part of a previous business combination is classified as a direct financing lease or a sales-type lease when applying the lease classification guidance in Topic 842. The amendment also cross-references to other transition guidance applicable to those changes in lease classification for lessees. [See Section 16.10 of this Roadmap.]

**Issue 9: Certain Transition Adjustments**

When an entity initially applies Topic 842 retrospectively to each prior reporting period and does not elect the package of practical expedients in Topic 842, paragraph 842-10-65-1(p) requires a lessee to write off, as an adjustment to equity, any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 for leases previously classified as operating leases under Topic 840. Stakeholders questioned why those nonqualifying costs should be charged to equity when those costs are incurred after the beginning of the earliest period presented in the financial statements in which an entity adopts Topic 842. Similar issues also were noted elsewhere in the transition guidance when an entity initially applies Topic 842 retrospectively to each prior reporting period.

The amendments clarify whether to recognize a transition adjustment to earnings rather than through equity when an entity initially applies Topic 842 retrospectively to each prior reporting period. [See Sections 16.3.1, 16.3.2.1.1, 16.3.2.2, 16.4.1, 16.4.2, 16.4.4 of this Roadmap.]
<table>
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<tr>
<th>Area for Improvement</th>
<th>Summary of Amendments</th>
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<tbody>
<tr>
<td><strong>Issue 10: Transition Guidance for Leases Previously Classified as Capital Leases Under Topic 840</strong></td>
<td>Paragraph 842-10-65-1(r) provides guidance to lessees for leases previously classified as capital leases under Topic 840 and classified as finance leases under Topic 842. Paragraph 842-10-65-1(r)(4) provides subsequent measurement guidance before the effective date when an entity initially applies Topic 842 retrospectively to each prior reporting period, but it refers readers to the subsequent measurement guidance in Topic 840 about operating leases. It should refer them to the subsequent measurement guidance applicable to capital leases. The amendment corrects that reference. [See Section 16.3.2.1.2 of this Roadmap.]</td>
</tr>
<tr>
<td><strong>Issue 11: Transition Guidance for Modifications to Leases Previously Classified as Direct Financing or Sales-Type Leases Under Topic 840</strong></td>
<td>Paragraph 842-10-65-1(x) provides transition guidance applicable to lessors for leases previously classified as direct financing leases or sales-type leases under Topic 840 and classified as direct financing leases or sales-type leases under Topic 842. For modifications to those leases beginning after the effective date, paragraph 842-10-65-1(x)(4) refers readers to other applicable guidance in Topic 842 to account for the modification, specifically paragraphs 842-10-25-16 through 25-17, depending on how the lease is classified after the modification. Stakeholders noted that it should refer to how the lease is classified before the modification to be consistent with the guidance provided in paragraphs 842-10-25-16 through 25-17. The amendment corrects that inconsistency. [See Section 16.4.3 of this Roadmap.]</td>
</tr>
<tr>
<td><strong>Issue 12: Transition Guidance for Sale and Leaseback Transactions</strong></td>
<td>Stakeholders noted that the heading above the transition guidance on sale and leaseback transactions appears to suggest that there is no transition guidance for sale and leaseback transactions that occur after the earliest comparative period presented in the financial statements in which an entity adopts Topic 842 but before the effective date. Some stakeholders also questioned some of the references included in paragraph 842-10-65-1(bb). The amendments clarify that the transition guidance on sale and leaseback transactions in paragraph 842-10-65-1(aa) through (ee) applies to all sale and leaseback transactions that occur before the effective date and corrects the referencing issues noted. [See Section 16.9 of this Roadmap.]</td>
</tr>
<tr>
<td><strong>Issue 13: Impairment of Net Investment in the Lease</strong></td>
<td>Paragraph 842-30-35-3 provides guidance to lessors for determining the loss allowance of the net investment in the lease and describes the cash flows that should be considered when the lessor determines that loss allowance. Stakeholders questioned whether the guidance, as written, would accelerate and improperly measure the loss allowance because the cash flows associated with the unguaranteed residual asset appear to be excluded from the evaluation. The amendment clarifies the application of the guidance for determining the loss allowance of the net investment in the lease, including the cash flows to consider in that assessment. [See Section 9.3.7.5 of this Roadmap.]</td>
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<tr>
<th>Area for Improvement</th>
<th>Summary of Amendments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Issue 14: Unguaranteed Residual Asset</strong></td>
<td>The amendment clarifies that a lessor should not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term to the extent that the lessor sells substantially all of the lease receivable associated with a direct financing lease or a sales-type lease, consistent with Topic 840. [See Section 9.3.7.6 of this Roadmap.]</td>
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</tbody>
</table>

Paragraph 842-30-35-4 provides guidance explaining that if a lessor sells the lease receivable associated with a direct financing lease or a sales-type lease and retains an interest in the residual value of the asset, the lessor should not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term. Stakeholders questioned whether the Board intended to change the application as compared with current generally accepted accounting principles (GAAP) because the guidance in paragraph 840-30-35-53 (which will be superseded by the amendments in Update 2016-02) requires a lessor to continue to recognize interest resulting from accretion of the unguaranteed residual asset to its estimated value unless the lessor sells substantially all of the minimum rental payments.

**Issue 15: Effect of Initial Direct Costs on the Rate Implicit in the Lease**

Stakeholders noted that the ordering of the illustration in Case C of Example 1 in paragraphs 842-30-55-31 through 55-39 has raised questions about how initial direct costs factor into determining the rate implicit in the lease for lease classification purposes for lessors only.

The amendment more clearly aligns the illustration to the guidance in paragraph 842-10-25-4. [See Sections 9.3.7.1.2 and 9.3.8.1 of this Roadmap.]

**Issue 16: Failed Sale and Leaseback Transaction**

In accordance with Subtopic 842-40, Leases — Sale and Leaseback Transactions, when a sale and leaseback transaction does not qualify as a sale, the entity should account for the transaction as a financing arrangement. Paragraph 842-40-30-6(a) further requires a seller-lessee to adjust the interest rate as necessary to prevent negative amortization of the financial liability recognized. Some stakeholders questioned whether the language used in paragraph 842-40-30-6(a) actually meets the objective of preventing negative amortization of the financial liability recognized by a seller-lessee in a failed sale and leaseback transaction.

The amendment clarifies that a seller-lessee in a failed sale and leaseback transaction should adjust the interest rate on its financial liability as necessary to ensure that the interest on the financial liability does not exceed the total payments (rather than the principal payments) on the financial liability. This clarification is also reflected in the relevant illustration on failed sale and leaseback transactions that is contained in Subtopic 842-40. [See Sections 10.4.2.1 and 10.4.2.3 of this Roadmap.]

### 17.3.1.3.1 Effective Date and Transition

The effective date of the amendments in ASU 2018-10 is aligned with that of ASU 2016-02. For entities that have early adopted ASC 842, the ASU is effective upon issuance and its transition requirements are the same as those in ASC 842.

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4 See footnote 3.
17.3.1.4  ASU 2018-11 on Targeted Improvements

In July 2018, the FASB issued ASU 2018-11 to provide entities with relief from the costs of implementing certain aspects of the new leasing standard. Specifically, under the amendments in ASU 2018-11:

• Entities may elect not to recast their comparative periods in the period of adoption when transitioning to ASC 842.
• Lessors may elect not to separate lease and nonlease components when certain conditions are met.

The scope of the amendments in the ASU is as follows:

• **Transition relief** — These amendments, which allow entities to report the comparative periods presented in the period of adoption under ASC 840, affect all entities with lease contracts that elect not to restate their comparative periods in transition.
• **Lessor relief** — These amendments, which give lessors the option of electing, as a practical expedient by class of underlying asset, not to separate the lease and nonlease components of a contract, only affect lessors whose lease contracts meet certain criteria (discussed below).

Note that while the transition relief amendments may benefit both lessees and lessors, the lessor relief amendments will benefit only lessors.

17.3.1.4.1  Transition Relief

ASC 842, as initially issued, required entities to use a “modified retrospective” transition approach that is intended to maximize comparability and be less complex than a full retrospective approach. See Chapter 16 for further discussion of the effective date and transition guidance.

Under the modified retrospective approach, ASC 842 is effectively implemented as of the beginning of the earliest comparative period presented in an entity’s financial statements. That is, a public entity for which the standard becomes effective on January 1, 2019, would first apply ASC 842 and recognize an adjustment for the effects of the transition as of January 1, 2017 (i.e., the date of initial application).

However, ASU 2018-11 amends ASC 842 so that entities may elect not to recast their comparative periods in transition (the Comparatives Under 840 Option). Effectively, ASU 2018-11 allows entities to change their date of initial application to the beginning of the period of adoption of ASC 842 (e.g., January 1, 2019, for a calendar-year PBE). In doing so, the entity would:

• Apply ASC 840 in the comparative periods.
• Provide the disclosures required by ASC 840 for all periods that continue to be presented in accordance with ASC 840.
• Recognize the effects of applying ASC 842 as a cumulative-effect adjustment to retained earnings as of the effective date (e.g., January 1, 2019); under the Comparatives Under 840 Option, this date would represent the date of initial application.

The entity would not:

• Restate comparative periods for the effects of applying ASC 842.
• Provide the disclosures required by ASC 842 for the comparative periods.
• Change how the transition requirements apply, only when the transition requirements apply.
17.3.1.4.1.1 Effective Date and Transition

The transition relief amendments in ASU 2018-11 apply to entities that have not yet adopted ASC 842.\footnote{See footnote 3.} Entities that have early adopted ASC 842 cannot elect the Comparatives Under 840 Option.

See Sections 16.1.1 and 16.11 for further discussion of the transition relief amendments in ASU 2018-11, including the related disclosure requirements.

17.3.1.4.2 Lessor’s Separation of Lease and Nonlease Components

ASU 2016-02, as initially issued, required lessors to separate lease and nonlease components in all circumstances. Once separate components were identified, lessors were required to use the relative stand-alone selling price allocation method in ASC 606 to allocate the consideration in the contract to the separated components. ASC 842 (including its presentation and disclosure guidance) applied to the lease component, while other guidance, typically ASC 606 (including its presentation and disclosure guidance), applied to the nonlease component.

As a result of feedback received from stakeholders indicating that the costs of complying with the separation and allocation requirements for lessors outweigh the benefits, the FASB amended ASC 842 to give lessors the option of electing a practical expedient under which they would not be required to separate lease and nonlease components, provided that the nonlease component(s) otherwise would be accounted for under the revenue guidance in ASC 606 and both of the following conditions are met:

- \textit{Criterion A} — The timing and pattern of transfer for the lease component are the same as those for the nonlease components associated with that lease component.
- \textit{Criterion B} — The lease component, if accounted for separately, would be classified as an operating lease.

The practical expedient can be elected by class of underlying asset and should be applied, as of the date elected, to all transactions within those classes of underlying assets that qualify for the expedient.

Further, ASC 842-10-15-42C clarifies that the presence of a nonlease component that is ineligible for the practical expedient does not preclude a lessor from electing the expedient for the lease component and nonlease component(s) that meet the criteria. Rather, the lessor would account for the nonlease components that do not qualify for the practical expedient separately from the combined lease and nonlease components that do qualify.

See Section 4.3.3.2 for more information about the practical expedient related to a lessor’s separation of lease and nonlease components.

17.3.1.4.2.1 Disclosure Requirements

When a lessor elects the practical expedient to combine lease and nonlease components in a contract, it is required to provide certain disclosures. Such disclosures include (1) the lessor’s election to combine lease components with associated nonlease components, (2) the class(es) of underlying asset(s) for which the election was made, (3) the nature of the items that are being combined, (4) any nonlease components that were not eligible for the practical expedient, and (5) which standard applies to the combined component (i.e., ASC 842 or ASC 606). (See Section 15.3.2.4 for additional discussion of the disclosure requirements related to ASU 2018-11.)
17.3.1.4.2.2 Effective Date and Transition

For entities that have not yet adopted ASU 2016-02, the effective date of ASU 2018-11 is aligned with the new leasing standard’s effective date and transition requirements.\(^6\)

Upon transition to ASU 2018-11, a lessor electing the practical expedient would be required to apply it to all new and existing transactions within a class of underlying asset that qualify for the expedient as of the date elected. That is, a lessor would not be permitted to apply the practical expedient only to new or modified transactions within a class of underlying asset. See Section 16.4.6 for further discussion of transition requirements related to ASU 2018-11.

17.3.1.5 ASU 2018-20 on Narrow-Scope Improvements for Lessors

In December 2018, the FASB issued ASU 2018-20, which addresses certain concerns raised by lessors regarding the guidance in ASU 2016-02. Specifically, ASU 2018-20 includes amendments related to the following items:

- **Item 1** — “Sales taxes and other similar taxes collected from lessees.”
- **Item 2** — Lessor costs.
- **Item 3** — “Recognition of variable payments for contracts with lease and nonlease components.”

17.3.1.5.1 Sales Taxes and Other Similar Taxes Collected From Lessees

Under ASC 606, as amended by ASU 2016-12, entities can elect an accounting policy of presenting sales taxes collected from customers on a net basis. Specifically, ASC 606-10-32-2A states, in part:

> An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes).

As issued, ASU 2016-02 did not provide lessors with a similar practical expedient for sales taxes collected from lessees. Feedback from stakeholders cited operational challenges with applying the new leasing guidance without such an expedient. Stakeholders noted that although lessors are not within the scope of ASC 606, they are performing a revenue-generating activity in a manner similar to a service accounted for under ASC 606. Therefore, these stakeholders requested that the FASB provide a similar practical expedient under which lessors could elect to present sales taxes collected from lessees on a net basis.

Accordingly, ASU 2018-20 offers lessors an accounting policy election under which they can exclude from lease revenue sales taxes and other similar taxes assessed by a governmental authority and collected by the lessor from a lessee. This is a policy election by the entity. Lessors making this accounting policy election must disclose that they have done so in addition to complying with the disclosure requirements in ASC 235-10-50-1 through 50-6. See Section 15.3.6 for further details about the disclosure requirements in ASU 2018-20 and Section 4.4.2.1.2 for a general discussion of ASU 2018-20.

\(^6\) See footnote 3.
17.3.1.5.2 Lessor Costs

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 on behalf of the lessor or as a reimbursement to the lessor, does not transfer a good or service to the lessee separately from the right to use the underlying asset. ASU 2016-02, as initially issued, required a lessor to report those amounts, regardless of the payor, as revenue and expenses.

Under ASC 606, an entity must evaluate whether it is acting as the principal or the agent in the transaction to determine whether revenue should be presented on a gross or net basis. However, after the issuance of the new revenue standard, stakeholders raised questions about whether an entity should be required to estimate gross revenue when it is acting as the principal but there is uncertainty in the transaction price that is not expected to ultimately be resolved. As a result, when the FASB issued amendments to the principal-versus-agent guidance in ASU 2016-08, it specifically addressed this question in paragraph BC38(c) of the Background Information and Basis for Conclusions of that ASU:

The determination of whether revenue may be estimated or not is based on an assessment of the transaction price guidance in Section 606-10-32 on measurement (such as, the amount of consideration which the entity expects to be entitled to for transferring promised goods or services to a customer and the constraint on variable consideration). The guidance on variable consideration is instructive as to whether amounts should be recognized as revenue. A key tenet of variable consideration is that at some point the uncertainty in the transaction price ultimately [will] be resolved. When the uncertainty is not expected to ultimately be resolved, the guidance indicates that the difference between the amount to which the entity is entitled from the intermediary and the amount charged by the intermediary to the end customer is not variable consideration and, therefore, is not part of the entity’s transaction price.

In light of the guidance in the Background Information and Basis for Conclusions of ASU 2016-08, some lessor stakeholders requested that the FASB provide a similar accounting policy election under which lessors would not be required to recognize lease revenue (and the corresponding expense) for certain costs that are considered lessor costs under ASC 842.

Accordingly, ASU 2018-20 addresses stakeholder concerns about the challenges related to determining costs paid by lessees directly to third parties on behalf of lessors by requiring lessors to exclude such costs from variable payments, and thus from lease revenue. Lessor costs are not a component in the contract because they are neither lease components nor nonlease components (e.g., services). Some common examples of lessor costs include property taxes and insurance in a real estate lease.

Although stakeholders requested a policy election, the amendments in ASU 2018-20 indicate that lessor costs that are paid directly to a third party by a lessor and then reimbursed by the lessee must be accounted for as variable payments. Paragraph BC28 of ASU 2018-20 notes that “[a]lthough the economics between Lessee-Paid and Lessee-Reimbursed are similar in that both may be costs of the lessor, the Board highlighted that all Lessee-Reimbursed costs are known amounts to the lessor and concluded that those costs should be accounted for as lessor costs.”

See Section 4.4.2.1.1 for a detailed discussion of ASU 2018-20.

17.3.1.5.3 Recognition of Variable Payments for Contracts With Lease and Nonlease Components

ASU 2016-02 initially required lessors to recognize variable payments “in profit or loss in the period when changes in the facts and circumstances on which the variable payment is based occur,” regardless of whether the variable payment is related to the lease or nonlease component in the contract.
Stakeholders observed that the guidance, as originally issued, may lead a lessor to recognize as revenue a variable payment related to a nonlease component before the nonlease component is transferred to the customer. That is, as issued, ASC 842-10-15-40, read literally, implied that as soon as an uncertainty that created variability in the consideration is resolved, that amount should be recognized as revenue regardless of whether the item to which it is related has been delivered to the customer-lessee.

To clarify the paragraph’s intent, ASU 2018-20 amended ASC 842 to require a lessor to allocate (rather than recognize) certain variable payments to the lease and nonlease components when the changes in facts and circumstances on which the variable payment is based occur. After the allocation, the amount of variable payments allocated to the lease component would be “recognized as income in profit or loss in accordance with this Topic [ASC 842], while variable payment amounts allocated to nonlease component(s) [would] be recognized in accordance with other Topics (for example, Topic 606 . . .).”

See Section 4.4.2.2 and Q&A 4-11, respectively, for more information about allocating the consideration in the contract and recognizing variable payments in accordance with ASC 842-10-15-40 when a portion is attributable to the nonlease component(s).

17.3.1.5.4 Effective Date and Transition

If an entity has not yet adopted ASU 2016-02 on the date of issuance of ASU 2018-20 (i.e., December 10, 2018), the effective date of ASU 2018-20 is aligned with that of ASU 2016-02.7 In addition, such an entity should consistently apply the amendments to all new and existing leases and apply the same transition method elected for ASU 2016-02.

17.3.1.6 TRG Activities — Billed Operating Lease Receivables

In June 2016, the FASB issued ASU 2016-13, which adds to U.S. GAAP an impairment model — known as the current expected credit losses (CECL) model — that is based on expected losses rather than incurred losses. Once effective, the new guidance will significantly change the accounting for credit impairment under ASC 326.8 (See Deloitte’s June 17, 2016, Heads Up for more information about the new guidance.)

Upon issuing the new credit loss standard, the FASB formed a credit losses transition resource group (TRG).9 At the TRG’s June 11, 2018, meeting,10 a stakeholder asked the FASB staff “whether billed operating lease receivables are within the scope of the guidance in Subtopic 326-20.” The stakeholder noted that views on this issue differ and that such views include the following:

- “Topic 842 has specific guidance . . . indicating that if the assessment of collectibility of an operating lease changes, any amount of lease income recognized that has not been collected should be reversed through a current-period adjustment to lease income.”
- “[T]he scope of Subtopic 326-20 includes financing receivables and billed operating lease receivables appear to meet that definition.”

7 See footnote 3.
8 ASC 326 represents a new topic in the Codification that includes both legacy impairment guidance moved from other Codification sections and new credit losses guidance introduced by ASU 2016-13. Some of the guidance moved from other Codification sections was also amended by ASU 2016-13.
9 The purpose of the TRG is not to issue guidance but instead to seek and provide feedback on potential issues related to implementation of the new credit loss standard.
10 Quoted material is from the TRG’s June 11, 2018, meeting handout.
In response to this inquiry, the FASB staff stated its belief that “operating lease receivables are not within the scope of Topic 326-20” and that “it was never the Board’s intent to include operating leases within the scope.” In November 2018, the FASB issued ASU 2018-19 to clarify certain aspects of ASU 2016-13, including that operating lease receivables are within the scope of ASC 842 rather than ASC 326. Therefore, an entity would apply ASC 842 rather than ASC 326-20 to account for changes in the collectibility assessment for operating leases. When applying ASC 842, an entity would recognize changes in the collectibility assessment for an operating lease receivable as an adjustment to lease income in accordance with ASC 842-10-25-13.

See additional discussion in Section 9.3.9.2.1.

17.3.1.7  ASU 2019-01 on Codification Improvements

In March 2019, the FASB issued ASU 2019-01 on Codification improvements related to the following three ASC 842 issues:

- Determination of the fair value of the underlying asset by lessors that are not manufacturers or dealers.
- Presentation in the statement of cash flows for sales-type and direct financing leases by lessors within the scope of ASC 942.
- Clarification of interim disclosure requirements during transition.

17.3.1.7.1  Determination of the Fair Value of the Underlying Asset by Lessors That Are Not Manufacturers or Dealers

ASC 840-10-55-44 provides guidance on determining fair value and applying it to lease classification and measurement for lessors that are not manufacturers or dealers (“qualifying lessors”), stating that:

> If the lessor is not a manufacturer or dealer, the fair value of the property at lease inception ordinarily will be its cost, reflecting any volume or trade discounts that may apply. However, if there has been a significant lapse of time between the acquisition of the property by the lessor and lease inception, the determination of fair value should be made in light of market conditions prevailing at lease inception, which may indicate that the fair value of the property is greater or less than its cost or carrying amount, if different.

ASC 842, as originally issued, eliminated this fair value exception and instead required that the definition of fair value established in ASC 820 be applied for all aspects of lease accounting in ASC 842.

Stakeholders communicated to the FASB that not carrying forward the fair value exception to ASC 842 would have significant adverse financial reporting consequences for qualifying lessors in certain industries. Specifically, a lessor that is not a manufacturer or dealer would be required to recognize (i.e., expense) acquisition costs (e.g., sales taxes and delivery charges) at lease commencement regardless of how long the lessor has held the asset. Consequently, a lessor whose business model consists of financing the cost of the underlying asset to the lessee would need to record a day 1 loss under ASC 842 in many cases. Further, to recover these costs, the lessor would recognize interest income for sales-type and direct financing leases that is significantly greater than that being recognized under ASC 840. Stakeholders expressed their belief that this accounting outcome is neither useful to investors nor representative of the business model of these lessors.

In response to this issue, the Board issued the amendment in ASU 2019-01 to provide a similar fair value exception as is provided in ASC 840-10-55-44. Therefore, unless a significant lapse of time has occurred, lessors that are not manufacturers or dealers will continue to use their cost, reflecting any volume or trade discounts that may apply, as the fair value of the underlying asset.
17.3.1.7.2 Statement of Cash Flows Presentation for Sales-Type and Direct Financing Leases by Lessors Within the Scope of ASC 942

ASC 842, as originally issued, contained guidance that conflicted with industry-specific GAAP for depository and lending lessors on the presentation of principal payments received from sales-type and direct financing leases. That is, ASC 842 initially required all lessors to classify cash receipts from leases within “operating activities” in accordance with ASC 842-30-45-5, while ASC 942 provides an example in which principal payments received under leases are classified as investing activities for entities within the scope of ASC 942. (This example existed before, and was not consequentially amended by, the issuance of ASC 842.)

The Board issued the amendment in ASU 2019-01 to clarify that the existing guidance in ASC 942 should continue to be applied after the adoption of ASC 842. Accordingly, depository and lending lessors should continue to classify principal payments received from sales-type and direct financing leases within “investing activities.”

17.3.1.7.3 Clarification of Interim Disclosure Requirements During Transition

ASU 2019-01 also clarifies the transition guidance in ASC 842-10-65-1(i), noting that entities adopting ASC 842 need not provide the interim-period disclosures required by ASC 250-10-50-3, which states:

In the fiscal year in which a new accounting principle is adopted, financial information reported for interim periods after the date of adoption shall disclose the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and related per-share amounts, if applicable, for those post-change interim periods.

Accordingly, interim disclosures about the effect on income in the year of adoption of ASC 842 are excluded from the required disclosures in transition. The similar annual disclosures in ASC 250-10-50-1(b)(2) about the effect on income have always been excluded from the ASC 842 disclosures in transition.

17.3.1.7.4 Transition and Effective Date

There is no separate effective date and transition guidance for the Codification improvement related to interim disclosure requirements because that amendment represents a clarification of existing guidance. However, the effective date of the other two amendments in ASU 2019-01 (related to the determination of fair value and presentation in the statement of cash flows) is aligned with the effective dates of ASU 2016-02.11

Early adoption is permitted for all entities. In accordance with ASC 842-10-65-1(c), for entities that early adopt the ASU, the amendments are effective as of the date on which the entity first applies ASU 2016-02.

17.3.2 Other FASB Activity

Since its issuance of ASU 2016-02 in February 2016, the FASB has met on numerous occasions to discuss implementation and interpretive issues that have arisen in practice and that various stakeholders have communicated to the Board. The table below summarizes the topics discussed at these meetings (organized by subject matter) and provides links to where each issue, the related guidance, or both are discussed in more detail in the Roadmap. When a topic was discussed at several meetings, only the meeting that reflects the final status of the topic is included. Further, the table below does not include the topics that ultimately resulted in standard setting (e.g., land easements, transition

11 See footnote 3.
relief, lessor’s separation of lease and nonlease components, and narrow-scope improvements for lessors), since these are discussed elsewhere in this Roadmap.

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<th>Summary of Board Discussion</th>
<th>Meeting Date</th>
<th>Roadmap Reference</th>
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<tr>
<td><strong>Scope, Identifying a Lease, and Components of a Contract</strong></td>
<td>The Board discussed “whether a pipeline lateral is an identified asset under Topic 842, and, if so, how an entity determines whether the customer has the right to control the use of that pipeline lateral throughout the period of use (that is, whether there is a lease of the pipeline lateral).” The Board agreed that, under ASC 842-10-15-16, a pipeline lateral is an identified asset and that the assessment of whether it is a lease must focus on whether the customer has the right to control the use of the identified asset in accordance with ASC 842-10-15-4. While highlighting that the specific facts and circumstances of each arrangement must be considered, the staff discussed two types of pipeline laterals.</td>
<td>May 10, 2017</td>
<td>Q&amp;As 3-3 and 3-13</td>
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<tr>
<td><strong>Lease Term, Lease Payments, and Discount Rate</strong></td>
<td>Some have suggested that, when a sublease has the same contractual terms as the head lease, it is unclear how an entity determines the lease term of the head lease. For example, some believe that if lessee renewal options are included in a sublease, the head lessee’s lease term (for the head lease) must include the periods covered by those renewal options. The Board, acknowledging that ASC 840 is silent on this issue, does not believe that the guidance in ASC 842-10-30-1(c) should be interpreted as meaning that all renewal options outside the lessee’s control must be included in the term of the head lease.</td>
<td>November 30, 2016</td>
<td>Q&amp;A 12-1</td>
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<td>Stakeholders have questioned whether the interest portion of an operating lease payment should be included as a cash outflow in the determination of the undiscounted cash flows used in the asset group recoverability test. The Board generally agreed that lessees should exclude interest payments when calculating the undiscounted cash flows in the assessment of an asset group for impairment under ASC 360. However, some Board members also believe that an entity’s decision to include interest in its impairment analysis could be viewed as an accounting policy election.</td>
<td>November 30, 2016</td>
<td>Section 8.4.4</td>
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<tr>
<td><strong>Lessor Accounting</strong></td>
<td>A lessor’s initial measurement of a sales-type lease that includes significant variable lease payments may result in a loss at lease commencement (i.e., a day 1 loss) if the lease receivable, plus the unguaranteed residual asset, is less than the net carrying value of the underlying asset being leased. This could occur if payments on a lease of, for example, a solar farm are based entirely on the production of electricity (i.e., 100 percent variable). The Board discussed whether a day 1 loss would be appropriate in these situations or whether other possible approaches would be acceptable, including the use of a negative discount rate to avoid the loss at commencement. The Board believes that while stakeholders may disagree with the day 1 loss outcome, ASC 842 is clear on how the initial measurement guidance should be applied to sales-type leases. In addition, the Board stated that the use of a negative discount rate would not be appropriate and should not be applied under ASC 842.</td>
<td>November 30, 2016</td>
<td>Q&amp;A 9-13</td>
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Stakeholders have raised questions about whether lessors that are accounting for the impairment of operating lease receivables should only apply the guidance in ASC 842-30, or whether they are allowed to also apply ASC 450 to record a general allowance on a lease portfolio level.

Before adopting ASC 842, lessors would typically apply the guidance in ASC 310, which refers to ASC 450 and requires an entity to accrue a general allowance if certain conditions are met.

While the establishment of a general reserve under ASC 842-30 is not specifically prohibited, ASC 842-30-25-12 and 25-13 indicate that a lessor must evaluate the collectibility of operating lease payments at the individual lease level. If the collectibility of an individual lease is determined not to be probable, the lessor must derecognize any receivable previously recorded for this lease and must recognize revenue on an ongoing basis only when cash is received. The lessor will continue to account for revenue on a cash basis and will not establish a receivable until it is once again probable that the operating lease payments for that lease will be collected.

The Board observed that there is diversity in practice related to whether an entity records a general reserve in addition to performing the collectibility assessment on a lease-by-lease basis as prescribed by ASC 842-30. The Board also acknowledged that when a general reserve is applied, there is diversity in practice in the income statement treatment of the allowance as either a reduction to revenue or bad-debt expense.

In response to stakeholder concerns, the FASB staff cited two methods that an entity can use to account for the impairment of operating lease receivables:

1. Recognize impairment only at the individual lease level.
2. Recognize a general allowance in accordance with ASC 450 in conjunction with applying the guidance within ASC 842-30.

The FASB staff agreed that under the second approach, the income statement treatment of the general allowance (i.e., the offsetting entry related to setting up and adjusting the allowance) could be a reduction of revenue or a bad-debt expense.

The FASB staff determined that additional standard-setting activity related to this issue is unnecessary at this time.
### Transition

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<tr>
<td>Impact of prior asset group impairments of operating lease ROU asset measurement</td>
<td>Some stakeholders have suggested that it is unclear whether an entity would be expected to allocate prior-period asset group impairments to the operating lease ROU asset when transitioning to ASC 842. The Board stated that a lessee should not revisit prior impairment allocation conclusions and should not include any previous impairments in the measurement of an ROU asset upon adopting the guidance.</td>
<td>November 30, 2016</td>
<td>Section 16.3.1.1.2</td>
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<tr>
<td>Whether an entity should apply the guidance in ASC 840 or ASC 842 during transition</td>
<td>The FASB staff highlighted that it had “received several specific transition inquiries.” Therefore, while not answering any specific inquiry, the staff believed that it was important to highlight the Board’s objectives in its transition decisions in the hope that it would resolve future questions that stakeholders may have. Two core objectives of transition were discussed: 1. Leverage existing systems and processes for in-place leases. 2. Limit optionality. In addition, the discussion highlighted the following key outcomes of the Board’s transition provisions:  • “Leases entered into on or after the effective date of Topic 842 should always be accounted for by applying the guidance in Topic 842.”  • “Leases that have ended before the date of initial application . . . require no transition accounting.”</td>
<td>May 10, 2017</td>
<td>Chapter 16</td>
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ASC 606 requires entities to assess whether a contract is partially within the scope of ASC 606 and partially within the scope of other ASC topics (e.g., ASC 840). ASC 606 also provides guidance on how to separate the components of a contract that are within the scope of different ASC topics. Separation is based on the guidance in the other ASC topics if such guidance exists; otherwise, separation is based on the guidance in ASC 606 (i.e., it is based on the relative stand-alone selling price). As a result, the adoption of ASC 606 could affect contracts that include both revenue and lease components. The question addressed by the Board was whether the application of ASC 606 to prior periods should have an impact only on the revenue component of a contract or whether a lessor is required to reassess the accounting for the entire contract, including lease components. The accounting for the lease component could change if the transaction price is allocated on the basis of the relative stand-alone selling price and the amount allocated to the lease component is affected by the adoption of ASC 606.

The Board decided that an entity is not required to reallocate contract consideration between revenue and lease components when it adopts ASC 606. In other words, application of ASC 606 should only affect the accounting for the revenue components of contracts and not the lease components. The Board indicated that it will reflect this discussion in the meeting minutes rather than requiring future standard setting.

### 17.3.3 Ongoing FASB Activity

The FASB plans to hold a public roundtable to discuss ASC 842 implementation challenges. This roundtable is part of the FASB's broader outreach effort and may ultimately result in further standard-setting activities, depending on the feedback received and the magnitude of the potential update. All FASB board members are expected to be present at the roundtable, as well as members of industry groups, various preparers (public and private companies), users, and public accounting firms. We also expect the SEC staff to observe the meeting.

The table below summarizes the nine agenda topics the FASB staff identified for the roundtable that was previously expected to take place in the spring of 2020. As of the date of this publication, the FASB staff's discussion papers related to each topic have not been distributed; thus, the “expected areas of

12 At its April 8, 2020, meeting, the FASB noted that this roundtable was going to be delayed as a result of the ongoing disruptions caused by the COVID-19 pandemic. While the exact date of the rescheduled meeting is unknown, we expect that it will most likely occur during the latter half of 2020. For more information about the FASB's response to COVID-19, see Section 17.3.4 of this Roadmap and Deloitte's Financial Reporting Alert, "Financial Reporting Considerations Related to COVID-19 and an Economic Downturn."
focus" below could change and additional topics may be added. We plan to summarize the results of the roundtable in a future publication that will be accessible through DART.

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<td>Incremental borrowing rate</td>
<td>We expect the focus of this topic to be on the level of effort preparers will need to expend to develop and support their incremental borrowing rate. This issue may include a discussion of adjustments necessary to reflect the payment timing and structure of the lease and whether such adjustments are required or optional. Various issues related to the collateral assumption used to develop an incremental borrowing rate may also be discussed. This topic is also expected to include discussion of the private-company alternative related to electing the risk-free discount rate as an accounting policy for all leases.</td>
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<tr>
<td>Implicit rate</td>
<td>We expect this issue to focus on when it is appropriate for an entity to use the rate implicit in the lease and the circumstances under which an implicit rate can be “readily determined.” This topic is likely to include discussion of whether (1) the phrase “readily determined” indicates that an entity is required to have direct knowledge of all inputs needed to determine the implicit rate or all material inputs or (2) a reasonable and supportable estimate is sufficient. In addition, the discussion is likely to include a request for feedback on an option (but not a requirement) to use the implicit rate when the rate is reliably estimable. The aforementioned issues related to determining the rate implicit in the lease were submitted by Deloitte to the FASB through an agenda request in January 2019. This agenda request can be accessed through the above link or through the FASB’s listing of agenda requests in the reference library section of its Web site.</td>
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<tr>
<td>Embedded leases</td>
<td>This discussion is expected to explore methods or clarifications that could reduce the cost and complexity of identifying embedded leases by soliciting feedback from participants regarding their current processes and procedures.</td>
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<tr>
<td>Related parties</td>
<td>This topic is expected to address challenges entities have encountered in practice when applying the related-party guidance in ASC 842, including determining the legally enforceable terms of a related-party lease agreement. Moreover, the FASB will most likely solicit private-company feedback on the cost and complexity of complying with the standard to determine the legally enforceable terms, particularly for those private companies without internal legal counsel. We also expect that there may be discussion of the “form over substance” requirement for related-party leases in ASC 842 and how far that guidance extends (e.g., whether form obviates the need for a relative selling price allocation of contract consideration).</td>
</tr>
<tr>
<td>Lessee’s allocation of variable payments</td>
<td>Certain lessees have experienced difficulty in allocating variable payments for noncomponents (e.g., property taxes) between lease and nonlease components within their IT systems when the practical expedient related to not separating the two has not been elected. Others find it counterintuitive that variable payments that are economically linked to a single component in the arrangement must be allocated to all components. This agenda topic is expected to explore whether a lessee should be allowed (or required) to allocate variable payments entirely to one component (e.g., allocating a variable property tax payment entirely to the lease component of property without making an allocation to the nonlease component of CAM). For current guidance on how a lessee should allocate variable payments, see Section 4.4.1.2 and Example 4-5.</td>
</tr>
</tbody>
</table>
### 17.3.4 FASB’s Response to the COVID-19 Pandemic

On April 8, 2020, the FASB met to discuss its ongoing efforts to monitor and respond to the impact of COVID-19 on the preparation of financial statements under U.S. GAAP, including the related accounting and financial reporting implications. Specifically, the Board discussed proposals to delay the effective dates of certain recently issued standards, including ASC 842, for certain entities. The Board later finalized this proposed deferral for certain entities on June 3, 2020, by issuing ASU 2020-05. (See Chapter 16 for more information.) Further, the FASB discussed and provided feedback on technical inquiries received from stakeholders regarding certain accounting topics affected by COVID-19, including staff guidance on how to account for rent concessions provided as a result of the pandemic.
On April 10, 2020, the FASB issued a staff Q&A (the “Staff Q&A”) to provide guidance on its remarks at the April 8 Board meeting about accounting for rent concessions resulting from the COVID-19 pandemic. Specifically, the Staff Q&A affirms the discussion at the April 8 meeting by allowing entities to forgo performing the lease-by-lease legal analysis to determine whether contractual provisions in an existing lease agreement provide enforceable rights and obligations related to lease concessions as long as the concessions are related to COVID-19 and the changes to the lease do not result in a substantial increase in the rights of the lessor or the obligations of the lessee. In addition, the Staff Q&A affirms that entities may make an election to account for eligible concessions, regardless of their form, either by (1) applying the modification framework for these concessions in accordance with ASC 840 or ASC 842 as applicable or (2) accounting for the concessions as if they were made under the enforceable rights included in the original agreement and are thus outside of the modification framework.

See Deloitte’s March 25, 2020, Financial Reporting Alert (updated May 7, 2020) for more information on applying the FASB’s relief related to qualifying concessions as well as interpretive responses to frequently asked questions.
Chapter 18 — Reporting Considerations for SEC Registrants

18.1 SAB Topic 11.M Disclosures

18.2 Financial Statements and Other Affected Financial Information in Exchange Act Reports, Registration Statements, and Other Nonpublic Offerings

   18.2.1 Adoption as of the Beginning of the Year of Adoption by Using the Comparatives Under 840 Option

   18.2.2 Adoption as of the Beginning of the Earliest Comparative Period Presented

18.3 SEC Regulation S-X, Rules 3-09 and 4-08(g) — Financial Statements and Summarized Financial Information for Equity Method Investments

18.4 Permissibility of Non-PBE Adoption Dates for Other Entities’ Financial Statements or Financial Information Required in a Registrant’s Filings

18.5 Changes in Internal Control Over Financial Reporting

18.6 The Effects of Accounting Changes by a Successor Entity on the Predecessor-Period Financial Statements

18.7 Adoption of ASC 842 for an EGC That Elected Private-Company Adoption Dates

18.8 Relationship Between ASC 842 Maturity Analysis Disclosures and Tabular Disclosure of Contractual Obligations

The SEC staff continues to focus on the relationship between implementation issues under the new leasing standard and certain SEC reporting requirements. These requirements pertain to the inclusion, presentation, and disclosure of certain financial information before and after adoption of the new leasing standard.

18.1 SAB Topic 11.M Disclosures

The SEC staff has continued to emphasize the importance of providing investors with disclosures that explain the impact that new accounting standards are expected to have on an entity’s financial statements (“transition disclosures”). Such disclosures include information that investors may need to determine the effects of adopting a new standard and how the adoption will affect comparability from period to period. Transition disclosures should include not only an explanation of the transition method elected (as discussed in Chapter 16) but also information about the impact that the new leasing standard is expected to have on an entity’s financial statements. The SEC staff has highlighted that, in the past, transparent disclosures about the anticipated effects of a new standard in multiple reporting periods preceding its adoption have prevented market participants from reacting adversely to significant accounting changes. In addition, the staff has indicated that it expects to see robust qualitative and

1 See SAB Topic 11.M.
quantitative disclosures about (1) the anticipated impact of new standards and (2) the status of management’s progress in implementation as the adoption date of the new standard approaches. Registrants that have not yet adopted the new leasing standard, such as EGCs that have elected to use the non-PBE effective date of ASC 842, should continue to focus on providing appropriate disclosures in the periods leading up to adoption of the new leasing standard.

The SEC staff has also reiterated that a registrant should provide transparent transition disclosures that comply with the requirements of SAB Topic 11.M and has indicated that when a registrant is unable to reasonably estimate the quantitative impact of adopting the new leasing standard, the registrant should consider providing additional qualitative disclosures about the significance of the impact on its financial statements. The European Securities and Markets Authority has issued a similar public statement for European issuers of public securities that will be adopting new accounting standards, including IFRS 16, reminding entities of the requirement to disclose an impending change in accounting policies for accounting standards that have been issued but are not yet effective and the expected impact of such a change on the financial statements.

There will not be a one-size-fits-all model for communicating the impact of adoption, but entities could consider providing (1) a short narrative that qualitatively discusses the impact of the change or, to the extent available, (2) tabular information (or ranges) identifying the expected accounting under the new leasing standard, such as amounts or ranges of newly recognized ROU assets and liabilities. The following are sample disclosures that an entity could provide about qualitative aspects of the impact of adoption, depending on its specific facts and circumstances:

- ASC 842 provides a package of transition practical expedients that allow an entity to not reassess (1) whether any expired or existing contracts contain a lease, (2) the lease classification of any expired or existing lease, and (3) initial direct costs for any existing lease. We expect to elect the package of transition practical expedients.
- As disclosed in note X, we currently have operating lease commitments of $X billion on an undiscounted basis. Upon adoption of ASC 842, we expect substantially all of these commitments will be recognized as ROU assets and liabilities, on a discounted basis.
- We [are implementing/have implemented] a new enterprise-wide lease accounting system and are [implementing/modifying] internal controls to address the collection, recording, and accounting for leases in accordance with ASC 842.

If an entity chooses to provide quantitative disclosures, it should consider including information reflecting the entity’s selected transition approach (i.e., the modified retrospective method either as of the beginning of the earliest comparative period or as of the beginning of the year of adoption by using the Comparatives Under 840 Option — see Section 16.1.1), since stakeholders would benefit from perspective on the overall impact of adoption as well as any opening adjustments to retained earnings.

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2 This was announced by the SEC observer at the September 22, 2016, EITF meeting. See Deloitte's September 22, 2016, *Financial Reporting Alert* for additional information about the SEC staff’s comments on transition issues.
Chapter 18 — Reporting Considerations for SEC Registrants

18.2 Financial Statements and Other Affected Financial Information in Exchange Act Reports, Registration Statements, and Other Nonpublic Offerings

18.2.1 Adoption as of the Beginning of the Year of Adoption by Using the Comparatives Under 840 Option

As discussed in Section 16.1.1, entities that elect to adopt the standard as of the beginning of the year of adoption by using the Comparatives Under 840 Option will recognize the effects of applying ASC 842 as a cumulative-effect adjustment to opening retained earnings but will not adjust prior periods. Thus, in both quarterly and annual reports after adoption, an entity would not be required to recast its prior-period financial statements and disclosures to comply with the new leasing standard since an entity applying this transition method is permitted to report historical comparative periods in accordance with ASC 840.

18.2.1.1 Annual Disclosures Needed in Quarterly Filings for the Year of Adoption

Although ASC 842 may not require entities to provide certain of the prescribed disclosures discussed in Chapter 15 in interim financial statements, SEC rules and staff interpretations require SEC registrants that first adopt a new standard in an interim period to include both annual and interim disclosures in the first interim period after the adoption of a new accounting standard and in each subsequent quarter in the year of adoption. Specifically, Section 1500 of the FRM states:

[Regulation] S-X Article 10 requires disclosures about material matters that were not disclosed in the most recent annual financial statements. Accordingly, when a registrant adopts a new accounting standard in an interim period, the registrant is expected to provide both the annual and the interim period financial statement disclosures prescribed by the new accounting standard, to the extent not duplicative. These disclosures should be included in each quarterly report in the year of adoption.

As a result, an SEC registrant that first adopts the new leasing standard in an interim period will need to comply with ASC 842’s full suite of disclosure requirements in that quarter and each subsequent quarter in the year of adoption, to the extent that the disclosures are material and do not duplicate existing information.

18.2.1.2 Selected Financial Data Table Requirements Under SEC Regulation S-K, Item 301

SEC Regulation S-K, Item 301, requires an SEC registrant to disclose certain financial data for “[e]ach of the last five fiscal years of the registrant” and “[a]ny additional fiscal years necessary to keep the information from being misleading.” The selected financial data will reflect the adoption method; thus, the most recent period will reflect the requirements of the new leasing standard and the earlier periods will reflect ASC 840. Accordingly, entities should disclose the method used to reflect the information and the lack of comparability of the data presented for the earlier periods in the selected financial data table (if the disclosures are applicable and material).

18.2.1.3 Registration Statements and Other Nonpublic Offerings

Because this method of adoption does not affect prior-period financial statements, an entity is not required to provide any additional retrospective financial statement disclosures or information beyond the transition disclosures discussed above for the financial statements included or incorporated by reference into a registration statement or other nonpublic offering that occurs after the quarter of adoption.
18.2.2 Adoption as of the Beginning of the Earliest Comparative Period Presented

As discussed in Chapter 16, entities that elect to adopt the standard as of the beginning of the earliest comparative period presented will recognize the effects of applying ASC 842 as a cumulative-effect adjustment to retained earnings as of the beginning of the earliest period presented in their annual financial statements and revise the information for the prior years for all years presented in their annual financial statements for the year of adoption. In its quarterly reports, if the registrant first adopts the new standard in an interim period, and in its annual report after adoption, an entity would recast the prior-period financial statements, disclosures, and other information (e.g., MD&A, selected financial data, and selected quarterly financial data) to comply with ASC 842.

Example 18-1

Form 10-Q That First Reports the Adoption of the New Leasing Standard

Company A adopts the new leasing standard on January 1, 2019, and uses the original transition method, retrospectively adjusting comparative periods to reflect the standard. Provided that A first adopts the standard in its interim periods, when A files its Form 10-Q for the quarter ended March 31, 2019, it must retrospectively recast its financial statements for the adoption of ASC 842 for the comparative interim period ended March 31, 2018. Further, A must update MD&A for the interim period ended March 31, 2018, to reflect the retrospective adoption of the new leasing standard. However, there is no immediate requirement for A to recast the annual financial statements presented in its Form 10-K for the year ended December 31, 2018. When A files its 2019 Form 10-K, it would recast the comparative 2018 and 2017 financial statements and disclosures to comply with ASC 842. The date of initial application is January 1, 2017, because this is the first day of the comparative three-year period presented in the 2019 Form 10-K.

Ordinarily, an entity is not required to present the recasted annual prior-period financial information (i.e., for 2018 and 2017) until the subsequent Form 10-K is filed (i.e., the 2019 Form 10-K). However, Section 18.2.2.3 addresses circumstances in which the affected comparative periods (i.e., 2018 and 2017) may need to be recast before the filing of the subsequent Form 10-K.

18.2.2.1 Annual Disclosures Needed in Quarterly Filings for the Year of Adoption

As discussed in more detail in Section 18.2.1.1, SEC rules and staff interpretations require SEC registrants that first adopt a new standard in an interim period to provide both annual and interim disclosures in the first interim period after the adoption of a new accounting standard and in each subsequent quarter in the year of adoption.

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3 See Section 9830 of the FRM for guidance on MD&A in registration statements.
4 See Section 1610 of the FRM for guidance on selected financial data.
5 See Section 4420 of the FRM and SEC Regulation S-K, Item 302.
18.2.2.2 Selected Financial Data Table Requirements Under SEC Regulation S-K, Item 301

SEC Regulation S-K, Item 301, requires an SEC registrant to disclose certain financial data for “[e]ach of the last five fiscal years of the registrant” and “[a]ny additional fiscal years necessary to keep the information from being misleading.” As noted in the highlights of the March 21, 2016, CAQ SEC Regulations Committee joint meeting with the SEC staff, the staff stated that it would not expect SEC registrants adopting the ASU as of the earliest comparative period in the financial statements to reflect the requirements of ASC 842 for all five periods in the selected financial data table. Rather, the staff would expect the selected financial data table to conform to the transition provisions of ASC 842. Thus, the three most recent years will reflect the requirements of the new leasing standard and the earlier periods (i.e., years 4 and 5) will reflect ASC 840. Accordingly, entities should disclose the method used to reflect the information and the lack of comparability of the data presented for the earlier periods in the selected financial data table (if such disclosure is applicable and material).

18.2.2.3 Registration Statements and Other Nonpublic Offerings

For registrants that adopt the new leasing standard as of the beginning of the earliest comparative period presented and first adopt a new standard in an interim period, the requirement to retrospectively revise the annual preadoption financial statements and other affected financial information may be accelerated when the preadoption financial statements are reissued, as discussed in ASC 855-10-25-4 (see also Form S-3, Item 11(b)(ii)). Such reissuance may occur when a registrant (1) files a new or amended registration statement, (2) files a Form S-8, (3) issues a prospectus supplement to a currently effective registration statement (e.g., an existing Form S-3 that already is effective but upon which the registrant wishes to draw down or issue securities), or (4) issues securities in a nonpublic offering. The discussion below addresses these requirements in the context of the adoption of the new leasing guidance. A registrant may need to similarly consider other retrospective changes, such as changes in segment presentation under ASC 280 and presentation of discontinued operations under ASC 205-20. These considerations would not apply to an EGC that elects to adopt the leasing standard for the first time in its annual report rather than in its quarterly reports as permitted. See Section 18.7 for more information.

18.2.2.3.1 New Registration Statements (Other Than Form S-8)

If a registrant files a new or amended registration statement before it files the Form 10-Q that first reports the adoption of the new leasing standard (i.e., before the filing of the first-quarter 2019 Form 10-Q), the registrant is not required (or permitted) to file updated financial statements for prior periods to reflect the adoption of the new leasing standard. However, the registrant should consult with its legal counsel and independent accountants regarding the appropriate disclosure to provide in the registration statement.

If a registrant files a new or amended registration statement after it files the Form 10-Q that first reports the adoption of the new leasing standard and chooses to adopt the standard as of the earliest comparative period presented, the registrant generally must file updated financial statements that reflect the new leasing standard for the relevant comparative periods. Thus, a calendar-year-end registrant would update the financial statements included in the 2018 Form 10-K (i.e., for 2018 and 2017) to reflect the new leasing standard for the applicable periods. Because the new leasing standard

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6 Certain registrants, such as smaller reporting companies or EGCs, may present only two years of historical financial statements in certain circumstances. Therefore, only the two most recent years would reflect the new leasing standard and the remaining years (i.e., years 3, 4, and 5) would reflect ASC 840.

7 SEC registrants that file a proxy statement with the SEC should also consult this guidance. For information about Schedule TO (used to file tender offers), see paragraph 14310.3 of the FRM.

8 See the highlights of the June 23, 2009, CAQ SEC Regulations Committee joint meeting with the SEC staff.
refers to the “earliest comparative period presented,” the SEC staff has clarified that the reissuance of the financial statements in the 2018 Form 10-K accelerates the requirement to retrospectively restate the financial statements for 2018 and 2017; however, it does not change the date of initial application (i.e., January 1, 2017, for a calendar-year-end entity). Accordingly, the financial statements for 2016 that are included or incorporated by reference in the new registration statement would not be retrospectively restated for the new leasing standard. The financial statements for 2016, the earliest year presented, will reflect the legacy ASC 840 accounting requirements. See paragraph 11210.1 of the FRM for further discussion.

In addition, other affected financial information (e.g., MD&A⁹, selected financial data,¹⁰ and selected quarterly financial data¹¹) also should be updated to reflect the retrospectively restated financial statements. For new or amended registration statements that normally incorporate the financial statements by reference (e.g., Form S-3), the registrant may file updated financial statements as well as other affected financial information that reflects the retrospectively restated financial statements on Form 8-K; alternatively, the registrant can include the retrospectively restated financial statements and related information in its registration statement. If the retrospectively restated financial statements are filed on Form 8-K, the Form 8-K will be incorporated by reference into the registration statement and will update the affected sections of the registrant’s previously filed Exchange Act reports (e.g., Form 10-K). Because they were not incorrect when filed, prior Exchange Act reports should not be amended (i.e., the registrant should not file a Form 10-K/A). For more information, see Topic 13 of the FRM.

To prepare itself for a potential registration statement, a registrant is permitted to file updated financial statements and other affected financial information that reflect the retrospectively restated financial statements in a Form 8-K once the adoption of the new leasing standard has been reported in the first-quarter Form 10-Q. However, the registrant is not required to do so until immediately before a registration statement is filed. If the registrant expects to file a new registration statement, it may file the Form 8-K simultaneously with or any time after the filing of the Form 10-Q that reports the adoption of the new leasing standard but before or simultaneously with the filing of the new registration statement.

Example 18-2

Registration Statement After Adoption of the New Leasing Standard

Facts

Example 1
Company A files a new registration statement on May 15, 2019. Company A must either (1) include financial statements and other affected financial information that reflect the adoption of the new leasing standard for the annual periods ended December 31, 2018, and December 31, 2017, or (2) incorporate by reference a previously filed Form 8-K that contains financial statements and other affected financial information that reflect the adoption of the new leasing standard for the annual periods ended December 31, 2018, and December 31, 2017. In both cases, the financial statements for December 31, 2016, included in such filings would reflect the application of ASC 840.

⁹ See footnote 3.
¹⁰ See footnote 4.
¹¹ See footnote 5.
Example 18-2 (continued)

**Example 2**
Company A files a new registration statement on April 10, 2019, before it files the Form 10-Q reflecting the adoption of the new leasing standard. Company A is not required (or permitted) to (1) include in its registration statement updated financial statements that reflect the adoption of the new leasing standard or (2) incorporate by reference a Form 8-K containing updated financial statements and other affected financial information that reflected the new leasing standard. However, A should consult with its legal counsel and independent accountants regarding the appropriate disclosure to provide in the new registration statement.

18.2.2.3.2 Form S-8
The requirements for a Form S-8 are addressed in Question 126.40 of the SEC staff's C&DIs on Securities Act forms:

**C&DI — Securities Act Forms**

**Question 126.40**
**Question:** After its Form 10-K is filed, a registrant has a change in accounting principles (or changes in segment presentation or discontinued operations), which will cause the financial presentation in its subsequent Form 10-Qs to differ from that in its most recent Form 10-K. In this situation, Item 11(b)(ii) of Form S-3 would require the annual audited financial statements filed in the Form 10-K to be restated to reflect the change in accounting principles (or changes in segment presentation or discontinued operations). Would General Instruction G.2 of Form S-8, which requires that “material changes in the registrant’s affairs” be disclosed in the registration statement, also require such restatement?

**Answer:** Not necessarily. Form S-8 does not contain express language similar to Item 11(b)(ii) of Form S-3, requiring the restatement of financial statements to reflect specified events. The fact that financial statements eventually will be retroactively restated does not necessarily mean that there are “material changes in the registrant’s affairs,” thereby requiring the financial statements to be restated for inclusion, or incorporation by reference, in a Form S-8. In other words, financial statements for which Item 11(b)(ii) of Form S-3 would require restatement may not necessarily need to be restated for incorporation by reference in a Form S-8. The registrant is responsible for determining if there has been a material change and, if so, the related information that is required to be disclosed in a Form S-8. Correspondingly, it is the auditor’s responsibility to determine if it will issue a consent to use of its report in a Form S-8 if there has been a change in the financial statements in a subsequent Form 10-Q and the financial statements in the Form 10-K have not been retroactively restated.

Accordingly, if a registrant adopted ASC 842 as of the beginning of the earliest comparative period presented, it is generally not required to update its previously issued financial statements to reflect the adoption of the new leasing standard when these financial statements are incorporated by reference into Form S-8, unless the adoption of ASC 842 constitutes a “material change in the registrant’s affairs.”

18.2.2.3.3 Prospectus Supplements to Registration Statements That Currently Are Effective
For currently effective registration statements (e.g., an existing Form S-3) upon which a registrant wishes to draw down or issue securities, the registrant may use a prospectus supplement. Paragraph 13110.2 of the FRM indicates that “a prospectus supplement used to update a delayed or continuous offering registered on Form S-3 (e.g., a shelf takedown) is not subject to the Item 11(b)(ii) updating requirements.” Rather, the prospectus must be updated “in accordance with S-K 512(a) with respect to any fundamental change.”
The issuance of a prospectus supplement does not constitute a reissuance of the financial statements included or incorporated in the effective registration statement. Management of registrants that adopt the new leasing standard as of the beginning of the earliest comparative period presented, in consultation with legal counsel, should determine whether the retrospective presentation of leases under ASC 842 constitutes a fundamental change. (For more information, see SEC Regulation S-K, Item 512(a).) If the registrant and its legal counsel determine that the retrospective adjustment to present the adoption of the new leasing standard is a fundamental change, updated financial statements and other affected financial information should be filed on Form 8-K or included in the registration statement, as described above. However, if the registrant and its legal counsel determine that the retrospective adjustment for the adoption of the new leasing standard is not a fundamental change, the financial statements do not need to be updated but the registrant should consult with its legal counsel and independent accountants regarding the appropriate disclosure to provide in the prospectus supplement. In addition, all post-effective amendments are considered “new filings” and are subject to the guidance discussed in Section 18.2.2.3.1.

18.2.2.3.4 Nonpublic Offerings

Financial statements subject to retrospective changes may also be included in (i.e., reproduced) or incorporated into a nonpublic offering, such as a private placement in accordance with SEC Regulation D or Rule 144A of the Securities Act:

- **Financial statement included in a nonpublic offering** — We believe that, under U.S. GAAP, entities are generally required to update the financial statements for prior periods to reflect the adoption of the new leasing standard if they adopt the standard as of the earliest comparative period presented. Accordingly, the considerations related to updating the financial statements for the adoption of the new leasing standard would be similar to those discussed in Section 18.2.2.3.1.

- **Financial statements incorporated by reference into a nonpublic offering** — We believe that the considerations related to restating the financial statements for the new leasing standard would be the same as those discussed in Section 18.2.2.3.3.

18.3 SEC Regulation S-X, Rules 3-09 and 4-08(g) — Financial Statements and Summarized Financial Information for Equity Method Investments

Under SEC Regulation S-X, Rules 3-09 and 4-08(g), SEC registrants are required to evaluate the significance of an equity method investee in accordance with the tests in SEC Regulation S-X, Rule 1-02(w) (i.e., the asset, income, or investment test), to determine whether they must provide the investee's financial statements, the investee's summarized financial information, or both. Under these rules, the prescribed significance tests are performed annually in connection with the filing of a Form 10-K (i.e., at the end of the registrant's fiscal year). Accordingly, significance is not remeasured when updated financial statements that reflect retrospective adjustments are filed in a Form 8-K (or are included in or incorporated into a registration statement).

As indicated in Topic 11 and paragraph 2410.8 of the FRM, when a change in accounting is retrospectively applied in financial statements included in a registrant's Form 10-K, the registrant is not required to recalculate the significance of an equity method investee under Rules 3-09 and 4-08(g). Therefore, for periods before the date of initial adoption of the new leasing standard, registrants may continue to measure the significance of their equity method investees by using results from their preadoption financial statements.\(^{12}\)

\(^{12}\) For a discontinued operation, a registrant should be mindful that significance under Rules 3-09 and 4-08(g) should be measured for each annual period presented in the financial statements on the basis of amounts that were retrospectively adjusted. Consequently, as a result of retrospective adjustments for a discontinued operation, a previously insignificant equity method investee may become significant. For additional information, see Deloitte's *A Roadmap to Disposals of Long-Lived Assets and Discontinued Operations*. 

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18.4 Permissibility of Non-PBE Adoption Dates for Other Entities’ Financial Statements or Financial Information Required in a Registrant’s Filings

At the July 20, 2017, EITF meeting, the SEC staff announced that it would not object when certain PBEs elect to use the non-PBE effective dates solely to adopt the FASB’s new standards on revenue and leasing. The staff announcement clarifies that the ability to use non-PBE effective dates to adopt the new revenue and leasing standards is limited to the subset of PBEs “that otherwise would not meet the definition of a public business entity except for a requirement to include or inclusion of its financial statements or financial information in another entity’s filings with the SEC” (referred to herein as “specified PBEs”).

While the staff announcement is written in the context of specified PBEs, the principal beneficiaries of the relief will be SEC filers that include financial statements or financial information prepared by specified PBEs in their own filings. SEC Regulation S-X rules under which such filings may be prepared could include:

- Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired.”
- Rule 3-09, “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons.”
- Rule 3-14, “Special Instructions for Real Estate Operations to Be Acquired.”
- Rule 4-08(g), “Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons.”

Under the new leasing standard, there is one adoption date for PBEs and another (later) adoption date for non-PBEs.

The ASC master glossary defines a PBE, in part, as a business entity that is “required by the [SEC] to file or furnish financial statements, or [that] 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)” (emphasis added). The definition further states that “[a]n 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.”

Before the staff’s announcement, certain nonpublic companies applying the PBE definition in the adoption-date criteria would have been required to use the public-company adoption dates for the new revenue and leasing standards. While the SEC staff announcement provides considerable and welcome relief to registrants preparing to adopt the new leasing standard, it is purposely narrow in scope and should not be applied by analogy to the adoption-date assessment for any other standards besides the revenue and leasing standards. The SEC staff announcement does not preclude specified PBEs from adopting the provisions of the new revenue and leasing standards on the adoption date applicable to all other PBEs if a specified PBE wishes to use the PBE adoption date.

In November 2019, the FASB issued ASU 2019-10, which, among other things, amends the effective dates of ASC 842 for non-PBEs to fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. At the 2019 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff announced that it would not object if specified PBEs adopt ASC 842 by using ASU 2019-10’s timelines that apply to non-PBEs. This position was subsequently codified in ASU 2020-02. As of the date of this publication, the SEC staff has not provided guidance on the additional deferral of the effective dates of ASC 842 for non-PBEs to fiscal years beginning after December 15, 2021, under ASU 2020-05. Stay tuned for further guidance.
Example 18-3

Company A, a publicly traded manufacturer, holds equity method investments in three of its nonpublic suppliers. After applying the Regulation S-X significance tests, A has determined that it must include summarized financial information for Suppliers X, Y, and Z (under Regulation S-X, Rule 4-08(g)) in its SEC filing. Suppliers X, Y, and Z meet the definition of a PBE only because they are required to include their financial information in A's SEC filing (i.e., they qualify as specified PBEs). Consequently, X, Y, and Z plan to use the non-PBE adoption dates of the new revenue and leasing standards when preparing their own stand-alone financial statements. When including the summarized financial information of X, Y, and Z in its own SEC filing, A is not required to adjust the suppliers' financial statements to reflect the PBE adoption date of the new revenue and leasing standards.

Connecting the Dots — Including Financial Statements or Financial Information of Specified PBEs

A registrant that has passed certain significance tests required by Regulation S-X may be required to include in its SEC filing the financial statements or financial information of another entity. We believe that, in a manner consistent with paragraph 11120.2 of the FRM, it is also appropriate for the registrant to use financial information prepared by specified PBEs that apply non-PBE adoption dates when performing these significance tests. However, on the basis of paragraph 3250.1(m) of the FRM, if pro forma financial information is being prepared under Regulation S-X, Article 11, to reflect the acquisition of a significant business, the registrant must still conform the target's transition dates and methods of adoption to its own in the pro forma presentation for the periods after adoption.

18.5 Changes in Internal Control Over Financial Reporting

Registrants are required to disclose any material changes in their ICFR in a Form 10-Q or Form 10-K in accordance with SEC Regulation S-K, Item 308(c). Accordingly, registrants will need to be mindful of these disclosure requirements when establishing new controls and processes related to the adoption of the new leasing standard. For further discussion of ICFR, see Appendix E.

18.6 The Effects of Accounting Changes by a Successor Entity on the Predecessor-Period Financial Statements

At the March 23, 2017, CAQ SEC Regulations Committee joint meeting with the SEC staff (the “March 2017 CAQ meeting”), the SEC staff discussed the effect on predecessor-period financial statements of accounting changes by a successor, specifically when the successor's basis of accounting differs from that of its predecessor because of a change in control, pushdown accounting, or fresh-start reporting. For example, this situation would arise if (1) a transaction that occurs on November 15, 2018, causes a change in basis for which a successor/predecessor black-line presentation is required and (2) the successor entity retrospectively adopts a new accounting standard that is effective as of January 1, 2019. This matter is particularly important in light of the significance of the new leasing standard and the lack of comparability that would result if the registrant chooses to adopt the new leasing standard as of the earliest comparative period presented but does not adjust the predecessor-period financial statements. As noted in the highlights of the March 2017 CAQ meeting, the SEC staff referred registrants to paragraph 13210.2 of the FRM, which, in the staff's view, indicates that the need to reflect the impact of discontinued operations in predecessor periods “does not apply to any other accounting changes.” The SEC staff subsequently confirmed this view at the September 26, 2017, CAQ SEC Regulations Committee joint meeting with the SEC staff.
18.7 Adoption of ASC 842 for an EGC That Elected Private-Company Adoption Dates

An EGC may elect to adopt new accounting standards on the basis of effective dates that apply to an entity that is not a PBE, including the option to first adopt a new standard in annual financial statements. However, such an election is available only for as long as the entity qualifies as an EGC. Questions have been raised regarding the transition provisions applicable when an entity loses EGC status after the effective date for a PBE but before the effective date for an entity that is not a PBE. As discussed in paragraph 10230.1 of the FRM, the SEC staff generally expects an EGC that loses its EGC status to comply with PBE requirements in the first filing after loss of EGC status. Further, the staff encourages EGCs to (1) review their plans to adopt accounting standards upon the loss of EGC status and (2) consult with the Division of Corporation Finance if they do not believe that they will be able to comply on a timely basis with the requirement to reflect new accounting standards. The scenarios discussed below reflect our general understanding of how an EGC that elected deferred adoption would reflect the new leasing standard after the deferral of adoption dates for non-PBEs (i.e., under ASU 2019-10). As of the date of this publication, the SEC staff has not provided guidance on the additional deferral of the effective dates of ASC 842 for non-PBEs to fiscal years beginning after December 15, 2021, under ASU 2020-05. Stay tuned for further guidance. The scenarios below were not updated for any future relief that may be granted by the SEC staff in conjunction with this ASU.

Scenario 1: SEC Registrant Loses Its EGC Status on November 30, 2020

Assume that a registrant is a November 30 year-end EGC; has elected to take advantage of the extended transition provisions and adopt the new leasing standard by using private-company adoption dates; and has elected the comparatives under 840 transition method.

If the registrant loses its EGC status on November 30, 2020, the registrant should:

<table>
<thead>
<tr>
<th>Adopt ASC 842:</th>
<th>For the annual period beginning on December 1, 2019.</th>
</tr>
</thead>
<tbody>
<tr>
<td>First present the application of ASC 842 in its:</td>
<td>Annual financial statements for the year ending November 30, 2020, included in its 2020 Form 10-K.</td>
</tr>
<tr>
<td>Present the application of ASC 842 in its selected quarterly financial data (SEC Regulation S-K, Item 302(a)) for its:</td>
<td>2020 quarterly periods in its 2020 Form 10-K. Further, we believe that the registrant should provide clear and transparent disclosures that the quarterly financial data presented in its 2020 Form 10-K do not mirror the information in its 2020 Forms 10-Q for the current year.</td>
</tr>
<tr>
<td>Present the application of ASC 842 in its quarterly interim financial statements for its:</td>
<td>2020 comparable quarterly periods presented in Forms 10-Q in 2021.</td>
</tr>
</tbody>
</table>

Scenario 2: Calendar-Year-End SEC Registrant Loses Its EGC Status on December 31, 2020

Assume that a registrant is a calendar-year-end EGC; has elected to take advantage of the extended transition provisions and adopt the new leasing standard by using private-company adoption dates; has elected the Comparatives Under 840 transition method; and the registrant loses its EGC status on December 31, 2020. We believe that the registrant should adopt the new leasing standard in its next filing after losing status on the basis of the guidance in paragraph 10230.1(f) of the FRM, which states, in part:

Generally, if an EGC loses its status after it would have had to adopt a standard absent the extended transition, the issuer should adopt the standard in its next filing after losing status. However, depending on the facts and circumstances, the staff may not object to other alternatives.

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It is our understanding that under these facts, the SEC staff would not object if the registrant were to:

<table>
<thead>
<tr>
<th>Scenario 2: Calendar-Year-End SEC Registrant Maintains Its EGC Status on December 31, 2020</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Adopt ASC 842:</strong></td>
</tr>
<tr>
<td><strong>First present the application of ASC 842 in its:</strong></td>
</tr>
<tr>
<td><strong>Present the application of ASC 842 in its selected quarterly financial data (SEC Regulation S-K, Item 302(a)) for its:</strong></td>
</tr>
<tr>
<td><strong>Present the application of ASC 842 in its quarterly interim financial statements for its:</strong></td>
</tr>
</tbody>
</table>

**Scenario 3: Calendar-Year-End SEC Registrant Loses Its EGC Status on December 31, 2021**

Assume the same facts as in Scenario 2, except the registrant loses its EGC status on December 31, 2021. On the basis of the guidance outlined in Scenario 2, we believe that the SEC staff would not object if the registrant were to:

<table>
<thead>
<tr>
<th>Scenario 3: Calendar-Year-End SEC Registrant Loses Its EGC Status on December 31, 2021</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Adopt ASC 842:</strong></td>
</tr>
<tr>
<td><strong>First present the application of ASC 842 in its:</strong></td>
</tr>
<tr>
<td><strong>Present the application of ASC 842 in its selected quarterly financial data (SEC Regulation S-K, Item 302(a)) for its:</strong></td>
</tr>
<tr>
<td><strong>Present the application of ASC 842 in its quarterly interim financial statements for its:</strong></td>
</tr>
</tbody>
</table>
### Scenario 4: Calendar-Year-End SEC Registrant Qualifies as an EGC on or After December 31, 2021

Assume the same facts as in Scenario 2, except the registrant qualifies as an EGC through the end of the transition period (i.e., through December 31, 2021) or later. We believe that the registrant could:

<table>
<thead>
<tr>
<th>Adopt ASC 842:</th>
<th>For the annual period beginning on January 1, 2021.</th>
</tr>
</thead>
<tbody>
<tr>
<td>First present the application of ASC 842 in its:</td>
<td>2021 annual financial statements included in its 2021 Form 10-K.</td>
</tr>
<tr>
<td>Present the application of ASC 842 in its selected quarterly financial data (SEC Regulation S-K, Item 302(a)) for its:</td>
<td>2022 quarterly periods in its 2022 Form 10-K. The registrant is not required to reflect the adoption of ASC 842 in the 2021 quarterly periods in its 2021 Form 10-K (see paragraph 11110.2 of the FRM). Further, we believe that the registrant should provide clear and transparent disclosures that the quarterly financial data presented in its 2021 Form 10-K are presented on a basis different from that of the annual financial statements presented in its 2021 Form 10-K.</td>
</tr>
<tr>
<td>Present the application of ASC 842 in its quarterly interim financial statements for its:</td>
<td>2022 quarterly periods presented in Forms 10-Q in 2022. The registrant is encouraged, but not required, to present the 2021 comparable quarters under ASC 842 in its Forms 10-Q in 2022. If the registrant does not present the comparable quarters under the new standard, the SEC staff would expect the registrant to provide clear and transparent disclosures that the prior-period information is presented on a basis different from that of the current year.</td>
</tr>
</tbody>
</table>

The above would apply for a registrant that qualifies as an EGC on December 31, 2021, and subsequently loses its EGC status.

### 18.8 Relationship Between ASC 842 Maturity Analysis Disclosures and Tabular Disclosure of Contractual Obligations

SEC Regulation S-K, Item 303(a)(5), requires registrants to provide in MD&A a tabular disclosure of contractual obligations as of their latest fiscal year-end balance sheet date. The registrant must disaggregate the contractual obligations by category as follows:

- Long-term debt obligations.
- Capital (finance) leases.
- Operating lease obligations.
- Purchase obligations.
- Other long-term liabilities reflected on the registrant’s balance sheet.

As noted in the highlights of the September 24, 2019, CAQ SEC Regulations Committee joint meeting, the SEC staff clarified that, for periods after the implementation of ASC 842, cash outflows included in the tabular disclosure of contractual obligations should be consistent with the maturity analysis of lease liabilities required by ASC 842-20-50-6 (see Section 15.2.5). In a manner consistent with the guidance in paragraph 9240.7 of the FRM, registrants may wish to supplement the tabular disclosure with a narrative discussion to address further aspects of their liquidity needs or future cash requirements that may not otherwise be reflected in the tabular disclosure (e.g., variable lease payments, forward-starting leases).
This appendix includes defined terms from the glossary sections in ASC 842.

<table>
<thead>
<tr>
<th><strong>ASC 842 Glossary</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Acquiree</strong>&lt;br&gt;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.</td>
</tr>
<tr>
<td><strong>Acquirer</strong>&lt;br&gt;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.</td>
</tr>
<tr>
<td><strong>Acquisition by a Not-for-Profit Entity</strong>&lt;br&gt;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.</td>
</tr>
<tr>
<td><strong>Advance Refunding</strong>&lt;br&gt;A transaction involving the issuance of new debt to replace existing debt with the proceeds from the new debt placed in trust or otherwise restricted to retire the existing debt at a determinable future date or dates.</td>
</tr>
<tr>
<td><strong>Business Combination</strong>&lt;br&gt;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.</td>
</tr>
<tr>
<td><strong>Commencement Date of the Lease (Commencement Date)</strong>&lt;br&gt;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.</td>
</tr>
</tbody>
</table>
### ASC 842 Glossary (continued)

**Consideration in the Contract**

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

**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.

**Direct Financing Lease**
From the perspective of a lessor, a lease that meets none of the criteria in paragraph 842-10-25-2 but meets the criteria in paragraph 842-10-25-3(b).

**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.

**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.

**Effective Date of the Modification**
The date that a lease modification is approved by both the lessee and the lessor.

**Estimated Residual Value**
The estimated fair value of the leased property at the end of the lease term.

**Fair Value**
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.

**Finance Lease**
From the perspective of a lessee, a lease that meets one or more of the criteria in paragraph 842-10-25-2.

**Fiscal Funding Clause**
A provision by which 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.

**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.
### ASC 842 Glossary (continued)

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial Direct Costs</strong></td>
<td>Incremental costs of a lease that would not have been incurred if the lease had not been obtained.</td>
</tr>
</tbody>
</table>
| **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. |
| **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. |
| **Lease Inception** | The date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition. |
| **Lease Liability** | A lessee's obligation to make the lease payments arising from a lease, measured on a discounted basis. |
| **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). |
| **Lease Payments** | See paragraph 842-10-30-5 for what constitutes lease payments from the perspective of a lessee and a lessor. |
| **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. |
Appendix A — Glossary of Terms in ASC 842-10-20, ASC 842-20-20, ASC 842-30-20, ASC 842-40-20, and ASC 842-50-20

**ASC 842 Glossary (continued)**

**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.

**Legal Entity**
Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.

**Lessee**
An entity that enters into a contract to obtain the right to use an underlying asset for a period of time in exchange for consideration.

**Lessor**
An entity that enters into a contract to provide the right to use an underlying asset for a period of time in exchange for consideration.

**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.

**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.
### ASC 842 Glossary (continued)

#### Minimum Lease Payments

Minimum lease payments comprise the payments that the lessee is obligated to make or can be required to make in connection with the leased property, excluding both of the following:

- **Contingent rentals**
- Any guarantee by the lessee of the lessor’s debt and the lessee’s obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property.

If the lease contains a bargain purchase option, only the minimum rental payments over the lease term and the payment called for by the bargain purchase option are required to be included in the minimum lease payments. Otherwise, minimum lease payments include all of the following:

- The minimum rental payments called for by the lease over the lease term.
- Any guarantee of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property or of rental payments beyond the lease term by the lessee (including a third party related to the lessee) or a third party unrelated to either the lessee or the lessor, provided the third party is financially capable of discharging the obligations that may arise from the guarantee. If the lessor has the right to require the lessee to purchase the property at termination of the lease for a certain or determinable amount, that amount is required to be considered a lessee guarantee of the residual value. If the lessee agrees to make up any deficiency below a stated amount in the lessor’s realization of the residual value, the residual value guarantee to be included in the minimum lease payments is required to be the stated amount, rather than an estimate of the deficiency to be made up.
- Any payment that the lessee must make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the payment would constitute a purchase of the leased property. Note that the definition of lease term includes all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at lease inception, to be reasonably assured. If the lease term has been extended because of that provision, the related penalty is not included in minimum lease payments.
- Payments made before the beginning of the lease term. The lessee is required to use the same interest rate to accrete payments to be made before the beginning of the lease term that it uses to discount lease payments to be made during the lease term.
- Fees that are paid by the lessee to the owners of the special-purpose entity for structuring the lease transaction. Such fees are required to be included as part of minimum lease payments (but not included in the fair value of the leased property).

Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. However, lease payments that depend on an existing index or rate, such as the Consumer Price Index or the prime interest rate, are required to be included in minimum lease payments based on the index or rate existing at lease inception; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and, thus, affect the determination of income as accruable.

#### Monetary Liability

An obligation to pay a sum of money the amount of which is fixed or determinable without reference to future prices of specific goods and services.
### ASC 842 Glossary (continued)

**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.

**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.

**Operating Lease**
From the perspective of a lessee, any lease other than a finance lease.

From the perspective of a lessor, any lease other than a sales-type lease or a direct financing lease.

**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).

**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.
ASC 842 Glossary (continued)

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).

Probable
The future event or events are likely to occur.

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 notes) 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.

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. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used.
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.

Remote
The chance of the future event or events occurring is slight.

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.

Right-of-Use Asset
An asset that represents a lessee's right to use an underlying asset for the lease term.

Sales-Type Lease
From the perspective of a lessor, a lease that meets one or more of the criteria in paragraph 842-10-25-2.

Security
A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.
**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.

**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.

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

**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.

**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.

**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.

**Useful Life**
The period over which an asset is expected to contribute directly or indirectly to future cash flows.

**Variable Interest Entity**
A legal entity subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

**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.

**Warranty**
A guarantee for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party. The obligation may be incurred in connection with the sale of goods or services; if so, it may require further performance by the seller after the sale has taken place.
Appendix B — Differences Between U.S. GAAP and IFRS Standards

Although the FASB and IASB conducted joint deliberations and intended to converge their respective leasing standards (ASC 842 and IFRS 16), there are several notable differences between the two standards. The following table summarizes these differences:

<table>
<thead>
<tr>
<th>Key Provision</th>
<th>ASC 842</th>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scope</strong></td>
<td>Scope includes leases of all PP&amp;E and excludes:</td>
<td>Scope includes leases of all assets (not limited to PP&amp;E). Exceptions are similar to those in ASC 842. Lessees can elect to apply the guidance to rights to use certain intangible assets.</td>
</tr>
<tr>
<td></td>
<td>• Rights to use intangible assets.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Rights to explore for or use nonregenerative resources.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Rights to use biological assets.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Rights to use inventory.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Rights to use assets under construction.</td>
<td></td>
</tr>
<tr>
<td><strong>Short-term lease definition</strong></td>
<td>A short-term lease is defined as a lease that has a lease term of 12 months or less and does not include a purchase option that the lessee is reasonably certain to exercise.</td>
<td>A short-term lease is defined as a lease that has a lease term of 12 months or less and does not include a purchase option (i.e., the likelihood that the purchase option will be exercised is not considered).</td>
</tr>
<tr>
<td><strong>Leases of low-value assets</strong></td>
<td>No exemption under U.S. GAAP. However, the FASB believes that an entity will be able to adopt a reasonable capitalization policy based on materiality.</td>
<td>A lessee may elect to recognize the payments for a lease of a low-value asset on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease under IAS 17). These leases would not be reflected on the lessee's balance sheet. IFRS 16 does not define &quot;low value&quot;; however, the Basis for Conclusions refers to assets individually with a value, when new, of $5,000 or less. In addition, an entity will be able to adopt a reasonable capitalization policy based on materiality.</td>
</tr>
</tbody>
</table>
### Key Provision

<table>
<thead>
<tr>
<th></th>
<th>ASC 842</th>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lease classification</strong></td>
<td>Lessee — There are two accounting models for leases, and the model will dictate the pattern of expense recognition associated with the lease. Therefore, a lessee must perform a lease classification assessment at the commencement date. Under ASC 842-10-25-2, a lessee must classify a lease as a finance lease if any of the following criteria are met:</td>
<td>Lessee — There is only a single accounting model for leases (i.e., all leases are effectively equivalent to finance leases under ASC 842), so classification of leases is unnecessary.</td>
</tr>
<tr>
<td></td>
<td>• “The lease transfers ownership of the underlying asset.”</td>
<td><strong>Lessor</strong> — A lessor must perform a lease classification assessment as of the <strong>inception date</strong>. A lease is classified as a finance lease if it transfers substantially all of the risks and rewards related to ownership; otherwise, it is classified as an operating lease. This determination is not based on meeting any criterion. However, examples of situations that individually or in combination would indicate a finance lease include:</td>
</tr>
<tr>
<td></td>
<td>• “The lease grants . . . an option to purchase the underlying asset that the lessee is reasonably certain to exercise.”</td>
<td>• The lease transfers ownership of the underlying asset.</td>
</tr>
<tr>
<td></td>
<td>• “The lease term is for the major part of the remaining economic life of the underlying asset.”</td>
<td>• The lease term is for the major part of the remaining economic life of the underlying asset.</td>
</tr>
<tr>
<td></td>
<td>• “The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset.”</td>
<td>• The present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset.</td>
</tr>
<tr>
<td></td>
<td>• “The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor.”</td>
<td>• The underlying asset is of a specialized nature and has no alternative use to the lessor.</td>
</tr>
<tr>
<td></td>
<td>If none of these criteria are met, the lease would be classified as an operating lease.</td>
<td>Other situations in which a lease could be a finance lease include:</td>
</tr>
<tr>
<td></td>
<td><strong>Lessor</strong> — A lessor must perform a lease classification assessment as of the <strong>commencement date</strong>. The criteria governing when a lessor must classify a lease as a sales-type lease are the same as those that govern when a lessee must classify a lease as a finance lease (noted above). If none of these criteria are met, the lessor would classify the lease as a direct financing lease in accordance with ASC 842-10-25-3 if (1) the sum of the lease payments and any third-party guarantee of the residual value “equals or exceeds substantially all of the fair value of the underlying asset” and (2) ”[i]t is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.” Otherwise, the lease would be classified as an operating lease.</td>
<td>• The lessee bears the lessor’s losses for early cancellation.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Gains or losses related to the asset at the end of the lease accrue to the lessee.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The lessee can renew the lease for rent that is substantially lower than the market rate.</td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>Key Provision</th>
<th>ASC 842</th>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lessee's subsequent accounting for ROU asset and lease expense</td>
<td>The accounting depends on the lease classification:</td>
<td>A single accounting model. The ROU asset is generally amortized on a straight-line basis. This amortization, when combined with the interest on the lease liability, results in a front-loaded expense profile. That is, the single lessee accounting model under IFRS 16 is similar to that of a finance lease under ASC 842. Interest expense on the lease liability and amortization of the ROU asset are presented separately in the income statement.</td>
</tr>
<tr>
<td></td>
<td><em>Finance leases</em> — The ROU asset is generally amortized on a straight-line basis. This amortization, when combined with the interest on the lease liability, results in a front-loaded expense profile. Interest and amortization are presented separately in the income statement.</td>
<td></td>
</tr>
<tr>
<td></td>
<td><em>Operating leases</em> — Lease expense generally results in a straight-line expense profile that is presented as a single line in the income statement. As interest on the lease liability is generally declining over the lease term, amortization of the ROU asset is increasing over the lease term to provide a constant expense profile.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>A single accounting model. The ROU asset is generally amortized on a straight-line basis. This amortization, when combined with the interest on the lease liability, results in a front-loaded expense profile. That is, the single lessee accounting model under IFRS 16 is similar to that of a finance lease under ASC 842. Interest expense on the lease liability and amortization of the ROU asset are presented separately in the income statement.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lessor accounting</td>
<td><em>Core model</em> — Substantially retains the lessor measurement approach in ASC 840 for operating, direct financing, and sales-type leases.</td>
<td><em>Core model</em> — Substantially retains the lessor measurement approach in IAS 17 for operating and finance leases.</td>
</tr>
<tr>
<td></td>
<td>Selling profit for a sales-type lease is recognized at lease commencement. Selling profit on a direct financing lease, if any, is deferred and recognized as interest income over the lease term.</td>
<td>Selling profit for a finance lease is recognized at lease commencement.</td>
</tr>
<tr>
<td></td>
<td><em>Separating lease and nonlease components</em> — ASU 2018-11 offers lessors a practical expedient under which they are allowed not to separate lease and nonlease components when certain conditions are met.</td>
<td><em>Separating lease and nonlease components</em> — A similar practical expedient is not available.</td>
</tr>
<tr>
<td></td>
<td><em>Sales tax and lessor costs</em> — ASU 2018-20 offers lessors a practical expedient under which they can present sales taxes collected from lessees on a net basis. ASU 2018-20 also added a requirement that lessor costs paid directly to a third party by a lessee should be excluded from variable payments.</td>
<td><em>Sales tax and lessor costs</em> — A similar practical expedient is not available. In addition, there are no similar provisions related to lessor costs paid directly to a third party by a lessee.</td>
</tr>
<tr>
<td></td>
<td><em>Fair value of underlying asset</em> — ASU 2019-01 amends the definition of fair value for lessors that are not manufacturers or dealers in such a way that the fair value of the underlying asset is its cost unless a significant lapse of time has occurred.</td>
<td><em>Fair value of underlying asset</em> — A similar amendment to the definition of fair value has not been made.</td>
</tr>
<tr>
<td><strong>Key Provision</strong></td>
<td><strong>ASC 842</strong></td>
<td><strong>IFRS 16</strong></td>
</tr>
<tr>
<td>-------------------</td>
<td>-------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Recognition of variable lease payments that do not depend on an index or rate</td>
<td>A lessee should recognize variable lease payments not included in its lease liability (e.g., payments based on the achievement of a target) in the period in which achievement of the target that triggers the variable lease payments becomes probable.</td>
<td>A lessee should recognize variable lease payments not included in its lease liability (e.g., payments based on the achievement of a target) in the period in which the target is achieved.</td>
</tr>
<tr>
<td>Reassessment of variable lease payments that depend on an index or rate</td>
<td>A lessee reassesses variable payments based on an index or rate only when the lease obligation is remeasured for other reasons (e.g., a change in lease term or modification).</td>
<td>A lessee reassesses variable payments based on an index or rate whenever there is a change in contractual cash flows (e.g., the lease payments are adjusted for a change in the CPI) or when the lease obligation is remeasured for other reasons.</td>
</tr>
<tr>
<td>Lessee's incremental borrowing rate</td>
<td>The lessee's incremental borrowing rate is the rate a lessee would pay to borrow, on a collateralized basis over a similar term, <strong>an amount equal to the lease payments</strong> in a similar economic environment.</td>
<td>The lessee's incremental borrowing rate is the rate a lessee would pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset with a value similar to the ROU asset in a similar economic environment.</td>
</tr>
<tr>
<td>Discount rate for private companies</td>
<td>Private-company lessees can elect to use a risk-free rate.</td>
<td>No exemptions provided for private-company lessees.</td>
</tr>
</tbody>
</table>
| Modifications of operating leases for lessors | If an operating lease is modified and not accounted for as a separate contract, the treatment depends on the classification of the modified lease:  
- **Modified lease classified as an operating lease** — The lessor should include any prepaid or accrued lease rentals related to the original lease in the lease payments associated with the new lease.  
- **Modified lease classified as a sales-type or direct financing lease** — The lessor should derecognize any deferred rent liability or accrued rent asset and adjust the selling profit/loss. | A lessor should account for a modification to an operating lease (not accounted for as a separate contract) as a new lease from the date of the modification. The lessor should include any prepaid or accrued lease payments related to the original lease in the lease payments associated with the new lease. |
| Modifications that reduce the lease term for lessees | A reduction in the lease term is **not** considered a decrease in the scope of the lease. A lessee should thus remeasure the lease liability, with a corresponding reduction in the ROU asset, but should **not** recognize any gain or loss as of the effective date of the modification unless the ROU asset is reduced to zero. | A reduction in the lease term is considered a decrease in the scope of the lease. A lessee should thus remeasure the lease liability, with a proportionate reduction in the ROU asset, and recognize a gain or loss for any difference as of the effective date of the modification. |
Appendix B — Differences Between U.S. GAAP and IFRS Standards

(Table continued)

<table>
<thead>
<tr>
<th>Key Provision</th>
<th>ASC 842</th>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modifications of sales-type or direct financing leases for lessors</td>
<td>A lessor's accounting for a modification to a sales-type or direct financing lease depends on the original and modified lease classification.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Original lease is a sales-type lease:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Modified lease is a sales-type or direct financing lease — The discount rate for the modified lease is adjusted 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 modification date.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Modified lease is an operating lease — The carrying amount of the underlying asset should equal the net investment in the original lease before the modification date.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Original lease is a direct financing lease:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Modified lease is a direct financing lease — The discount rate for the modified lease is adjusted 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 modification date.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Modified lease is a sales-type lease — The lessor calculates the selling profit/loss on the lease, the fair value of the underlying asset, and the asset's carrying amount immediately before the modification date.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Modified lease is an operating lease — The carrying amount of the underlying asset should equal the net investment in the original lease before the modification date.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>A lessor's accounting for a modification to a finance lease (not accounted for as a separate contract) depends on whether the lease would have been classified as an operating lease had the modification been in effect at lease inception:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Modified lease would have been classified as an operating lease — The lessor should account for the lease modification as a new lease from the modification date. The carrying amount of the underlying asset should be measured as the net investment in the lease immediately before the modification date.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Modified lease would not have been classified as an operating lease — The lessor applies the requirements in IFRS 9.</td>
<td></td>
</tr>
</tbody>
</table>
### Key Provision

<table>
<thead>
<tr>
<th>ASC 842</th>
</tr>
</thead>
<tbody>
<tr>
<td>The intermediate lessor would classify a sublease by considering the <strong>underlying asset</strong> of the head lease (instead of the ROU asset) as the leased asset in the sublease.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>The intermediate lessor would classify a sublease by considering the <strong>ROU asset</strong> of the head lease as the leased asset in the sublease.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sale-and-leaseback arrangements</th>
</tr>
</thead>
<tbody>
<tr>
<td>The transaction would not be considered a sale if (1) it does not qualify as a sale under ASC 606 or (2) the leaseback is a finance lease. A repurchase option would result in a failed sale unless (1) the exercise price of the option is at fair value and (2) alternative assets are readily available in the marketplace. If the transaction qualifies as a sale, the entire gain on the transaction would be recognized.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>The transaction would not be considered a sale if it does not qualify as a sale under IFRS 15. A repurchase option would always result in a failed sale. For transactions that qualify as a sale, the gain would be limited to the amount related to the residual portion of the asset sold. The amount of the gain related to the underlying asset leased back to the lessee would be offset against the lessee's ROU asset.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Balance sheet presentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>If a lessee does not separately present ROU assets and lease liabilities on the balance sheet, the lessee must disclose the line item in which its ROU assets and lease liabilities are included. This requirement applies to both finance leases and operating leases.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>If a lessee does not separately present ROU assets and lease liabilities on the balance sheet, the lessee must present the ROU assets as if the underlying asset were owned and disclose the line item in which its ROU assets and lease liabilities are included.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of cash flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>A lessee should present payments associated with operating leases as an operating activity in the statement of cash flows. A lessee should present payments associated with finance leases in the statement of cash flows as (1) a financing activity, for the principal portion of the payment, and (2) an operating activity, for the interest portion of the payment.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>As noted in the “<strong>Lessee's subsequent accounting for ROU asset and lease expense</strong>” key provision above, a lessee is required to use a single approach (similar to the FASB's finance lease approach) to subsequently account for the ROU asset. For this reason, the lessee should account for payments of interest as either a financing or an operating activity in the statement of cash flows, depending on the lessee's accounting policy election under IAS 7.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Effective date</th>
</tr>
</thead>
</table>
| **Public entities** — Effective for annual reporting periods beginning after December 15, 2018.  
**Public NFPs**¹ — Effective for annual reporting periods beginning after December 15, 2019.  
**Nonpublic entities** — Effective for annual reporting periods beginning after December 15, 2021.  
Early adoption is permitted. |

<table>
<thead>
<tr>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effective for annual reporting periods beginning on or after January 1, 2019. Early adoption is permitted provided that the entity has also adopted IFRS 15.</td>
</tr>
</tbody>
</table>

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¹ The deferral provided by ASU 2020-05 applies to public NFPs that have not issued financial statements or made financial statements available for issuance as of June 3, 2020. Public NFPs that have issued financial statements or have made financial statements available for issuance before that date must comply with the effective dates prescribed for public companies above.
### Transition

<table>
<thead>
<tr>
<th>Key Provision</th>
<th>ASC 842</th>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transition</td>
<td>ASC 842, as originally issued, required entities to transition to ASC 842 by using a modified retrospective approach. Under the modified retrospective approach, entities must restate comparative periods under ASC 842, with certain practical reliefs. Thereafter, the FASB issued ASU 2018-11, which gives entities the option of not restating comparative periods and applying ASC 842 as of the adoption date. Moreover, ASU 2018-01 provides a transition practical expedient for existing or expired land easements that were not previously accounted for as leases in accordance with ASC 840. The practical expedient allows entities to elect not to assess whether those land easements are, or contain, leases in accordance with ASC 842 when transitioning to ASC 842.</td>
<td>Entities may elect to transition to IFRS 16 by using either a full retrospective approach or a modified retrospective approach. Under the modified retrospective approach, entities do not restate comparative periods. Entities should recognize a cumulative adjustment to retained earnings as of the date of initial adoption (e.g., January 1, 2019). A similar transition practical expedient for existing or expired land easements is not available.</td>
</tr>
</tbody>
</table>

In addition, while certain of the presentation and disclosure requirements in ASC 842 are similar to those in IFRS 16, there are also certain differences (quantitative and qualitative) in this area.

Other differences between ASC 842 and IFRS 16 may also arise as a result of existing differences between U.S. GAAP and IFRS Standards, including those related to (1) impairment of financial instruments and long-lived assets other than goodwill and (2) the accounting for investment properties.
# Appendix C — Differences Between ASC 840 and ASC 842

The following table illustrates the key differences between ASC 842 and ASC 840:

<table>
<thead>
<tr>
<th>Key Provision</th>
<th>ASC 842</th>
<th>ASC 840</th>
</tr>
</thead>
<tbody>
<tr>
<td>Substantive substitution rights</td>
<td>For a substitution right to be substantive and thus preclude lease accounting, the supplier must both (1) have the practical ability to substitute the asset and (2) economically benefit from the substitution. The concept of economically benefitting from the substitution is a new concept under ASC 842.</td>
<td>A lease does not exist if the supplier has the right and ability to substitute other PP&amp;E to fulfill the arrangement. The supplier does not need to economically benefit from the substitution for lease accounting to be precluded (the substitution must be practicable and economically feasible).</td>
</tr>
<tr>
<td>Right to control the use of the asset</td>
<td>To control the use of the asset, the customer must have the right to (1) obtain substantially all of the economic benefits from using the asset and (2) direct the use of the asset (i.e., determine HAFWP the asset will be used throughout the period of use).</td>
<td>A customer does not need to both obtain substantially all of the economic benefits and direct the use of the asset to control the use of the asset. For example, the customer can control the use of the asset if (1) it obtains substantially all of the output or other utility generated by the asset and (2) the price it pays is neither contractually fixed per unit of output nor equal to the current market price of the output.</td>
</tr>
<tr>
<td>Separating land and other lease components</td>
<td>A lessee should account for land and buildings as separate lease components unless the accounting effect of doing so would be insignificant (e.g., there would be no impact on lease classification or the amount recognized for the land component would be insignificant).</td>
<td>When the lease meets either the transfer-of-ownership or bargain-purchase-price classification criteria, the lessee should account for the land and other assets separately. Otherwise, when the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception, the lessee should classify the land and other assets separately.</td>
</tr>
</tbody>
</table>
Appendix C — Differences Between ASC 840 and ASC 842

(Table continued)

<table>
<thead>
<tr>
<th>Key Provision</th>
<th>ASC 842</th>
<th>ASC 840</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separating lease and nonlease</td>
<td>As a practical expedient, a lessee may elect not to separate lease and nonlease components in the contract. If this practical expedient is elected, the lessee must account for the combined components as a single lease component.</td>
<td>A similar practical expedient does not exist under ASC 840.</td>
</tr>
<tr>
<td>components</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maintenance</td>
<td>Maintenance services represent a nonlease component that must be separated from the lease component(s) in the contract (if the practical expedient described above is not elected).</td>
<td>Amounts paid by the lessee to the lessor for maintenance are generally considered executory costs.</td>
</tr>
<tr>
<td>Classification criteria</td>
<td>A lease should be classified as a finance lease if it meets one of the following criteria:</td>
<td>A lease should be classified as a capital lease if it meets one of the following criteria:</td>
</tr>
<tr>
<td></td>
<td>• Transfer of ownership.</td>
<td>• Transfer of ownership.</td>
</tr>
<tr>
<td></td>
<td>• Bargain purchase option.</td>
<td>• Bargain purchase option.</td>
</tr>
<tr>
<td></td>
<td>• Lease term is for a major part of the estimated economic life of the leased property.</td>
<td>• Lease term is equal to 75 percent or more of the estimated economic life of the leased property.</td>
</tr>
<tr>
<td></td>
<td>• Present value of the lease payments is substantially all of the fair value of the leased property.</td>
<td>• Present value of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased property.</td>
</tr>
<tr>
<td></td>
<td>• The leased asset is so specialized that it would have no alternative use to the lessor at the end of the lease term.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Although the lease classification criteria under ASC 842 differ from those under ASC 840, the FASB has stated that an entity may use the bright lines established under ASC 840 when evaluating the more principles-based criteria in ASC 842.</td>
<td></td>
</tr>
<tr>
<td>Executory costs</td>
<td>Executory costs (e.g., reimbursement for a lessor’s property taxes and insurance) are allocated to both lease and nonlease components in the contract on the same basis as the other consideration in the contract. The portion of executory costs allocated to the lease component(s) in the contract is considered part of the lease payments (to the extent that the payments are fixed).</td>
<td>All executory costs are excluded from the determination of minimum lease payments for classification and measurement purposes.</td>
</tr>
</tbody>
</table>

1 In July 2018, the FASB issued ASU 2018-11, which includes a practical expedient that allows lessors, when certain conditions are met, not to separate lease and nonlease components. Under ASU 2018-11, lessors availing themselves of this practical expedient would not account for affected nonlease components separately. See Section 17.3.1.4.2 for further discussion.
<table>
<thead>
<tr>
<th>Key Provision</th>
<th>ASC 842</th>
<th>ASC 840</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residual value guarantees</td>
<td>A lessee should include in the lease payments only the amount of the residual value guarantee that it is probable the lessee will owe at the end of the lease term.</td>
<td>A lessee should include in the minimum lease payments the full amount of the residual value guaranteed by the lessee.</td>
</tr>
<tr>
<td>Discount rate</td>
<td>A lessee should use the rate implicit in the lease if it is readily determinable, regardless of whether it is higher than the lessee’s incremental borrowing rate.</td>
<td>A lessee should use the rate implicit in the lease if it is readily determinable, unless that rate exceeds the lessee’s incremental borrowing rate.</td>
</tr>
<tr>
<td></td>
<td>The rate implicit in the lease takes into account the lessor’s initial direct costs.</td>
<td>The rate implicit in the lease does not incorporate the lessor’s initial direct costs.</td>
</tr>
<tr>
<td></td>
<td>The discount rate used must reflect a secured borrowing rate.</td>
<td>The lessee’s incremental borrowing rate may be unsecured if it is consistent with the financing that would have been obtained to purchase the underlying asset (and not leased).</td>
</tr>
<tr>
<td>Inception date vs. commencement</td>
<td>A lease is classified and initially measured on the lease commencement date.</td>
<td>A lease is classified and initially measured on the lease inception date.</td>
</tr>
<tr>
<td>date</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lessee accounting</td>
<td>All leases (finance and operating) other than those that qualify for the short-term scope exception must be recognized on the lessee’s balance sheet. A lessee recognizes a liability for its lease obligation and a corresponding asset representing its right to use the underlying asset over the lease term.</td>
<td>A lessee only recognizes capital leases on its balance sheet. Leases classified as operating leases are not capitalized on a lessee’s balance sheet.</td>
</tr>
<tr>
<td>Sales-type versus direct financing</td>
<td>The distinction between a sales-type lease and a direct financing lease is based on whether the lessee obtains control of the underlying asset. This assessment is not affected by the relationship of the fair value to the carrying amount of the underlying asset. If the lessee obtains control of the underlying asset, the lease is classified as a sales-type lease. If the lessee does not obtain control of the underlying asset (but the lessor relinquishes control), the lease is classified as a direct financing lease.</td>
<td>The distinction between a sales-type lease and a direct financing lease is based on whether there is a difference between the fair value and carrying amount of the underlying asset. If the fair value equals the carrying amount of the underlying asset, the lease is classified as a direct financing lease. Otherwise, the lease is classified as a sales-type lease.</td>
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</table>
### Key Provision

<table>
<thead>
<tr>
<th>Key Provision</th>
<th>ASC 842</th>
<th>ASC 840</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collectibility</td>
<td>Lessors should consider collectibility in accounting for their leases, and such consideration differs depending on whether the lease is classified as a sales-type, direct financing, or operating lease. A lease can still be classified as a sales-type lease if there are collectibility concerns. For a sales-type lease to be recognized, collectibility of the lease payments must be probable (in a manner consistent with ASC 606). The collectibility guidance for direct financing and operating leases is aligned with ASC 840 (i.e., if the lease is not a sales-type lease, the lease should be classified as an operating lease if collectibility of the lease payments and any residual value guarantee is not probable at lease commencement). A lessor cannot recognize a capital lease unless collectibility of the minimum lease payments is reasonably predictable.</td>
<td>A lessor cannot recognize a capital lease unless collectibility of the minimum lease payments is reasonably predictable.</td>
</tr>
<tr>
<td>Lessor's accounting for direct financing leases</td>
<td>A lessor must defer selling profit for a direct financing lease and recognize the deferred amount over the lease term. Because a direct financing lease can only arise if the fair value equals the carrying amount of the underlying asset, no profit or loss arises under a direct financing lease.</td>
<td></td>
</tr>
<tr>
<td>Leases involving real estate</td>
<td>There is no unique guidance on classifying and accounting for leases involving real estate. Leases involving real estate are subject to the same general classification and measurement guidance as leases involving other PP&amp;E. Leases involving real estate are subject to specific guidance that is unique to real estate (e.g., the lessor will only classify a lease involving real estate as a sales-type lease if it meets the transfer-of-ownership criterion in ASC 840-10-25-1(a)).</td>
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<tr>
<th>Key Provision</th>
<th>ASC 842</th>
<th>ASC 840</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale-and-leaseback arrangements</td>
<td>All assets are subject to the same sale-and-leaseback guidance (i.e., there is no unique guidance on sale-and-leaseback arrangements involving real estate). An entity should assess the criteria in ASC 606 to determine whether a sale has occurred. A repurchase option precludes sale accounting unless (1) the option is priced at the fair value of the asset on the date of exercise and (2) alternative assets exist that are substantially the same as the transferred asset and are readily available in the marketplace. The existence of a leaseback by itself would not indicate that a sale has not occurred unless the leaseback is classified as a finance lease.</td>
<td>There is specific guidance on sale-and-leaseback arrangements involving real estate (including integral equipment). A sale-and-leaseback arrangement involving nonintegral equipment that includes a repurchase option may not result in a failed sale if the option does not economically compel the seller-lessee to repurchase the equipment.</td>
</tr>
</tbody>
</table>
| Leveraged lease accounting        | ASC 842 does not include guidance on leveraged leases. Entities are not permitted to account for any new lease arrangements as leveraged leases after the effective date of ASC 842. Leveraged leases existing as of the effective date of ASC 842 would be subject to the guidance in ASC 842-50, which is generally consistent with the legacy accounting requirements for leveraged leases and effectively grandfathers in that guidance. If a leveraged lease is modified after the effective date of ASC 842, it would be accounted for as a new lease. | A lease is a leveraged lease if it meets all of the following characteristics:  
  - It meets the criteria to be classified as a direct financing lease.  
  - It involves at least three parties, including a long-term creditor.  
  - The financing provided by the creditor is nonrecourse with respect to the lessor’s general credit.  
  - The lessor’s net investment declines during the early years and rises during the later years. |
| Build-to-suit lease arrangements   | ASC 842 supersedes the guidance in ASC 840 on build-to-suit arrangements. Under ASC 842, the accounting for a build-to-suit arrangement depends on whether the lessee controls the underlying asset during the construction period. | A lessee is considered the owner of an asset during the construction period if the lessee has substantially all of the construction period risks. There are certain automatic indicators of ownership, which have historically caused a number of lessees to be deemed owners of assets during the construction period. |
### Key Provision

<table>
<thead>
<tr>
<th>Related-party leases</th>
<th><strong>ASC 842</strong></th>
<th><strong>ASC 840</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Entities should account for related-party leasing arrangements on the basis of the legally enforceable terms and conditions of the lease rather than the substance of the arrangement.</td>
<td>Entities should account for related-party leasing arrangements on the basis of the substance of the contract.</td>
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<table>
<thead>
<tr>
<th>Reassessment (identifying a lease)</th>
<th><strong>ASC 842</strong></th>
<th><strong>ASC 840</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity should only reassess whether the contract is or contains a lease if the terms and conditions of the contract are changed.</td>
<td>An entity should only reassess whether an arrangement is or contains a lease if any of the following occur:</td>
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<tr>
<td></td>
<td>- Change in contractual terms.</td>
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<td></td>
<td>- Renewal or extension (excluding a modification).</td>
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<td></td>
<td>- Dependency on specific PP&amp;E.</td>
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<td></td>
<td>- Physical change to PP&amp;E.</td>
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<thead>
<tr>
<th>Reassessment (lessee measurement)</th>
<th><strong>ASC 842</strong></th>
<th><strong>ASC 840</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Upon a reassessment event, a lessee should remeasure its ROU asset and lease liability on its balance sheet. A lessee should use the discount rate that applies as of the date of the reassessment event to remeasure its ROU asset and lease liability.</td>
<td>A lessee should not remeasure a capital lease liability during the lease term unless the lease is modified. If the lease is modified and remeasured, the remeasurement should be based on the discount rate that was used at lease inception (i.e., the discount rate should not be updated).</td>
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<table>
<thead>
<tr>
<th>Lease modifications</th>
<th><strong>ASC 842</strong></th>
<th><strong>ASC 840</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>The lease modification guidance is more extensive under ASC 842, and the two-step model from ASC 840 is not carried forward. The changes are primarily related to aligning the modification guidance with the guidance in ASC 606.</td>
<td>A modification of a lease should be accounted for as a new lease if the modification would have resulted in a different lease classification had the changed terms been in effect at lease inception. A lease modification does not include renewals or extensions of the lease if such renewals or extensions were already included in the lease term.</td>
<td></td>
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<table>
<thead>
<tr>
<th>Initial direct costs</th>
<th><strong>ASC 842</strong></th>
<th><strong>ASC 840</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial direct costs include only those costs that are incremental to the arrangement and that would not have been incurred if the lease had not been obtained.</td>
<td>In addition to costs that are incremental to the arrangement and that would not have been incurred if the lease had not been obtained, initial direct costs include costs directly related to the following activities:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Evaluating the prospective lessee’s financial condition.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Evaluating and recording guarantees, collateral, and other security arrangements.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Negotiating lease terms.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Preparing and processing lease documents.</td>
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</tr>
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<td></td>
<td>- Closing the transaction.</td>
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<tr>
<th>Key Provision</th>
<th>ASC 842</th>
<th>ASC 840</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of cash flows (lessor)</td>
<td>A lessor must classify cash received from leases in the operating activities section of its statement of cash flows.²</td>
<td>ASC 840 does not include guidance on the classification of cash received from leases in a lessor’s statement of cash flows.</td>
</tr>
<tr>
<td>Disclosures</td>
<td>An entity must disclose significantly more quantitative and qualitative information under ASC 842.</td>
<td>Lessees and lessors are subject to relatively limited disclosure requirements.</td>
</tr>
</tbody>
</table>

² In March 2019, the FASB issued ASU 2019-01, which amends the presentation of the statement of cash flows for entities within the scope of ASC 942. Such entities are required to classify principal payments received from sales-type and direct financing leases in the investing activities section of their statement of cash flows. This requirement is associated with an illustrative example in ASC 942 that existed before the adoption of, and was not amended by, ASC 842.
Appendix D — Implementation Activities

D.1 Introduction

In implementing ASU 2016-02 and other related ASUs (collectively referred to as “ASC 842” herein), entities will need to change not only their accounting for and financial reporting of leases but also their related systems and processes. It is important for all entities to develop an implementation plan well before ASC 842’s effective date. Though some of the accounting changes may seem intuitive, the data and systems requirements needed to bring about those changes are significant and, without preparation, may be overwhelming.

Further, because many companies have numerous lease agreements involving multiple decentralized locations and lease data may be maintained in spreadsheets or hard copies, the collection and abstraction of data can be resource-intensive and time-consuming. Although certain elements of a company’s lease data may be in an electronic format, such data may not have been subjected to Sarbanes-Oxley internal control procedures, may reside in disparate systems, and may be insufficient under the requirements in ASC 842. A centralized information repository may be critical to the development of a lease inventory.

The objectives of this appendix are to (1) help entities begin their planning and assessment process related to adopting ASC 842 and (2) provide entities whose adoption might be further along with some ideas to supplement their current implementation approach and ensure that they consider all critical steps in the process. This appendix is divided into the following sections:

- Getting Started (Section D.2) — This section provides readers with helpful tips and some suggested “dos and don'ts” for implementing the guidance in ASC 842.
- Phases of Implementation (Section D.3) — This section summarizes five phases of implementing the guidance in ASC 842, including activities that an entity may consider including in its implementation roadmap and factors governing the approximate length of time that each activity will take to complete.
- Important Decisions (Section D.4) — This section focuses on certain decisions that an entity will need to make to adopt ASC 842.

D.2 Getting Started

The adoption of ASC 842 may be a daunting task, but by developing a detailed and thoughtful implementation plan, entities can break down the transition into multiple stages so that they can work toward achievable goals.
Before charting a course for their transition to ASC 842, entities should consider the following “dos and don’ts”:

• **Dos:**
  - Identify a cross-functional team of professionals from all key decision-making departments at the entity’s organization (e.g., accounting, finance, IT, tax, human resources, real estate, procurement, investor relations, legal, internal audit) to ensure that all departments are represented before management agrees on a plan on how to adopt ASC 842. In doing so, an entity may need to establish a steering committee, program management team, or both, made up of individuals from various functions and business units. In addition, global or multinational entities should identify key contacts in each international region, especially if business models differ internationally.
  - Keep all affected departments abreast of the transition plan. This is especially important given the extensive changes in ASC 842 with respect to the lessee accounting model. Historically, entities may not have involved departments outside of accounting (e.g., IT, tax, human resources, real estate, procurement, and legal) in decisions related to the implementation of new accounting guidance. An entity could consider developing a periodic communication detailing accomplishments and upcoming activities to keep personnel outside the steering committee and the program management team informed during the implementation period.
  - Create a roadmap outlining realistic goals and key milestones for the entity to work toward in making the transition to ASC 842.
  - Assess the various solutions available for complying with the requirements in ASC 842 and test the solutions against the entity’s business needs.
  - Consider changing how the entity executes and manages leases (e.g., centralized vs. decentralized approach), since the entity may have an opportunity to change those historical practices during the implementation period.
  - Leverage knowledge and efficiencies gained from the adoption of other accounting standards.
  - Engage with auditors early in the implementation process to obtain concurrence on the entity’s accounting policies and positions under ASC 842.

• **Don’ts:**
  - Do not assume that ASC 842 does not have a significant impact on the entity. Although the guidance focuses on changes to the lessee accounting model, the entity should also analyze the changes to the lessor accounting model.
  - Do not underestimate the time and resources needed to appropriately implement ASC 842 and collect the necessary data. Start planning now to ensure that the entity is ready before the effective date.
  - Do not include only a small group of accounting personnel on the transition/implementation team.
  - Do not make decisions in silos. Specifically, do not (1) make IT design decisions before identifying business and functional requirements or (2) make business decisions without the involvement of IT.
  - Do not overlook the new quantitative and qualitative disclosure requirements when identifying the data needs and building the business/functional requirements.
D.3 Phases of Implementation

One of the key ingredients for a successful adoption of ASC 842 is putting together a roadmap for implementation. The sections below highlight five phases of adopting ASC 842, including key activities that an entity may perform when developing such a roadmap as well as factors it may consider to gauge how much time and effort it will take to complete certain steps in the transition to ASC 842.

The activities and timing for each entity’s roadmap will vary depending on (1) the quantity and variability of the entity’s contracts, (2) its existing systems and processes, and (3) the amount of resources dedicated to its transition plan.

As illustrated below, stakeholders throughout the organization will need to be involved in the adoption of ASC 842. Further, while the initial steps of an adoption plan focus on understanding the technical accounting changes, other aspects of the project can occur contemporaneously. As certain technical accounting conclusions are reached, the total lease population can be identified, IT/systems implications can be assessed, and internal training can begin. During the implementation period, an entity’s normal operations do not cease; new leases are entered into and existing leases are modified or terminated. Accordingly, the adoption of ASC 842 should not be viewed as a linear process.

The five phases of adopting ASC 842, as discussed in Sections D.3.1 through D.3.5 below, are (1) assessment, readiness, and planning; (2) development of policies and selection of a software or IT system solution, if applicable (“solution”); (3) lease abstraction and data storage; (4) solution implementation; and (5) deployment and aftercare. Key activities are associated with each phase of adoption. Certain of these activities may be performed during multiple phases of the adoption process, while others may apply to a single phase.

D.3.1 Phase 1: Assessment, Readiness, and Planning

The first phase of the adoption effort should focus on understanding the accounting and disclosure requirements, understanding an entity’s lease population, and performing a data gap analysis. Sections D.3.1.1 through D.3.1.3 below discuss these activities.

D.3.1.1 Understanding the Accounting and Disclosure Requirements

One of the first steps an entity must take in creating a transition plan is to understand the technical accounting changes and elections offered under ASC 842. Further, it is critical for entities with international operations that will be subject to statutory filing requirements to understand the differences between ASC 842 and IFRS 16 (see Appendix B for a summary of these differences).
Although entities frequently focus on the changes to a lessee's recognition and measurement for leases (see Chapter 8), it is also important for entities to consider implications for lessors (see Chapter 9) and the new disclosure requirements (see Chapter 15). In addition to understanding the new disclosure requirements, an entity should continually monitor the disclosure requirements of SAB Topic 11.M (SAB 74)\(^1\) during the implementation period. Furthermore, an entity should consider the relevant principles and key points of COSO's\(^2\) Internal Control — Integrated Framework, as updated in 2013 (see Appendix E). Further, SEC registrants are required to disclose any material changes in their ICFR in a Form 10-Q or Form 10-K in accordance with SEC Regulation S-K, Item 308(c). The implementation activities related to disclosures may be monitored and considered in all phases of the implementation period.

### D.3.1.2 Understanding the Lease Population

As part of the first phase of the adoption process, an entity should determine its complete lease population. The purpose of understanding this information is to allow the entity to identify potential accounting, data, or other operational issues so that it can plan the level of effort it will need to expend to achieve compliance and align resources for the future phases.

To better understand the lease population, an entity could give a lease survey to all relevant personnel or business units. Such a survey should request the number of contracts by class of underlying asset for lessees, lessors, and subleases. It may also be helpful for the survey to contain questions about the existence of certain contract terms and attributes. These may include, but are not limited to, the following:

- Variable lease payments, including variable lease payments with a floor or minimum.
- Renewal, termination, and purchase options.
- Lease incentives.
- Refundable and nonrefundable security deposits.
- Residual value guarantees.
- Initial direct costs.

The survey could also include questions about the frequency and nature of contract modifications as well as about the average term of the contracts. If an entity has international operations, it is important to learn the language of the contracts, if unknown. Finally, it may be useful to ask a question regarding the existence of contracts with any service providers that use their own assets to meet their obligations under the service arrangement (i.e., in the delivery of services to the entity). Such a question may help the entity begin to identify contracts that are, or contain, leases and that were not previously accounted for under ASC 840. Note that, as discussed in the Connecting the Dots in Section 16.5.2.1, entities may not carry forward any previous “errors” (i.e., incomplete identification of leases) in making the transition to ASC 842.

In addition to performing a lease survey, it may be necessary for an entity to sample leases for contract review to understand the lease population. It is recommended that contracts from various classes of underlying assets be selected for review. As part of the review, an entity should identify the contract terms and attributes and should corroborate the information gathered in the lease surveys.

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\(^1\) SEC Staff Accounting Bulletin (SAB) 74 was codified as SEC SAB Topic 11.M. See Deloitte's September 22, 2016, Financial Reporting Alert for further discussion.

\(^2\) The Committee of Sponsoring Organizations of the Treadway Commission.
D.3.1.3 Performing a Data Gap Analysis

Another key activity during the initial phase of lease implementation is a data gap analysis. In performing this analysis, an entity should reconcile the lease elements in its current system or spreadsheet to all the lease elements it needs to comply with the accounting and disclosure requirements of ASC 842. As part of this reconciliation, it is also recommended that the entity differentiate between gaps that must be filled for existing leases at transition and gaps that should be filled only on a go-forward basis for new leases.

The lease survey and contract review activities described in Section D.3.1.2 may also prove beneficial to the data gap analysis, since certain lease elements may not be relevant to an entity’s existing lease population and thus can be eliminated or deescalated when an entity addresses the data gaps identified at transition.

The data gap analysis is critical to understanding resource needs and required lead time in the later lease abstraction phase (see Section D.3.3).

D.3.2 Phase 2: Development of Policies and Solution Selection

The second phase of the adoption effort consists of two primary activities: the development of accounting policies and selection of the long-term solution (discussed in Section D.3.2.1 (below) and Section D.3.2.2). Entities are likely to commence the activities in phase 3 before the activities in phase 2 are substantially complete.

D.3.2.1 Development of Policies

The main technical accounting activities that an entity performs in developing accounting policies are (1) holding working sessions to understand lease strategies and practices; (2) understanding the lease population; and (3) documenting accounting policies, including practical expedient elections.

The development of policies is an iterative process. Consequently, there is no set rule on when an entity should perform this task. However, as the entity begins to understand more about its lease strategies and practices, it may be inclined to amend initial decisions. Accordingly, the development of accounting policies should be viewed as an ongoing part of the adoption process (i.e., an entity may perform this task during multiple phases of its adoption efforts).

The working sessions held to understand lease strategies and practices will be the key to determining accounting policies and supporting the ultimate decisions reached. The working sessions may highlight key attributes of certain agreements by underlying class of asset, the business decision for including the contract terms in the agreement, when options (e.g., purchase options or renewal options) are considered and exercised by the entity, and other relevant information. In addition, an entity is likely to hold working sessions with its treasury department regarding the determination of the discount rate, as defined under ASC 842 (see Chapter 7).
After completing these activities, an entity will be able to determine and document its updated accounting policies under ASC 842. These policies may address the following topics:

- Scope and definition of a lease (see Chapters 2 and 3, respectively), including conclusions about embedded leases.
- Lease term, including application of the “reasonably certain” threshold (see Chapter 5).
- Determination of lease classification (see Chapter 8 for lessees and Chapter 9 for lessors).
- Discount rate (see Chapter 7).
- Presentation and disclosures (see Chapters 14 and 15, respectively).
- Differences between U.S. GAAP and IFRS Standards (see Appendix B).
- Portfolio approach (see Chapter 8).

An entity should also determine which practical expedients it will elect in adopting ASC 842, including those related to transition relief, separating lease and nonlease components, short-term leases, and the discount rate. These decisions are described in further detail in Section D.4.1. For assistance in making the decisions, the entity should leverage the knowledge gained in phase 1 and in the working sessions described above.

The entity’s tax department should also assess the impact of ASC 842 and document and implement changes to its existing processes. This assessment and these process changes may be completed during or after the other accounting policy development activities. The tax department may consult personnel from the core accounting function to better understand the lease landscape and changes.

In developing these policies, entities should ensure that they (1) dedicate enough time and resources to them and (2) obtain auditor concurrence before finalizing them.

**D.3.2.2 Solution Selection**

Activities related to solution selection include, but are not limited to, developing business and functional requirements. The purpose of developing business requirements is to (1) present and document the key requirements for any system changes that are needed and (2) identify the data requirements and ledger systems affected by ASC 842. The objective of developing functional requirements is to establish granular accounting calculation rules that an entity’s solution will need to perform, while also considering other business needs. That is, solutions do not need to be limited to compliance and can focus on other business efficiencies, such as lease administration (e.g., processing lease payments) or procurement decisions (e.g., lease vs. buy).

Although the development of business and functional requirements has historically been an IT activity, entities should review these requirements with other business functions, including the core accounting function, corporate real estate, and procurement, to ensure that the requirements are sufficient.

Ultimately, an entity may decide either to (1) enhance its existing IT infrastructure to better comprehend the storage, calculation, and reporting requirements or (2) select a new solution. If an entity is considering a new solution, it should build a vendor scorecard to ensure that all business functions provide feedback and that systems are compared on a similar basis. Often, it takes significant time to contract with the external technology vendor.
Appendix D — Implementation Activities

D.3.3  Phase 3: Lease Abstraction and Data Storage

The third phase of the adoption effort is centered on data readiness, which includes activities related to lease abstraction and data storage. This is often considered to be the most difficult phase of implementing ASC 842. Many entities have entered into numerous lease agreements at decentralized locations and have lease data in disparate spreadsheets or hard copies. Furthermore, lease agreements may not contain required information (e.g., the incremental borrowing rate). Consequently, collecting and abstracting lease data may be time-consuming and resource-intensive. As mentioned previously, entities are likely to commence the activities in phase 3 before the activities in phase 2 are substantially complete. Sections D.3.3.1 through D.3.3.3 below discuss the activities performed during this phase.

D.3.3.1  Data Validation, Normalization, and Migration

The initial step in addressing data readiness is to validate the data (i.e., ensure that it is accurate). Such data can take many forms and be applied in various ways. For example, one business unit may have updated the lease payment stream for an adjustment to an index, while another business unit may track the adjustment separately.

Upon determining which data will be leveraged in a new solution, an entity must normalize the data (i.e., organize it in a consistent format to increase readability and usability) and migrate it (e.g., upload it to the system).

D.3.3.2  Supplemental or Comprehensive Lease Abstraction

When an entity completes the validation phase for existing data, it should use the results of the data gap analysis to identify which supplemental elements to abstract. For some entities, some or all leases may have to undergo comprehensive abstraction.

As mentioned previously, not all required data elements can be determined from the lease agreement. Furthermore, an entity will often need to use judgment in assessing whether certain data elements are required (e.g., when determining the lease term). Those performing the abstraction should work closely with the core accounting function to understand the appropriate method to use for this process.

The abstracted data may be stored, as applicable, in an offline template, a temporary solution, or the new long-term solution selected, depending on the timing of the other phase activities.

D.3.3.3  Process Change to Initial Data Capture and Data Maintenance

An entity should establish a process for capturing the normalized data, as soon as its format is known, to address the new requirements. For example, for new leases, entities may train personnel to appropriately abstract all relevant data so that the previous data activities described are completed on an ongoing basis. Also, entities should establish a process for identifying modifications or terminations for existing leases for which the previously described activities were not performed. That is, while the validation and abstraction are being completed, an entity’s data should not become stale.

D.3.4  Phase 4: Solution Implementation

The solution that is selected in phase 2, if applicable, will govern the timing and activities in the solution implementation phase, which may include technical integration with an entity’s existing system(s), customized configuration, and validation of functionality. These activities may be conducted (1) in house, (2) with an external vendor, or (3) both. An entity’s IT department is often heavily involved in a solution implementation; however, the core accounting function should also participate.
The solution implementation phase should also include revisions to the design and development of internal controls to address the changes to the lease accounting process for the new solution.

D.3.5 Phase 5: Deployment and Aftercare

Although adopting ASC 842 may seem like a one-time effort, the success of an entity's adoption of the guidance in ASC 842 depends partly on the activities performed during the deployment and aftercare phase. After adoption, the entity should perform a postimplementation review to ensure that (1) any system modifications or upgrades are functioning as intended, (2) any changed or newly implemented internal controls are operating effectively, (3) the entity's personnel are following the new accounting policies, and (4) disclosures are comparable to those prepared by others in the same industry or industries. Depending on the outcome of the postimplementation review, some entities may need to continually dedicate resources to ensure compliance with ASC 842.

D.4 Important Decisions

Discussed below are some of the important topics that all entities should consider while making the transition to ASC 842.

D.4.1 Entity Elections and Transition Reliefs

ASC 842 offers explicit practical expedients that can be elected by certain entities or in certain arrangements. These elections include the following:

- Elections by class of underlying asset:
  - Short-term leases (see Section 8.2.1).
  - Separating lease from nonlease components (see Section 4.3.3).
- Election for lessors for all leases:
  - Sales taxes collected from a lessee (see Section 4.4.2.1.2).
- Election for private-company lessees for all leases:
  - Discount rate (see Section 7.2.3).
- Transition reliefs:
  - Use of hindsight (see Section 16.5.1).
  - Package of practical expedients (see Section 16.5.2): whether a contract is or contains a lease, lease classification, and initial direct costs.
  - Land easement practical expedient (see Section 2.4).

D.4.2 Individual-Contract Versus Portfolio Approach

In addition to making decisions about the expedients explicitly offered in ASC 842, an entity will need to determine whether to apply the guidance in ASC 842 on a contract-by-contract basis to all leases or whether to account for certain types of leases on a portfolio basis (see Section 8.2.2). Although ASC 842 should generally be applied on an individual-contract basis, an entity may apply a "portfolio approach" if it reasonably expects that the impact of such an approach on the financial statements would not be materially different.
The effort an entity needs to expend in gathering information will likely dictate whether it applies the portfolio approach to certain leases. For leases in which all contract terms are nearly the same and data elements can be summarized rather than abstracted from the individual lease contracts, the portfolio approach may be an effective option. That is, a primary benefit of the portfolio approach is to eliminate the cost of individually gathering data for all of the contracts.

**D.4.3 Dual Reporting Requirements**

An entity is required\(^3\) to restate prior periods under the modified retrospective method. That is, an entity will need to run parallel financial reporting systems during the period of transition to capture existing leases under ASC 842 and ASC 840.

An entity may leverage the new processes and systems established to comply with ASC 842 when applying ASC 840 during the dual reporting period. Conversely, an entity may decide not to disrupt the existing process and to apply both the existing and new processes during the dual reporting period. The entity’s resource limitations and system capabilities are key factors for it to consider in determining the best approach to use for dual reporting.

**D.4.4 Capitalization Policy Considerations**

Entities may want to consider establishing a materiality threshold for evaluating whether to recognize, on the balance sheet, leases that otherwise must be recognized under ASC 842. For more information, see Q&A 2-1.

\(^3\) This transition requirement is not applicable if the lessee elects the Comparatives Under 840 Option. For more information, see Sections 16.1 and 17.3.1.4.1.
Appendix E — Internal Control Over Financial Reporting

E.1 Preadoption Disclosure Controls

The SEC has been emphasizing the importance of transition-period disclosures (or preadoption disclosures) in accordance with SAB 74.¹ These disclosures should be both qualitative and quantitative and should be included in MD&A (subject to disclosure controls and procedures) and the footnotes to the financial statements (subject to ICFR). The SEC staff has also made clear its expectation that the preadoption disclosures should become more robust and quantitative as ASU 2016-02’s effective date approaches.

In light of the SEC’s guidance and recent comments from the SEC staff, such disclosures should address the impact ASU 2016-02 and other related ASUs (collectively referred to as “ASC 842” herein) are expected to have on the financial statements and should include:

- A comparison of the company’s current accounting policies with the expected accounting under ASC 842.
- The status of the implementation process.
- The nature of any significant implementation matters that have not yet been addressed.

A company that is able to reasonably estimate the quantitative impact of ASC 842 should also disclose those amounts.

Internal controls over these preadoption disclosures are important to management’s ability to address the risks that the disclosures are inaccurate or incomplete. Management should first identify whether appropriate internal controls exist for the disclosures and then specify the information and analysis used to support those controls. Next, management needs to test the design and operating effectiveness of the relevant controls given that they should be included within the scope of management’s report on ICFR in the year before the adoption of ASC 842, as applicable.

When assessing whether appropriate internal controls exist with respect to the preadoption disclosures, management may consider whether procedures are in place to evaluate:

- Competence — The preadoption disclosures are prepared by competent individuals with knowledge of ASC 842 and potential impacts on the company.
- Compliance — The disclosures meet the SEC’s requirements and guidelines.
- Data quality — The quantitative disclosures (if known and estimated) are calculated on the basis of reliable inputs that are subject to appropriate internal control.

¹ SEC SAB 74 was codified as SEC SAB Topic 11.M. See Deloitte’s September 22, 2016, Financial Reporting Alert for further discussion.
Appendix E — Internal Control Over Financial Reporting

• **Review** — The disclosures are reviewed by appropriate levels of management.
• **Monitoring** — The company's monitoring function (e.g., internal audit, disclosure committee, or audit committee) appropriately reviews the internal controls in accordance with company protocols.

E.2 Internal Control Considerations Related to the Adoption of ASC 842

E.2.1 Internal Controls Over Adoption

There are often unique circumstances and considerations associated with the adoption of a new accounting standard that can pose a higher risk of material misstatement to the financial statements. Thus, companies should consider the circumstances that may only be present during the adoption period and evaluate whether there are any unique risks for which an entity needs to design “one-time” internal controls that may operate exclusively during the adoption period. Management should also consider the internal controls, documentation, and evidence it needs to support:

• Entity-level controls such as the control environment and general “tone at the top.”
• Identification of lease agreements or contracts in accordance with company policies.
• Accounting conclusions reached (such as by preparing accounting white papers or internal memos memorializing management’s considerations and conclusions).
• Information used to support accounting conclusions, new estimates, adjustments to the financial statements, and disclosure requirements.
• Identification and implementation of changes to IT systems, including the logic of reports.
• The modified retrospective transition approach.
• The accounting logic used and journal entries (including the transition adjustments) that record the adoption’s impact.
• Any practical expedients applied and related disclosures.
• Changes to the monthly, quarterly, or annual close process and related reporting requirements (e.g., internal reporting, disclosure controls and procedures).

E.2.2 Lease-Related Risks, Internal Controls, and Documentation

It is possible that, as a result of ASC 842, new financial reporting risks will emerge, including new or modified fraud risks, and that new processes and internal controls will be required. Companies will therefore need to consider these new risks and how to change or modify internal controls to address the new risks.

Management will need to make significant assumptions and judgments because of new requirements under ASC 842. For example, since almost all leases will be recognized in the statement of financial position, management will need to use significant judgment in evaluating matters such as whether an arrangement is or contains a lease and in assessing a lease’s term, which would affect whether the lease qualifies for the short-term exemption. It is critical for management to (1) evaluate the risks of material misstatement associated with these significant judgments, (2) design and implement controls to address those risks, and (3) maintain documentation that supports the assumptions and judgments that underpin its estimates.

See Section E.4 for a table summarizing sample risks and controls that may help entities consider how ASC 842 will affect them.
E.2.3 Significant Changes in Information and Related Data-Quality Needs

Companies will need to gather and track new information to comply with ASC 842, including the related disclosure requirements. Management should consider whether appropriate controls are in place to support (1) any necessary IT changes (including change management controls and, once the IT changes have been implemented, the testing of their design and operating effectiveness) and (2) the accuracy of the information used by the entity in recognizing lease assets and liabilities and the related income and expense and providing the required disclosures. The table below illustrates some potential challenges and examples of practices related to internal control.

<table>
<thead>
<tr>
<th>Potential Challenge</th>
<th>Example of Internal Control Practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information requirements have not been updated to support the reporting (e.g., interim and annual requirements, including those related to disclosures) required under ASC 842.</td>
<td>Management establishes data governance, policies, and standards for identifying and resolving data gaps and implements processes to verify the quality of information needed for implementation of ASC 842.</td>
</tr>
<tr>
<td>Control expectations have not been considered for new information required under ASC 842.</td>
<td>The lease implementation team meets periodically with the ICFR/SOX(^2) team (and control owners as appropriate) to share relevant information about the adoption of ASC 842 so that the ICFR/SOX team can prepare and plan accordingly.</td>
</tr>
<tr>
<td>Internal controls over source data, report logic, or parameters have not been reconsidered.</td>
<td>Management takes steps to update and review the appropriate flowcharts, data flow diagrams, process narratives, procedure manuals, and control procedures to reflect the new processes as a result of ASC 842 and to support management's ICFR assessment.</td>
</tr>
</tbody>
</table>

E.2.4 Applying the COSO Principles

COSO's\(^3\) Internal Control — Integrated Framework, which was updated in 2013, establishes 17 principles and related guidance with respect to designing and evaluating internal controls. When implementing ASC 842, companies should consider the COSO principles in evaluating and designing controls (including those related to recognizing lease assets and liabilities and overall data quality, as discussed above), particularly when applying the framework in management's assessment of ICFR. In addition, as new controls are designed and implemented, control owners should consider the evidence and documentation that will be available to support management's assessment of ICFR. For more information, see Section E.5.

\(^3\) The Committee of Sponsoring Organizations of the Treadway Commission.
E.3 Evaluating Material Changes in Internal Control

SEC registrants are required to disclose any material changes\(^4\) (including improvements) in their ICFR in each quarterly and annual report in accordance with SEC Regulation S-K, Item 308(c). SEC guidance explains that materiality is determined on the basis of the impact on ICFR and the materiality standard articulated in TSC Industries Inc. v. Northway Inc.\(^5\) (i.e., that “an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote”).

As discussed previously, when a company adopts ASC 842, management will probably need to implement new controls or modify existing ones to address new or modified risks of material misstatement. Disclosure requirements will also be triggered by the adoption of a new accounting standard if such changes in internal control are material. In addition, management should consider whether there are appropriate controls for identifying and disclosing material changes in ICFR.

For example, management may consider whether there are controls related to the following:

- **Compliance** — Processes are in place to identify and evaluate material changes in internal control. Further, protocols exist for developing appropriate disclosures and reporting such information to appropriate levels of management (e.g., those signing the quarterly and annual certifications required under SEC Regulation S-K, Item 601(b)(31)).

- **Review** — The disclosures are reviewed by appropriate levels of management (including, as warranted, those signing the quarterly and annual certifications).

- **Monitoring** — The company's monitoring function (e.g., internal audit, disclosure committee, or audit committee) appropriately considers the state of the entity's ICFR to identify changes and monitor controls in accordance with company protocols.

In developing the required disclosures, companies should clearly state whether a material change has occurred and, if so, describe the nature of the change. The SEC staff has commented when a registrant has not explicitly asserted whether there has been a change in ICFR in the most recent fiscal quarter that could have a material effect on its ICFR. The staff has further stressed that registrants should avoid “boilerplate” disclosure in which they state that there have been no material changes affecting ICFR in a period, particularly when there have been identifiable events such as changes in accounting policies. For examples of appropriate disclosures to provide in such circumstances, see Section E.6.

\(^4\) SEC Rule No. 33-8238 states that “management . . . must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, any change in the issuer's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters, or fiscal year in the case of a foreign private issuer, that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.”

### E.4 Examples of Risks and Internal Control Considerations Related to the Adoption and Ongoing Accounting

The following table lists risks and internal control considerations related to the adoption of ASC 842 and the ongoing accounting under ASC 842 (the risks and considerations apply to both lessees and lessors, unless otherwise specified):

<table>
<thead>
<tr>
<th>Core Considerations</th>
<th>Examples of Risks</th>
<th>Examples of Control Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Adoption period</strong></td>
<td>All leases are not identified, in accordance with company policies.</td>
<td>Internal controls related to:</td>
</tr>
<tr>
<td></td>
<td>Accounting conclusions are inaccurate or incomplete.</td>
<td>• Documenting and reviewing revised accounting policies.</td>
</tr>
<tr>
<td></td>
<td>The recording of the adoption of ASC 842 is inaccurate or incomplete.</td>
<td>• Identifying the complete population of contracts to evaluate.</td>
</tr>
<tr>
<td></td>
<td>IT logic for reports and journal entries is inaccurate.</td>
<td>• Identifying all lease contracts or arrangements in accordance with company policies.</td>
</tr>
<tr>
<td><strong>Capturing leases</strong></td>
<td>All leases are not captured appropriately in accordance with company policies.</td>
<td>• Documenting and reviewing accounting conclusions.</td>
</tr>
<tr>
<td></td>
<td>Contracts are captured as leases when they do not meet the new requirements of a lease.</td>
<td>• Reviewing the application of the modified retrospective transition approach.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Evaluating whether the information used to record adjustments to the financial statements is accurate and complete.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Identifying, developing, and implementing new system requirements, including logic of reports.</td>
</tr>
<tr>
<td><strong>Calculating leases</strong></td>
<td>Lease assets/liabilities are not calculated appropriately.</td>
<td>Internal controls related to:</td>
</tr>
<tr>
<td></td>
<td>Lease income/expense is not calculated appropriately.</td>
<td>• Determining whether a contract or arrangement meets the new requirements of a lease.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Reassessing existing lease contracts to determine whether such arrangements meet the new requirements of a lease.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Identifying, and allocating consideration in the contract to, the lease and nonlease components in a contract or arrangement.</td>
</tr>
</tbody>
</table>

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6. This table does not take into account all possible lease-related risks and an entity should also consider risks in other accounting areas (e.g., income taxes, possible debt covenant violations).

7. Reassessment of lease contracts is not applicable if an entity (lessee or lessor) elects the transition relief package and discloses such election.
### Core Considerations

<table>
<thead>
<tr>
<th>Accounting for leases</th>
<th>Examples of Risks</th>
<th>Examples of Control Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Lease assets/liabilities are not appropriately accounted for.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Lease income/expense is not appropriately accounted for.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Internal controls related to:

- Initial measurement:
  - The recording of the ROU assets and related lease obligations on the balance sheet (lessee).
  - The recording of the lease investment and profit, when applicable, in the financial statements (lessor).

- Subsequent measurement:
  - The recording of subsequent adjustments (both balance sheet and profit and loss) to the financial statements on the basis of the lease classification.
  - Evaluating the ROU asset for impairment in accordance with ASC 360 (lessee).
  - Evaluating the lease investment for impairment in accordance with ASC 310 or ASC 326 (lessor).

- Other considerations:
  - Determining whether lease modifications or changes to lease terms have been identified, evaluated, and accounted for.
  - Evaluating whether sale-and-leaseback transactions, related-party leases, sublease transactions, and build-to-suit arrangements have been appropriately identified, evaluated, and accounted for.

<table>
<thead>
<tr>
<th>Presentation and disclosure for leases</th>
<th>Examples of Risks</th>
<th>Examples of Control Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Lease assets/liabilities are not presented appropriately.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Lease income/expense is not presented appropriately.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- The statement of cash flows is not presented appropriately on the basis of the lease classification.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Footnote disclosures are not accurate, complete, or understandable.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Internal controls related to:

- Evaluating presentation of lease assets/liabilities and income/expense, on the basis of the lease classification, in accordance with ASC 842.
- Reviewing the accuracy and completeness of lease disclosures, including related-party leases.
- Reviewing the disclosures for significant assumptions and judgments.
E.5 Applying the COSO Principles to Adoption

The 2013 COSO framework contains 17 principles that explain the concepts associated with the five components of internal control (control environment, risk assessment, control activities, information and communication, and monitoring activities). The components are related to all aspects of an organization’s objectives, which typically fall into three categories — operations, reporting, and compliance. These objectives, as well as the components, are also related to an entity’s structure. COSO uses the following cube to depict the relationship between objectives, components, and an entity’s structure:

In assessing the design of effective internal control with respect to ASC 842, a company may consider its objectives in terms of internal and external reporting and, on the basis of those objectives, may take into account the five components of internal control and the 17 principles within the components. The chart below summarizes the 17 principles and provides examples of how a company would apply them when implementing and adopting ASC 842.
<table>
<thead>
<tr>
<th>COSO Component</th>
<th>COSO Principle Summarized</th>
<th>Examples of the COSO Principles' Application in the Adoption of ASC 842</th>
</tr>
</thead>
</table>
| Control environment | 1. Demonstrates commitment to integrity and ethical values. | Principle 1  
  - Demonstrate appropriate tone at the top regarding the importance of the adoption and implementation of ASC 842 (e.g., through communications, dedication of resources, oversight).  
  - Incorporate the adoption of ASC 842 into expectations of standards of conduct (e.g., expectations regarding responsible conduct and developing sound judgments). |
| | 2. Board of directors exercises oversight responsibilities. | Principle 2  
  - The board of directors exercises appropriate oversight over:  
    - The adoption of ASC 842 (including appropriate disclosures and financial reporting).  
    - The assessment of risks resulting from ASC 842 and related development and implementation of internal controls to address the risks. |
| | 3. Establishes structure, authority, and responsibility. |  |
| | 4. Demonstrates commitment to competency. |  |
| | 5. Enforces accountability. |  |
| | Principle 3  
  - Evaluate and update lines of reporting and responsibilities. |  |
| | Principle 4  
  - Assess, identify, and monitor competencies required by ASC 842. Take steps to address any identified shortcomings. Adjust training, retention, and recruiting programs as necessary.  
  - Appropriately train key personnel and control performers to ensure competence in the organization.  
  - If using an outsourced service provider, determine whether (1) controls are in place to evaluate the provider's competence and objectivity and (2) management has sufficient understanding to perform effective oversight and review of the work performed by the provider. |  |
| | Principle 5  
  - Hold individuals accountable for their roles related to the adoption of ASC 842.  
  - Design accountability for individuals responsible for internal controls related to ASC 842. |  |
<table>
<thead>
<tr>
<th>COSO Component</th>
<th>COSO Principle Summarized</th>
<th>Examples of the COSO Principles’ Application in the Adoption of ASC 842</th>
</tr>
</thead>
</table>
• Identify objectives associated with the adoption of ASC 842 to enable identification of risks related to the objectives. |
|               | 7. Identifies and analyzes risk. | Principle 7  
• Identify and document risks associated with the adoption of ASC 842 (including those associated with IT changes and the modified retrospective transition method), and reconsider the risks throughout the adoption process. |
|               | 8. Assesses fraud risk. | Principle 8  
• Consider fraud risks related to the adoption of ASC 842 (e.g., considering the potential for new fraud schemes, particularly given changes in accounting, controls, and IT). |
|               | 9. Identifies and analyzes significant change. | Principle 9  
• Complete the assessment of ASC 842 and its impact on the company, including on internal control, data and system requirements, disclosures, and reporting. |
| Control activities | 10. Selects and develops control activities. | Principle 10  
• Evaluate the internal controls affected by the adoption of ASC 842 and identify new internal controls to address new risks associated with ASC 842. |
|               | 11. Selects and develops general controls over technology. | Principle 11  
• Consider impacts on general controls over technology and modify as appropriate. |
|               | 12. Deploys through policies and procedures. | Principle 12  
• Revise policies and procedures to address risks and internal controls related to ASC 842 and establish responsibility and accountability for executing the policies and procedures. |
### Appendix E — Internal Control Over Financial Reporting

(Table continued)

<table>
<thead>
<tr>
<th>COSO Component</th>
<th>COSO Principle Summarized</th>
<th>Examples of the COSO Principles’ Application in the Adoption of ASC 842</th>
</tr>
</thead>
</table>
| **Information and communication**  | 13. Uses relevant, quality information.  
15. Communicates externally. | Principle 13  
- Identify new information requirements, modify systems, update reports, and modify controls to produce relevant, quality information to support the functioning of internal controls. |
|                                     |                                                                                                           | Principle 14  
- Develop communication methods to ensure that required information (including accounting and operational changes) is communicated to all personnel so that they can understand and carry out their internal-control-related responsibilities. Provide updates as necessary.  
- Ensure that boards of directors and audit committees have information they need to perform their oversight responsibilities. |
|                                     |                                                                                                           | Principle 15  
- Ensure that processes are in place for communicating relevant and timely information regarding internal controls to external parties as appropriate (including through required external disclosures regarding changes in controls and quantitative and qualitative impacts of adoption). |
| **Monitoring activities**           | 16. Conducts ongoing and/or separate evaluations.  
17. Evaluates and communicates deficiencies. | Principle 16  
- Implement plans for ongoing and/or separate evaluations of internal controls related to ASC 842 (e.g., companies may consider evaluating new controls before ASC 842’s effective date or performing a test close). |
|                                     |                                                                                                           | Principle 17  
- Take corrective actions, including revising the risk assessment and redesigning internal controls, when gaps or deficiencies in controls are identified during the adoption process. |
E.6 Illustrative Disclosures — Material Change in Internal Control

### Example E-1

#### Several Quarters Before Adoption

During the quarter ended June 30, 20XX, we implemented new controls as part of our efforts to adopt ASU 2016-02. Those efforts resulted in changes to our accounting processes and procedures. In particular, we implemented new controls related to:

- Monitoring the adoption process.
- Implementing a new IT system to capture, calculate, and account for leases.
- Gathering the information and evaluating the analyses used in the development of disclosures required before ASU 2016-02’s effective date.

We evaluated the design of these new controls during the quarter ended June 30, 20XX. As we continue the implementation process, we expect that there will be additional changes in ICFR. However, there were no other changes in ICFR during the quarter ended June 30, 20XX, that materially affected ICFR or are reasonably likely to materially affect it.

### Example E-2

#### Shortly Before Adoption

During the quarter ended December 31, 20XX, we implemented a plan that called for modifications to ICFR related to the accounting for leases as a result of ASU 2016-02. The modified controls have been designed to address risks associated with accounting for lease assets and liabilities and the related income and expense under ASC 842. We have therefore augmented ICFR as follows:

- Enhanced the risk assessment process to take into account risks associated with ASC 842.
- Modified existing controls that address risks associated with accounting for lease assets and liabilities and the related income and expense, including the revision of our contract review controls.

There were no other changes in ICFR during the quarter ended December 31, 20XX, that materially affected ICFR or are reasonably likely to materially affect it.

### Example E-3

#### Upon Adoption

We implemented ASU 2016-02 as of January 1, 20XX. As a result, we made the following significant modifications to ICFR, including changes to accounting policies and procedures, operational processes, and documentation practices:

- Updated our policies and procedures related to accounting for lease assets and liabilities and related income and expense.
- Modified our contract review controls to consider the new criteria for determining whether a contract is or contains a lease, specifically to clarify the definition of a lease and align with the concept of control.
- Added controls for reevaluating our significant assumptions and judgments on a quarterly basis.
- Added controls to address related required disclosures regarding leases, including our significant assumptions and judgments used in applying ASC 842.

Other than the items described above, there were no changes in ICFR during the quarter ended March 31, 20XX, that materially affected ICFR or are reasonably likely to materially affect it.
Appendix F — Titles of Standards and Other Literature

**FASB Literature**

**ASC Topics**
ASC 210, *Balance Sheet*
ASC 230, *Statement of Cash Flows*
ASC 250, *Accounting Changes and Error Corrections*
ASC 270, *Interim Reporting*
ASC 310, *Receivables*
ASC 326, *Financial Instruments — Credit Losses*
ASC 330, *Inventory*
ASC 350, *Intangibles — Goodwill and Other*
ASC 360, *Property, Plant, and Equipment*
ASC 405, *Liabilities*
ASC 410, *Asset Retirement and Environmental Obligations*
ASC 420, *Exit or Disposal Cost Obligations*
ASC 450, *Contingencies*
ASC 460, *Guarantees*
ASC 470, *Debt*
ASC 606, *Revenue From Contracts With Customers*
ASC 610, *Other Income*
ASC 740, *Income Taxes*
ASC 805, *Business Combinations*
ASC 810, *Consolidation*
ASC 815, *Derivatives and Hedging*
ASC 830, *Foreign Currency Matters*
ASC 835, *Interest*
ASC 840, Leases  
ASC 842, Leases  
ASC 850, Related Party Disclosures  
ASC 853, Service Concession Arrangements  
ASC 860, Transfers and Servicing  
ASC 905, Agriculture  
ASC 930, Extractive Activities — Mining  
ASC 932, Extractive Activities — Oil and Gas  
ASC 942, Financial Services — Depository and Lending  

**ASUs**  
ASU 2014-09, Revenue From Contracts With Customers (Topic 606)  
ASU 2016-02, Leases (Topic 842)  
ASU 2016-10, Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing  
ASU 2016-13, Measurement of Credit Losses on Financial Instruments  
ASU 2017-13, Revenue Recognition (Topic 605), Revenue From Contracts With Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842)  
ASU 2018-01, Land Easement Practical Expedient for Transition to Topic 842  
ASU 2018-10, Codification Improvements to Topic 842, Leases  
ASU 2018-11, Leases (Topic 842): Targeted Improvements  
ASU 2018-19, Codification Improvements to Topic 326, Financial Instruments — Credit Losses  
ASU 2018-20, Narrow-Scope Improvements for Lessors  
ASU 2019-01, Leases (Topic 842): Codification Improvements  
ASU 2019-10, Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates  
ASU 2020-05, Revenue From Contracts With Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities  

**Proposed ASUs**  
No. 2013-270, Leases (Topic 842): a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840)  
No. 2018-310, Leases (Topic 842): Codification Improvements for Lessors
SEC Literature

Final Rule

FRM
Topic 1, “Registrant’s Financial Statements”
Topic 2, “Other Financial Statements Required”
Topic 3, “Pro Forma Financial Information”
Topic 4, “Independent Accountants’ Involvement”
Topic 9, “Management’s Discussion and Analysis of Financial Position and Results of Operations (MD&A)”
Topic 10, “Emerging Growth Companies”
Topic 11, “Reporting Issues Related to Adoption of New Accounting Standards”
Topic 13, “Effects of Subsequent Events on Financial Statements Required in Filings”
Topic 14, “Tender Offers”

Regulation S-K
Item 301, “Selected Financial Data”
Item 302(a), “Supplementary Financial Information: Selected Quarterly Financial Data”
Item 512(a), “Undertakings: Rule 415 Offering”
Item 601(b), “Exhibits: Description of Exhibits”

Regulation S-X
Rule 1-02(w), “Definitions of Terms Used in Regulation S-X: Significant Subsidiary”
Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired”
Rule 3-09, “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”
Rule 3-14, “Special Instructions for Real Estate Operations to Be Acquired”
Rule 4-08(g), “Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”
Rule 5-02, “Balance Sheets”
Rule 5-03, “Income Statements”
Article 10, “Interim Financial Statements”
Article 11, “Pro Forma Financial Information”
SAB Topics

International Standards
IFRS 9, Financial Instruments
IFRS 11, Joint Arrangements
IFRS 15, Revenue From Contracts With Customers
IFRS 16, Leases
IAS 7, Statement of Cash Flows
IAS 17, Leases

Superseded Literature
FASB Statements
No. 5, Accounting for Contingencies
No. 13, Accounting for Leases
No. 95, Statement of Cash Flows

FASB Interpretation
FIN 48, Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109

FASB Technical Bulletin
FTB 88-1, Issues Relating to Accounting for Leases

EITF Issue
01-8, “Determining Whether an Arrangement Contains a Lease”
08-2, “Lessor Revenue Recognition for Maintenance Services”
# Appendix G — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
</tr>
<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
</tr>
<tr>
<td>C&amp;DI</td>
<td>SEC Compliance and Disclosure Interpretation</td>
</tr>
<tr>
<td>CAM</td>
<td>common-area maintenance</td>
</tr>
<tr>
<td>CAQ</td>
<td>Center for Audit Quality</td>
</tr>
<tr>
<td>CECL</td>
<td>current expected credit loss</td>
</tr>
<tr>
<td>COSO</td>
<td>The Committee of Sponsoring Organizations of the Treadway Commission</td>
</tr>
<tr>
<td>CPI</td>
<td>consumer price index</td>
</tr>
<tr>
<td>CWIP</td>
<td>construction work-in-progress</td>
</tr>
<tr>
<td>DART</td>
<td>Deloitte Accounting Research Tool</td>
</tr>
<tr>
<td>ED</td>
<td>exposure draft</td>
</tr>
<tr>
<td>EGC</td>
<td>emerging growth company</td>
</tr>
<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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<tr>
<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
</tr>
<tr>
<td>FIN</td>
<td>FASB Interpretation Number</td>
</tr>
<tr>
<td>FRM</td>
<td>SEC Division of Corporation Finance Financial Reporting Manual</td>
</tr>
<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
</tr>
<tr>
<td>GPS</td>
<td>global positioning system</td>
</tr>
<tr>
<td>HAFWP</td>
<td>how and for what purpose</td>
</tr>
<tr>
<td>IAS</td>
<td>International Accounting Standard</td>
</tr>
<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
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<tr>
<td>ICFR</td>
<td>internal control over financial reporting</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
</tr>
<tr>
<td>IT</td>
<td>information technology</td>
</tr>
<tr>
<td>JOA</td>
<td>joint operating agreement</td>
</tr>
<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
</tr>
<tr>
<td>LILO</td>
<td>lease in, lease out</td>
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<tr>
<td>LLC</td>
<td>limited liability company</td>
</tr>
<tr>
<td>MAG</td>
<td>minimum annual guarantee</td>
</tr>
<tr>
<td>MD&amp;A</td>
<td>Management’s Discussion &amp; Analysis</td>
</tr>
<tr>
<td>OCA</td>
<td>SEC Office of the Chief Accountant</td>
</tr>
<tr>
<td>OCC</td>
<td>Office of the Comptroller of the Currency</td>
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<tr>
<td>PBE</td>
<td>public business entity</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>property, plant, and equipment</td>
</tr>
<tr>
<td>PPA</td>
<td>power purchase agreement</td>
</tr>
<tr>
<td>PRVG</td>
<td>portfolio residual value guarantee</td>
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<tr>
<td>PTC</td>
<td>production tax credit</td>
</tr>
<tr>
<td>Q&amp;A</td>
<td>question and answer</td>
</tr>
<tr>
<td>REC</td>
<td>renewable energy credit</td>
</tr>
<tr>
<td>REIT</td>
<td>real estate investment trust</td>
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<tr>
<td>ROU</td>
<td>right of use</td>
</tr>
<tr>
<td>RPS</td>
<td>renewable portfolio standard</td>
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<tr>
<td>SAB</td>
<td>Staff Accounting Bulletin</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
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<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
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<tr>
<td>SOX</td>
<td>Sarbanes-Oxley Act of 2002</td>
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<tr>
<td>SPE</td>
<td>special-purpose entity</td>
</tr>
<tr>
<td>VIE</td>
<td>variable interest entity</td>
</tr>
<tr>
<td>VIN</td>
<td>vehicle identification number</td>
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</tbody>
</table>
Appendix H — Changes Made in the 2020 Edition of This Publication

The tables below summarize the substantive changes made since the 2019 edition of this Roadmap as a result of FASB standard-setting activities, discussions regarding implementation matters with the FASB and SEC staffs, and other practice developments.

**New Q&As**

The following table lists the new Q&As that were developed as part of the 2020 refresh of this Roadmap:

<table>
<thead>
<tr>
<th>Q&amp;A Reference</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q&amp;A 2-1A</td>
<td>Rights to Use Land That Include More Than Natural Resource Rights</td>
</tr>
<tr>
<td>Q&amp;A 4-2A</td>
<td>Allocation of the Fair Value of Land When a Portion of a Multitenant Building Is Leased</td>
</tr>
<tr>
<td>Q&amp;A 4-2B</td>
<td>Identifying Lease Components When the Underlying Asset Is Replaced During the Lease Term</td>
</tr>
<tr>
<td>Q&amp;A 4-8B</td>
<td>Noncoterminous Lease and Nonlease Components</td>
</tr>
<tr>
<td>Q&amp;A 5-5</td>
<td>Impact of ROU Asset Impairment Indicator on Lease Term</td>
</tr>
<tr>
<td>Q&amp;A 6-17</td>
<td>“Key Money” Payment Made to an Existing Lessee to Assume a Lease</td>
</tr>
<tr>
<td>Q&amp;A 8-7D</td>
<td>Lease Classification Reassessment — How an Entity Considers Unamortized Balances When Performing the Fair Value Classification Test</td>
</tr>
<tr>
<td>Q&amp;A 8-8AA</td>
<td>Accounting for Leases Acquired in a Business Combination When It Is Reasonably Certain That the Acquirer Will Exercise a Purchase Option in an Acquired Operating Lease</td>
</tr>
<tr>
<td>Q&amp;A 8-12AA</td>
<td>ROU Assets That Are Held for Sale — Amortization Considerations</td>
</tr>
<tr>
<td>Q&amp;A 8-15AA</td>
<td>Reassessment of Whether a Contract Is or Contains a Lease</td>
</tr>
<tr>
<td>Q&amp;A 8-15AB</td>
<td>Lease Modification With Additional Right of Use and Changes to Existing Right of Use</td>
</tr>
<tr>
<td>Q&amp;A 8-15AC</td>
<td>Forward-Starting Lease for an Asset Subject to an Existing Lease</td>
</tr>
<tr>
<td>Q&amp;A 8-15AD</td>
<td>Penalty for a Partial Termination</td>
</tr>
<tr>
<td>Q&amp;A 8-15A</td>
<td>Reduction in Lease Term Versus Lease Termination</td>
</tr>
<tr>
<td>Q&amp;A 8-15B</td>
<td>Lease Modifications That Involve More Than One Change</td>
</tr>
<tr>
<td>Q&amp;A 9-17A</td>
<td>Lessor’s Accounting for an Operating Lease When Collectibility Subsequently Becomes Not Probable</td>
</tr>
<tr>
<td>Q&amp;A 9-17B</td>
<td>Recognition of a General Allowance for Operating Lease Receivables</td>
</tr>
<tr>
<td>Q&amp;A 9-17C</td>
<td>Income Statement Classification of General Allowance for Operating Lease Receivables</td>
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</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>Q&amp;A Reference</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q&amp;A 9-18A</td>
<td>Reimbursement of Capital Improvement That Is Not a Nonlease Component</td>
</tr>
<tr>
<td>Q&amp;A 10-2A</td>
<td>Third-Party Lessor Involvement in a Business Combination</td>
</tr>
<tr>
<td>Q&amp;A 10-6A</td>
<td>Sale and Leaseback With a Residual Value Guarantee and a Fair Value Purchase Option</td>
</tr>
</tbody>
</table>

**Other Content (Excluding New Q&As)**

The following other changes were made as part of the 2020 refresh of this Roadmap:

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.2.2</td>
<td>Land and Other Assets</td>
<td>Expanded to include Changing Lanes — Classification of the Land Component Under ASC 840</td>
</tr>
<tr>
<td>5.2.1</td>
<td>Noncancelable Period and Enforceable Period</td>
<td>Updated to clarify the distinction between enforceable period and lease term and to add Connecting the Dots — Enforceability Is a Broad Concept</td>
</tr>
<tr>
<td>Q&amp;A 6-4</td>
<td>Treatment of Payments to a Lessee When a Lease Is Terminated and the Lessee Enters Into a New Lease for Similar Assets</td>
<td>Amended Question 2 to discuss the impact of a contractual requirement to enter into a new lease and to add an example</td>
</tr>
<tr>
<td>Q&amp;A 8-5</td>
<td>Estimated Economic Life Versus Depreciable Life</td>
<td>Expanded to address differences between the definition of economic life and the definition of useful life</td>
</tr>
<tr>
<td>8.3.3.6</td>
<td>Substantially All of the Fair Value of the Underlying Asset</td>
<td>Expanded to include Changing Lanes — Consideration of Nonperformance-Related Default Provisions</td>
</tr>
<tr>
<td>8.6.1</td>
<td>Setting the stage</td>
<td>Expanded to include Connecting the Dots — Rent Concessions Provided as a Result of COVID-19</td>
</tr>
<tr>
<td>8.6.3.3</td>
<td>Modification in Which Classification Changes From Finance Lease to Operating Lease</td>
<td>Added interpretive guidance and an example</td>
</tr>
<tr>
<td>8.6.4.3</td>
<td>Lease Modifications That Involve More Than One Change</td>
<td>Added discussion of accounting considerations related to a lease modification that includes multiple changes</td>
</tr>
<tr>
<td>8.7.2</td>
<td>Lease Termination</td>
<td>Expanded discussion of partial terminations</td>
</tr>
<tr>
<td>Q&amp;A 8-16A</td>
<td>Foreign Exchange Rate Considerations Related to Lease Modifications and Remeasurements</td>
<td>Expanded to address foreign exchange rate considerations related to lease remeasurement events</td>
</tr>
<tr>
<td>Q&amp;A 9-2</td>
<td>Estimated Economic Life Versus Depreciable Life</td>
<td>Expanded to address differences between the definition of economic life and the definition of useful life</td>
</tr>
<tr>
<td>9.2.1.4</td>
<td>Substantially All of the Fair Value of the Underlying Asset</td>
<td>Expanded to include Changing Lanes — Consideration of Nonperformance-Related Default Provisions</td>
</tr>
</tbody>
</table>
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<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
</tr>
</thead>
</table>
| 9.3.4   | Lease Modification                                          | Expanded to include Connecting the Dots — Rent Concessions Provided as a Result of COVID-19  
Amended Connecting the Dots — Contract Modifications Accounted for as a Separate Contract Under ASC 842 Are Similar but Not Identical to Those Under ASC 606 to highlight a difference between ASC 606 and ASC 842  
Expanded discussion of partial terminations |
| 9.3.9.2 | Collectibility                                              | Amended to reflect practice developments related to lessor’s accounting for the collectibility of operating lease receivables |
| 9.4.4   | Accounting for Reimbursements of Repairs and Capital Improvements | Added discussion of lessor’s accounting for reimbursements of repairs and capital improvements by a lessee (this discussion includes Q&A 9-18A) |
| Q&A 10-8| Impact of Contingent Repurchase Provisions on Sale-and-Leaseback Accounting | Expanded discussion and added reference to Deloitte’s Revenue Roadmap |
| Q&A 10-9| Renewal Options in Which a Leaseback Could Potentially Be Extended for the Entire Economic Life of the Underlying Asset | Clarified that the existence of fixed-price renewal options would not automatically result in a failed sale-and-leaseback transaction |
| 11.1    | Overview                                                     | Expanded to include Changing Lanes — Scope of Accounting Guidance for a Future Lessor in Transactions in Which a Future Lessee (Potentially a Seller-Lessee) Controls the Underlying Asset Before Lease Commencement |
| 11.4    | Accounting by the Deemed Owner of an Asset                  | Expanded discussion of seller-lessee accounting for a financing obligation in a failed sale-and-leaseback transaction |
| Q&A 11-5| Depreciation Accounting When the Lessee Is the “Deemed Owner” and Fails to Qualify for Sale-and-Leaseback Accounting | Expanded discussion of residual value in Question 2 |
| Q&A 14-1| Whether an Entity That Presents a Classified Balance Sheet Is Required to Classify Its ROU Assets and Lease Liabilities as Current and Noncurrent | Clarified existing guidance in Question 2 and added a table to the example |
| 14.2.3  | Statement of Cash Flows                                     | Amended discussion of acceptable approaches to presenting changes in operating lease ROU assets in the statement of cash flows |
| 15.3.5.1.2 | Components of Net Investments in Leases                     | Expanded to include Changing Lanes — ASC 842 Amends Disclosure Requirements Pertaining to the Components of Net Investments in Leases |
### Table continued

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>15.3.5.3</td>
<td>Variable Lease Income</td>
<td>Added discussion of lessor disclosure requirements related to variable lease income</td>
</tr>
<tr>
<td>Chapter 16</td>
<td>Effective Date and Transition</td>
<td>Updated throughout to reflect the revised effective date of ASC 842 for certain entities. Moved certain SEC reporting discussions to Chapter 18</td>
</tr>
<tr>
<td>17.3.2</td>
<td>Other FASB Activity</td>
<td>Updated to reflect the FASB’s discussions of implementation and interpretive issues since the last publication date of this Roadmap</td>
</tr>
<tr>
<td>17.3.3</td>
<td>Ongoing FASB Activity</td>
<td>Added discussion of current FASB developments</td>
</tr>
<tr>
<td>17.3.4</td>
<td>FASB Response to the COVID-19 Pandemic</td>
<td>Added discussion of the FASB’s efforts to respond to the COVID-19 pandemic</td>
</tr>
<tr>
<td>18.7</td>
<td>Adoption of ASC 842 for an EGC That Elected Private-Company Adoption Dates</td>
<td>Updated to include various scenarios for an EGC adopting ASC 842</td>
</tr>
<tr>
<td>18.8</td>
<td>Relationship Between ASC 842 Maturity Analysis Disclosures and Tabular Disclosure of Contractual Obligations</td>
<td>Added discussion of lease payments included in the tabular disclosure of contractual obligations for SEC registrants</td>
</tr>
<tr>
<td>Appendix B</td>
<td>Differences Between U.S. GAAP and IFRS Standards</td>
<td>Added discussion of difference between U.S. GAAP and IFRS Standards with respect to modifications that reduce the lease term for lessees Deleted discussion of difference between U.S. GAAP and IFRS Standards with respect to related-party leases</td>
</tr>
</tbody>
</table>